Institute of International Finance

China's Economic and Financial Outlook

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Highlights

●China saw booming demand and supply in the first quarter driven by strong external demand, fast-growing new engines and rebounding real estate and private investments, with industrial activity, consumption, investment and exports growing faster to various degrees. GDP in the first quarter is expected to grow by around 6.9%, up 0.1 percentage points from the previous quarter. CPI is estimated to rise by about 2.4%, up 0.6 percentage points from the previous quarter.

●The second quarter will see continued transition from old growth engines to new ones, faster expansion of new engines and policy supports for consumption. Chinese economy will remain on the track of steady growth toward high-quality development. But the policy to cut overcapacities will go further. Investment can hardly maintain fast expansion and export growth may moderate. Financial de-leveraging and risk prevention will continue. The economy still faces many uncertainties. GDP is expected to grow by about 6.8% in the second quarter, and also by around 6.8% in annual terms.

●The macro policies will pursue new and improved ways of regulation while ensuring continuity and stability and becoming more forward-looking. The proactive fiscal policy will moderate to further stress the harmony of appropriate proactiveness and enhanced policy effects, and put tax cuts and fees reduction higher on the priority list. The two-pronged regulation framework based on monetary policy and macro-prudential policy will be improved to step up the coordination of the three major financial policies and prevent and defuse major financial risks.

Changes in China's Economic Growth

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High-quality Development by Shifting from Old Growth Drivers to New Ones

-- China's Economic and Financial Outlook (2018Q2)

China saw booming demand and supply in the first quarter driven by strong external demand, fast-growing new engines and rebounding real estate and private investments, with major indicators growing faster to various degrees. GDP in the first quarter is expected to grow by around 6.9%, up 0.1 percentage points from the previous quarter. The second quarter will see continued transition from old engines to new ones, faster expansion of new engines and policy supports for consumption. Chinese economy will remain on the track of steady growth. But the policy to cut overcapacities will go further. Investment can hardly maintain fast expansion and export growth may moderate. Financial de-leveraging and risk prevention will continue. The economy still faces some uncertainties. GDP is expected to grow by about 6.8% in the second quarter, and also by around 6.8% in annual terms. The proactive fiscal policy will moderate to further stress the coordination of appropriate proactiveness and enhanced policy effects, and put tax cuts and fees reduction higher on the priority list. The two-pronged regulation framework based on monetary policy and macro-prudential policy will be improved to prevent and defuse major financial risks.

I. 2018Q1 Economic Review and Q2 Outlook

I.1 The first quarter saw a boom in both demand and supply sides of China's economy

China saw a boom in demand and supply in the first quarter, as shown by stronger-than-expected upturn in economic activity. Major economic indicators including industrial activity, consumption, investment and exports grew faster to various degrees. The main characteristics of China's economic performance in the first quarter are as follows:

First, the economy was strong on both demand and supply sides, with main indicators outperforming expectations. On the supply side, industrial growth was notably better than expected. In January and February, the industrial value added of enterprises above designated size grew by 7.2% year-on-year, up 0.9 percentage points from one year ago. Production rallied markedly in mining, electricity, gas and water production and supply sectors, the main drivers of the stronger-than-expected industrial growth. Prices of coal and steel products surged on the overcapacity cuts and stricter environmental policy, giving rise to the expansion of mining activity. Mining growth rate was 1.6% year-on-year in January and February, up 5.2 percentage points from one year ago. The wide-spreading snowfalls in southern parts of China and the tight natural gas supply in the northern regions pushed much higher the growth in value added of the electricity, gas and water production and supply sectors, which grew by 13.3% year-on-year in January and February, up 4.9 percentage points from one year ago. Manufacturing value added grew by 7%, up 0.1 percentage points from one year ago, mainly due to faster growth in high-tech, equipment and consumer goods manufacturing. The national services industry production index grew by 8% year on year in January and February, up 0.1 percentage points from the fourth quarter of the previous year and indicating recovery.

On the demand side, investment, consumption and exports showed stable growth. Consumption has reversed the year-on-year growth downtrend seen in the past seven years in a row. Total retail sales of consumer goods grew by 9.7% year-on-year in January and February, up 0.2 percentage points from the same period of the previous year. By urban-rural classification, the stronger growth in consumption in the first two months was principally powered by urban consumption, which accelerated in January and February, 0.4 percentage points faster than one year ago, compared with slowdown in rural consumption. By type of consumption, the rebounding consumption growth was mainly driven by commodity consumption, which grew 0.3 percentage points faster in January and February than one year ago, compared with weaker growth in catering consumption. Specifically, the rally in consumption growth in the first two months was primarily driven by automobile, household appliances and clothing, with automobile contributing the most. Retail sales of automakers above designated size rose by 9.7% year-on-year in January and February, up 10.7 percentage points from the same period of the previous year, up 4.1 percentage points from the previous year, and up 2.5 percentage points from the average for the same period since 2013.

2018 began with a stronger-than-expected growth in investment, better than the previous year for the third consecutive year. Fixed asset investment (excluding rural households) grew by 7.9% in January and February, up 0.7 percentage points from the previous year, and above the market forecast of approximately 7%. The investment growth in excess of expectations was driven principally by the accelerating growth in real estate and private investments. Real estate investment grew by 9.9% year-on-year, up 1 percentage points from the same period of the previous year and 2.9 percentage points from the previous year, the highest since March 2015. Private investment expanded by 8.1% year-on-year, up 1.4 percentage points from the same period of the previous year and 2.1 percentage points from the previous year, the strongest since the beginning of 2016.

Exports recorded the strongest beginning of the past eight years. The strengthening global recovery underpinned strong growth in exports. Exports grew by 24.4% in January and February year-on-year (Figure 1), mainly benefiting from the strong demand in key destination markets, coupled with the year-on-year fall of 10% in the U.S. dollar index. By category of trade, general trade exports recorded a growth rate of 32.2%, much faster than total exports; processing trade exports expanded by 12.3%, the fastest for the same period in the past seven years. By regions, exports to the United States, EU and ASEAN grew by 26.6%, 24.7% and 27.7% respectively, similar to the growth rate of total exports; exports to Japan and South Korea grew by 13.4% and 11.1%, slower than total exports. Exports to the BRIC countries rose by 35.6%, significantly higher than growth rate of total exports.

Figure 1: Strongest Beginning of 8 Years in Exports

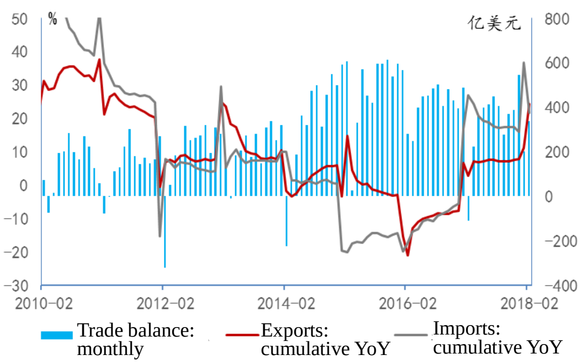
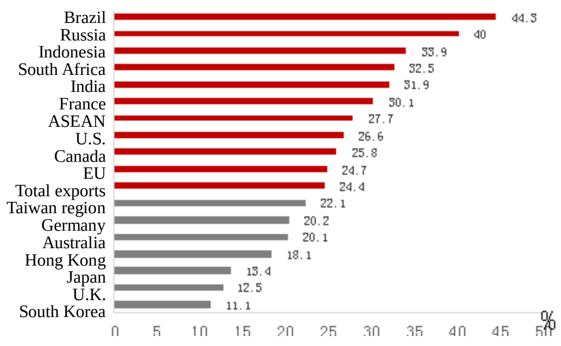


Figure 2: Growth Rates of Exports to Major Economies in Jan. and Feb.



Sources: Wind, BOC Institute of International Finance

Second, the new growth engines grew fast to underpin stable economic expansion. On the supply side, new growth engines have provided increasingly stronger driving forces. Of the industrial production in January and February, high-tech and equipment manufacturing value added grew by 11.9% and 8.4% respectively, 4.7 percentage points and 1.2 percentage points faster than industrial businesses above the designated scale. In the service sector, the business activity index of telecommunications, internet and environmental protection stayed above 56%, suggesting a high level of prosperity. On the demand side, online consumption has become a more prominent trend. Online retail sales of physical goods grew by 35.6% in January and February, up 10.1 percentage points from the same period of the previous year, accounting for 14.9% of total retail sales of consumer goods, up 3.8 percentage points from the same period of the previous year.

Third, the internal forces fueling economic growth, typically including private investment, regained momentum. The rally in private investment growth was seen in all the three major sectors in January and February, with the primary, secondary and tertiary sectors growing faster by 11.1 percentage points, 0.2 percentage points and 2.7 percentage points than the previous year, respectively. As the primary, secondary and tertiary sectors accounts for 4%, 49% and 47% of private investment respectively, it is clear that the tertiary sector was the largest contributor to private investment acceleration. The tertiary-sector private investment growth rate, once down below 1% in July 2016, returned to a double-digit one in January and February this year, the highest since September 2015.

Fourth, the stable economic performance is also accompanied by three issues requiring special attention. Given the internal and external environments and conditions, it is not difficult to achieve the economic growth target of 6.5% this year which creates a valuable time window for addressing medium- and long-term problems of the economy. In the future, more efforts should be concentrated on pursuing high-quality development of the economy. There are three issues requiring special attention: Firstly, de-leveraging should be continued steadily and prudently. Currently China sees the growth of macro leverage ratio weakening obviously, but the fast-growing residents' leverage ratio requires vigilance. Secondly, we should always maintain strong efforts to prevent financial risks, tighten supervision over shadow banking, internet finance and financial holding companies and pay close attention to the potential risk of volatile exchange rate, stock and other financial markets. Thirdly, the risk of structural inflation driven by supply-side factors deserves vigilance. CPI rose by 2.9% in February year-on-year, up 1.4 percentage points from the previous month.

II.2 China's economy will continue to grow fairly fast in the second quarter

In the second quarter, China's economy will remain on the track of fast growth in general. Globally, the world economy is in a positive trend. Developed nations and emerging market economies continue to recover synchronously and global trade and investment expand faster, but trade protectionism adds to the uncertainties in the global economic performance in the future. Domestically, China continues to move forward with the five priority tasks of cutting overcapacity, reducing excess inventory, de-leveraging, lowering costs, and strengthening points of weakness. The market demand-supply relations have improved, market participants are more energetic and the industrial production and service activity maintain the momentum of rapid growth. Residents' consumption upgrading will accelerate, relevant policies will be issued to encourage consumption growth, the quality of consumer products and services and the consumption environment will be improved. The driving forces of private investment will be restored gradually. The de-stocking and diversification of suppliers in the real estate market will bolster investment growth. Government expenditure will be weighted toward infrastructure development in central and western regions. However, it is difficult to further continue the momentum of exceptionally fast growth in foreign demand and rapid expansion in real estate investment, and domestically China prioritizes high-quality development. The overall economic performance in the second quarter may be weaker than the first quarter. GDP is expected to grow by about 6.8% in the second quarter, and by around 6.8% in annual terms.

On the supply side, the industrial growth will remain stable, with environmental policy effects deserving due attention in the short term. China will continue to cut overcapacity and institutionalize environmental protection in the future, so it is highly probable to see elevated prices of upstream products and the mining activity will continue to improve. The weakening seasonal factors are likely to moderate the growth in electricity, gas and water production and supply. New growth drivers will continue to gain momentum and the manufacturing activity will remain stable. In the short term, due attention should be paid to the effects of stricter environmental policies and the risk of overshooting prices of related products. **The service sector is projected to remain on the track of fast growth.** Firstly, the service demand index is high. The service-sector new orders index for January and February was 50.7%, above the boom-bust line for 10 consecutive months. Secondly, the service sector expectations are strong, evidenced by the service-sector business activity expectations index of 60.4% for January and February, above 60% for 9 months in a row. Thirdly, the policy encourages the increase of service supply, with the information service, culture and tourism projected to expand fast.

On the demand side, relevant policies are in favor of consumption growth. The *Report on the Work of the Government* released this year calls for actively increasing consumption. Relevant pro-consumption policies are conducive to consumption growth. Firstly, the continued tax and fee cuts help increase the income of people and fortify the foundation for consumption growth. Secondly, the availability of higher internet speeds at lower fee rates spurs information consumption growth. Thirdly, the rural revitalization strategy will push up the consumption of rural areas and rural residents. Fourthly, the extension of preferential policies on consumption tax on new-energy vehicles and the lowered ticket prices at key state tourist sites will give a strong impetus to consumption growth in relevant fields. Fifthly, the government will support additional supply of medical care, eldercare, education, culture, and sports services from private-sector suppliers, which helps meet the service-oriented and developmental consumption demand. Fifthly, the lower import tariffs on automobiles and some everyday consumer goods will encourage consumption of related import products.

Investment growth may slow down in the future. We should not be overoptimistic about the future investment trends in spite of the fairly fast investment growth seen early this year. Firstly, this year the government deficits will stay flat with last year, yet lower as a percentage of GDP, and the local government debt financing and PPP will be further regulated to weaken the support for infrastructure investment. Secondly, this year began with a marked deceleration in the growth of floor space of new housing starts, floor space of sold commodity housing and real estate investment funds, suggesting that it is hard to continue the current high speed of real estate investment. In January and February, the floor space of new housing starts, floor space of sold commodity housing and real estate investment funds slowed down by 1.5 percentage points, 4.1 percentage points and 3.4 percentage points from the previous year (Figure 3). Thirdly, the monetary policy will remain neutral and prudent, and the strengthened financial supervision and risk prevention will continue. The investment and financing environment will not be loosened obviously, placing some constraints on investment growth.

Growth in exports will probably decelerate. As shown by historical experience, the export growth rate in the first two months is 86.7% relevant to the annual export growth rate, with divergence seen only in a few years, including 2015 (Figure 4). As the export growth rate hit record highs early this year, the annual exports are projected to expand fast. But the prosperity investigation suggests a possible retreat in export growth in the short term. PMI's new export orders index fell back for two consecutive months, with the average (49.3%) for January and February down 1.6 percentage points from the average value of the previous quarter to a level below the boom-bust line. The new export orders index under the Export Managers Index compiled by China's customs service showed similar performance, with the average value down to 47.2% in January and February from 47.8% in the last quarter. Globally, since the U.S. additional tariffs on steel and aluminum imports trigger trade conflicts, there might be a larger number of more severe international trade disputes. Future exports will be held back by protectionism.

Figure 3: Slowdown in Growth of Property Development and Sales

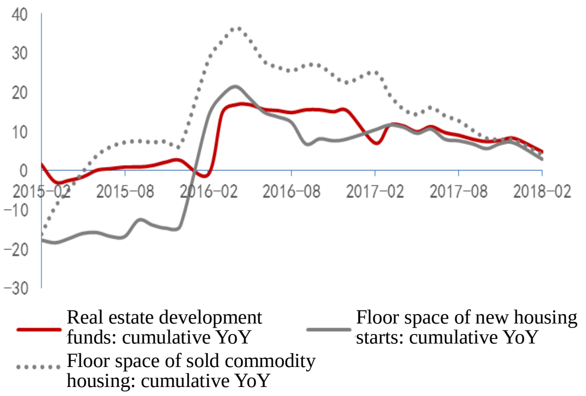
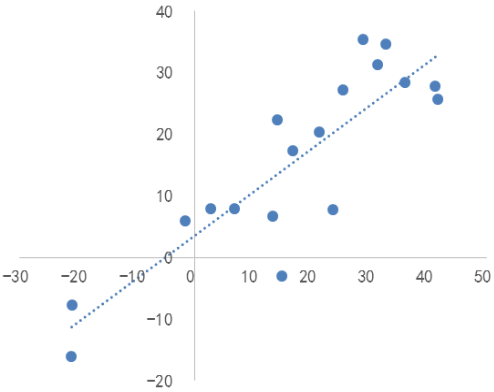


Figure 4: Relevancy of Year-beginning and Annual Export Growth Rates



Sources: Wind, BOC Institute of International Finance

In terms of inflation, CPI will rise faster than one year ago, while PPI increase will be less than one year ago. The CPI carryover effect will be approximately 1.4% in the second quarter, flat with the overall CPI growth rate for the second quarter of last year. CPI growth will be faster in the second quarter, considering the rising labor costs and robust service demand that comes as new drivers of food and service prices. The PPI carryover effect will be 3.9% in the second quarter. After the fast adjustment in the production capacity and the demand-supply relations last year, however, the new inflation factors on the production side have significantly diminished. The overall PPI growth rate is projected to be lower than last year.

II. 2018Q1 Financial Review and Q2 Outlook

In the first quarter, China's financial market was largely stable in spite of a sharp stock market fluctuation, and the A-share stock market rebounded in fluctuations after the U.S. stock market stabilized and no risk contagion took place within the financial market. The money supply volume rallied slightly, and the de-leveraging and risk prevention policies continued to force off-balance-sheet financing back onto balance sheet. Meanwhile, thanks to the central bank's large pool of monetary policy options and instruments available and effective peak shaving and valley filling operations, the banking system was in a slightly easing liquidity position. The liquidity level did not fluctuate violently, interest rates fell back slightly and RMB exchange rate against USD continued in an uptrend. In the second quarter, China's financial system may face certain pressure from issuance of new domestic regulatory rules, the high probability of further rate hikes to be announced by the Federal Reserve and volatile global financial markets.

II.1 2018Q1 Financial Review

II.1.1 The money supply growth has bottomed out, with off-balance-sheet items continuing to move back on

The growth rate of broad money supply (M2) rebounded slightly. At the end of February, M2 grew by 8.8% year-on-year, down 1.6 percentage points from the same period of the previous year, close to historical low and indicating a fruitful financial de-leveraging policy. By month, M2 growth rate in February rose by 0.2 percentage points, representing a continuation of the January rally. The substantial negative growth in government deposits is the main driver of M2 upturn. Government deposits fell by RMB528.7 billion in February, down RMB1.5 trillion from the previous-month growth, and up RMB58.2 billion and RMB359.7 billion from the decline recorded in February (month of Chinese New Year) 2015 and 2016 respectively.

The contraction in off-balance-sheet financing was primarily caused by the effort to move off-balance-sheet businesses back onto the balance sheet. The combined incremental aggregate financing to the real economy stood at RMB4.23 trillion in January and February, down RMB554.5 billion and RMB73.7 billion from 2017 and 2016, respectively. At the end of February, the outstanding aggregate financing to the real economy grew by 11.2% year-on-year, down 1.6 percentage points and 0.1 percentage points from the same period of the previous year and the last month respectively, suggesting weaker overall financing of the real economy than the same period of the past two years. By structure, though RMB and foreign-currency loans and direct financing (corporate bonds and equity financing) to the real economy rose by RMB345.7 billion and RMB263.5 billion from the same period of the previous year, respectively, yet were still insufficient to offset the sharp decline in off-balance-sheet financing. The off-balance-sheet financing demand continued to move to the balance sheet due to tightening regulation of bank trusts, entrusted loans and other off-balance-sheet businesses. At the end of February, the balance of off-balance-sheet financing including entrusted loans, trust loans and undiscounted bankers' acceptance bills accounted for 15.1%, down 0.3 percentage points from one year ago. Balance of RMB and foreign-currency loans accounted for 70.1%, up 0.9 percentage points from one year ago. Balance of direct financing including bonds and equity financing accounted for 14.2%, down 0.6 percentage points year-on-year.

New RMB loans expanded faster in the first two months than one year ago, with short-term residents' loans growing substantially. RMB3.74 trillion of RMB loans were added in January and February, up RMB540.7 billion year-on-year. Overall financing demand has not yet weakened. More specifically, medium- and long-term loans to the household sector dipped by RMB96.7 billion from one year ago while the growth in short-term loans to the housing sector increased by RMB221 billion, suggesting weaker demand for residential mortgages in the context of stable property market. It is noteworthy that, however, the strong growth in short-term household loans partially pointed to the booming demand for short-term loans including consumer credit and auto loans, and also indicated the likelihood that some loans were misused for property and stock market investments.

II.1.2 Total liquidity remains neutral with a slight loosening bias, with the price of funds staying stable toward a downtrend

The money market has been stable generally since the beginning of this year. **Firstly,** the total liquidity is neutral with a slight loosening bias, without any big ups and downs in fund demand and supply. The targeted reserve requirement ratio cuts for inclusive finance purposes freed up RMB450 billion of long-term liquidity in the first quarter. The central bank provided a 30-day temporary liquidity facility starting from mid-January to free up a total liquidity of RMB 2 trillion to cope with the heavy demand for cash ahead of the Chinese New Year. **Secondly**, the money market interest rates are trending downward stably. The 7-day interbank market pledge-style repurchase rate of depository institutions (DR007) fluctuates within the 2.5%-2.9% range. **Thirdly,** the structural liquidity crunch has been eased. In 2018, targeted reserve requirement ratio cuts have played a positive role in replenishing liquidity in the financial system and eased the year-end structural liquidity crunch. 3-month AAA+ interbank certificates of deposit (CDs) had a yield to maturity of 4.67% on March 23, down 76 BPs from the end of the previous year. The interest rate spread between R007 and DR007 plunged to 26 BPs on March 23 from 233 BPs at the end of the previous year.

II.1.3 The bond market had its financing function repaired and the stock market experienced a sharp adjustment

In the first quarter, the bond market was repaired temporarily by the neutral liquidity with a slight easing bias and the modest weakening marginal effects of strengthened financial supervision. On March 15, China Bond Assembled Index closed at 171.4, up 3.5 points from the end of last year. The bond market performance shows three characteristics. Firstly, the size of bond issued expanded. Bond issues totaled RMB4.69 trillion in the first two months, up RMB290 billion or 6.6% from one year ago. Secondly, cash bonds were traded actively. The cash bond transactions in the interbank market averaged RMB378.2 billion a day, up 16.9%. Thirdly, the issue interest rates trended downwards in general. The coupon rates of Treasury bonds, local government bonds, bonds of listed companies and interbank CDs fell by 36 BPs, 14 BPs, 73 BPs and 30 BPs from the beginning of last December.

In the first quarter, China's stock market fluctuated widely in the wake of the U.S. stock plunge, showing a fast and deep retreat. On February 9, Shanghai Stock Exchange (SSE) Composite Index closed at 3129.85, the highest single-day decline of 4.05% since the stock market circuit breaker was launched. The accumulated weekly drop was 9.6%, the sharpest in the past two years. After two consecutive weeks' decline, SSE Composite Index lost all its gain in 2017 to hit a half-year low. 2,969 and 82.75% of stocks fell on February 9 on Shanghai and Shenzhen stock markets. That round of A-share plummet is a combined result of domestic and overseas factors. On the one hand, the U.S. stock market slump was an immediate trigger. On the other hand, domestic factors including blue-chip valuation adjustments and tightening regulatory policies worsened this stock market adjustment to some degree. After the Chinese New Year, the A-share market rebounded in fluctuations as the U.S. stock market stabilized. After the United States announced the findings of Section 301 investigation of China, the U.S. stock market dived again on the market concern over the escalating risk of a U.S.-China trade war. As a result, SSE Composite Index and SZSE Component Index closed at 3153 and 10440 on March 23 respectively, down 5.8% and 6.6% from the beginning of this year.

II.1.4 RMB exchange rate against USD continued to rise with a stronger flexibility

The RMB appreciation against USD seen in 2017 has continued into 2018 to date. The central parity of RMB exchange rate against USD was 6.3272 on March 16, up 3.2% from the end of last year. The strong RMB exchange rate was mainly bolstered by the down-trending U.S. dollar index and the steady improvements in China's economic fundamentals. The main characteristics of RMB exchange rate are as followed: Firstly, RMB exchange rate against a basket of currencies rose steadily. CFETS RMB Exchange Rate Index was 96.12 at March 16, creeping up 1.3% from the end of last year. Secondly, RMB exchange rate against USD swung in both ways. The U.S. dollar index rebounded by 2.6% in fluctuations in February. The RMB exchange rate against USD retreated due to temporary USD strengthening. Given the strong fundamentals, however, the central parity of RMB exchange rate against USD dipped merely 0.04% in February. Thirdly, the trends in onshore and offshore RMB exchange rates have been converging increasingly. The spread between onshore and offshore RMB exchange rates against USD has narrowed gradually since this year began, indicating a higher level of consistency between RMB exchange rate expectations in onshore and offshore markets.

II.2 Financial Forecast for 2018Q2

II.2.1 Money supply growth will remain slow, with aggregate financing to the real economy

moderating toward stable growth

In the second quarter, firstly, the M2 growth rate is projected to stay low. Against the backdrop of strengthened supervision and de-leveraging, the internal circulation and nesting of funds in the financial system will continued to be controlled and reduced. M2 is expected to fluctuate narrowly around the current level in the second quarter, unlikely to decelerate or accelerate. Secondly, the growth in aggregate financing to the real economy will slow down steadily. The second quarter will see the continued backflows to balance sheet and further shrinkage of off-balance-sheet financing. Credit will show strong growth due to meeting part of the off-balance-sheet financing needs. Meanwhile, according to the *Report on the Work of the Government* released this year, the proportion of direct financing, especially equity financing, is expected to move higher this year. Overall, the growth in balance of aggregate financing to the real economy is projected to weaken and remain generally stable. Thirdly, the critical battle to prevent and defuse financial risks is not only to reduce the leverage ratio of businesses, but also to strictly control the excessive growth in residents' leverage ratio. Thus the growth in loans to the household sector is likely to decelerate. At the end of the second quarter, M2 is projected to grow by about 8.8%, and aggregate financing to the real economy is expected to grow by approximately 11.5% year-on-year.

II.2.2 The general principle of de-leveraging and preventing risks will remain unchanged, with the money market interest rates projected to fluctuate in an uptrend

The monetary market is estimated to remain largely stable in the second quarter, except for temporary structural cash crunch. Firstly, the general principle of de-leveraging and preventing risks will remain unchanged, and the valve of liquidity will not turn loose. The *Report on the Work of the Government* released this year states that China will "make sure that the valve of aggregate monetary supply is well controlled", compared with "regulating the valve of monetary supply properly" stated last year and no longer requires efforts to "maintain basic stability in liquidity". Also, while ensuring a reasonable, stable level of liquidity, the efforts to de-leverage and prevent and defuse financial risks will be supported. Secondly, the valve of liquidity will remain appropriately tight in the face of domestic and overseas uncertainties. RMB exchange rate against USD faces certain pressure of retreat in the second quarter, whether the funds outstanding for foreign exchange will continue to edge up is uncertain, which is likely to cause a liquidity run-off from the domestic market. Thirdly, structural liquidity crunch may be unavoidable and the money market interest rates are projected to dip structurally. In the context of frequent regulatory policy updates, the adjustments in market expectations and assets and liabilities of financial institutions may mount to structural pressure at some points of time. It is still possible to see the People's Bank of China raise reverse repo, MLF and other policy rates following the U.S. interest rate rises, limiting the room for continued decline in equilibrium interest rate.

II.2.3 The bond market will have limited room for interest rate cuts, while the stock market is likely to remain volatile

In the second quarter, the bond market is projected to end its minor rally due to the combined effects of various factors, with interest rates estimated to fluctuate in an uptrend. Firstly, the bond market can hardly maintain the neutral liquidity with an easing bias. In the context of de-leveraging and preventing risks, more regulatory rules will be promulgated to possibly further intensify the expectations of strengthened supervision. The market liquidity is likely to restore a structural tight balance. Secondly, the demand-supply contractions in the bond market may put a brake on further interest rate declines. Local government bond issues are estimated to stand at around RMB4.1 trillion this year, slightly below the level of last year. Historical data show enlarged local government bond issues in the second quarter. Moreover, this year bond issues might accelerate to bring a heavy pressure on bond market supplies. Thirdly, China's economy made a good start in the first quarter, with stable growth projected to continue into the second quarter. Meanwhile, the current shock on the supply side has created some pressure of structural inflation that deserves close attention. Fourthly, the global monetary policy reversal will stifle the sustained recovery of the bond market. At present the U.S. Treasury yields are soaring, with the 10-year Treasury yield already close to 3%, limiting the room for the domestic bond yield decline.

The current economic fundamentals provide a relatively strong support for the stock market, so the overall stock valuation stays in the relatively safe zone. The market is gradually dominated by the idea of value investing. The stock market is less leveraged and the leverage effects are relatively weak, with the foundation for cross-market risk transmission weakened gradually. Overall, the stock market is becoming increasingly resilient to risk. But the spillover effect of global monetary policies and the connectivity and contagion of stock markets have risen to an extent that cannot be ignored. Given the global stock markets disengaged from economic fundamentals and the escalating risk of a trade war between the United States and China, the U.S. stock market is likely to become more volatile in the future, making it more probable for China's stock market to fluctuate irrationally.

II.2.4 RMB exchange rate against USD will face a pressure of slight drop, possibly with a wider two-way swing

RMB rose 6% in value against USD in 2017, representing the strongest annual appreciation since 2008. RMB exchange rate against USD gained 3.2% from the beginning of this year to March 23. Of course, many uncertainties still exist at home and abroad. Of particular note, the spillover effects of the policies of major economies, such as the U.S. and EU, bring an external pressure and impact on China. The RMB exchange rate against USD will face a certain pressure of setback, possibly with a wider two-way swing. Firstly, as the Fed Chairman Powell is hawkish, coupled with the recent strong U.S. economic data, the Federal Reserve is highly probable to announce 3 to 4 rate hikes in 2018. Secondly, at present the U.S. Treasury yields are soaring, with the 10-year Treasury yield already close to 3%. If the U.S. Treasury yield breaks 3% and goes higher, another round of U.S. stock plunge will likely occur and send ripples to other financial markets. Meanwhile, the narrowing interest rate spread between the United States and China might trigger capital flight from China and RMB depreciation. Thirdly, China's high-quality development model featuring de-leveraging and structural adjustments may bring the economic growth down slightly from last year, thereby temporarily weakening the underpinning of RMB exchange rate.

III. Macroeconomic Policy Orientations

The *Report on the Work of the Government* released this year states that the proactive direction of the fiscal policy will remain the same, and China will concentrate efforts to increase efficiency. The key words have changed from "more proactive and effective" to "concentrate efforts to increase efficiency", highlighting the overall requirement that the future macro-economic policies should be fit for the fact that "China's economy is transitioning from a phase of high-speed growth to a stage of high-quality development". With a lower deficit-to-GDP ratio (2.6%) estimated and the government deficit projected to remain unchanged (RMB2.38 trillion) in 2018, the fiscal policy will attach greater importance to the coordination of keeping appropriately proactive and enhancing policy effects. Meanwhile, to prevent and defuse significant financial risks, ivorously promote financial reform, better support the development and opening-up of the real economy and achieve high-quality development, improving the two-pronged regulation framework based on the monetary policy and macro-prudential policy will be the theme of China's financial policies.

Table 1: Forecasts on China's Main Economic and Financial Indicators in 2018Q2 (%)

Indicator	2014 (R)	2015 (R)	2016 (R)	2017 (R)	2018		
					Q1 (E)	Q2 (F)	Full Year (F)
GDP	7.3	6.9	6.7	6.9	6.9	6.8	6.8
Industrial value added of enterprises above designated size	8.3	6.1	6.0	6.6	7.0	6.8	6.7
Value added of the services sector	7.8	8.2	7.8	8.0	7.5	7.5	7.8
Fixed asset investments	15.7	10.0	8.1	7.2	7.8	7.6	7.5
Total retail sales of consumer goods	12.0	10.7	10.4	10.2	9.8	10.0	10.0
Exports	6.0	-2.9	-7.7	7.9	17.0	12.0	10.0
Imports	0.5	-14.3	-5.5	15.9	18.0	13.0	11.0
Consumer Price Index (CPI)	2.0	1.4	2.0	1.6	2.4	2.5	2.5
Producer Price Index (PPI)	-1.9	-5.2	-1.4	6.3	3.8	4.0	3.5
Broad money supply (M2, ending balance)	12.2	13.3	11.3	8.2	8.7	8.8	9.0
Aggregate Financing to the Real Economy (Stock)	14.3	12.4	12.8	12.0	11.3	11.5	12.0

Sources: BOC Institute of International Finance

III.1 The proactive fiscal policy will concentrate efforts to increase efficiency for long-term benefits

First, the structure of budgetary spending will be improved to make sure that more financial allocations are used for the public goods and universal benefits. According to the 2018 draft budget approved by the National People's Congress, China's government expenditure is budgeted at RMB21 trillion, up about 7.6% year-on-year, higher than the budgetary revenue growth rate (6.1%) for 2018 and indicating fairly strong spending. In addition, China will accelerate well-regulated development of local government special bonds this year. This year, local government will issue RMB1.35 trillion special bonds in total, an increase of RMB550 billion year on year. Meanwhile, China will continue to improve the structure of budgetary spending with a stronger orientation to the public goods and universal benefits, putting focus on innovation-driven development, "agriculture, rural areas, and rural residents", and the improvement of living standards.

Second, slashing taxes and fees and reforming the tax system will be combined to foster the vitality and sustainability of economic growth. Reductions in taxes and non-tax burdens of market players are projected to exceed RMB1.1 trillion this year. Meanwhile, the tax system reform will become the outstanding highlight of fiscal and tax reforms this year. The value-added tax (VAT) system will be further improved to turn from three tax brackets into two and prioritize lowering rates in manufacturing and transportation. The personal income tax system will be reformed, including raising the personal income tax threshold, offering expense deductions for items like children's education and treatment for serious diseases. Legislation on real estate tax will be prudently advanced.

Third, local governments are encouraged to borrow money in accordance with laws and regulations, with out-of-order local government debts subject to tough crackdown. China will continue to advance local governments to issue new bonds and debt-converting bonds, which are estimated to total RMB2.18 trillion and RMB1.73 trillion respectively. Guidance and confinement remains the theme of local government debt management. On the one hand, China will reasonably increase the aggregate size of debts, steadily advance the special bond management reform and give priority to financing the smooth implementation of ongoing projects. On the other hand, tough crackdown will be imposed on out-of-order local government borrowings.

III.2 Strengthen coordination of monetary policy, macro-prudence and regulatory policy to provide help for de-leveraging and risk prevention

First, the monetary policy remains prudent and neutral to provide help for de-leveraging and risk prevention. On the one hand, the monetary policy will remain prudent and neutral. The monetary policy will increase and optimize the pool of monetary policy, boost the effectiveness of the tool combination and operations and keep the liquidity largely stable through peak shaving and valley filling. On the other hand, China will prioritize de-leveraging and preventing and defusing financial risks while maintaining stable growth. The macro-prudential assessment policy will be further improved, with the detailed rules for incorporating interbank certificates of deposit (CDs) and green finance in MPA likely to be issued and implemented soon. In addition, China will strengthen the coordination and interaction between the monetary policy and macro-prudential policy in terms of policy orientation and intensity of policy tool implementation.

Second, China will improve macro-prudential management and improve the two-pronged regulation framework. The components, weights and parameters of indicators will be improved according to MPA implementation and macro regulation needs. The macro-prudential management of shadow banking will be strengthened, with focus on off-balance-sheet and inter-bank businesses. The macro-prudential management of cross-border capital flows will be improved. The macro-prudential management of real estate finance will be strengthened, improving the differentiated housing credit policy and controlling the leverage ratio in the real estate market. Explorations will be made in the macro-prudential management of internet finance. Conditions permitting, internet finance businesses that have a large size and manifest systemic importance characteristics can be included in MPA.

Third, China will deepen the financial regulatory system reform and strengthen risk prevention in key fields. In the new regulatory landscape, China will continue to head for unified regulation to strengthen both functional and behavioral supervision. Extra attention will be paid to preventing risks in priority areas, including shadow banking, internet finance and financial holding companies. China will continue to curtail the unchecked expansion of shadow banking, prudently carry forward de-leveraging and continue to strengthen the penetrate-through regulation of off-balance-sheet and interbank businesses. China will pursue well-regulated development of internet finance, and toughen the crackdown on illegal fundraising, financial frauds and other activities that disturb the financial market order. The regulation of financial holding companies will be strengthened by formulating relevant laws and regulations and improving the "firewall" system and information disclosure mechanism.

III.3 China will move further forward in the five priority tasks of cutting overcapacity and excess inventory, deleveraging, reducing costs, and strengthening points of weakness

In terms of cutting overcapacity, the milestones achieved previously have eased the pressure of overcapacity reduction for this year. China will cut steel production capacity by around 30 million metric tons in 2018, less than the average of 34 million metric tons in the past five years. The coal production capacity will be cut by approximately 150 million metric tons, also less than the five-year average of 160 million metric tons. In terms of reducing excess inventory, given the clear progress made in reducing housing inventory in third- and fourth-tier cities, reducing excess food stockpiles is added as a new task this year. De-leveraging will be combined with fighting the critical battle of preventing financial risks and put focus on tackling both symptoms and root causes, i.e. taking prudent steps to deal with stock debts and accelerating debt-for-equity swap while regulating borrowing activities and improving financial supervision. In terms of lowering costs, policies will be more comprehensive and better-targeted. In addition to RMB800 billion of corporate and personal tax cuts, China will also slash government administrative fees, electricity prices, tolls on highways and bridges and intermediary service fees, thereby reduce the burdens on market participants by RMB300 billion and further unleash market vitality. In terms of strengthening points of weakness, China will continue to put forward targeted poverty alleviation, pollution prevention and control, as well as support the development of new growth drivers and the infrastructure construction in central and western regions.

III.4 The real estate policy will emphasize increase of supply and encouragement of both renting and purchasing

The real estate policy will, centering on establishing a long-acting mechanism, further emphasize the increase of supply to meet the rigid demand while curbing speculation under the guiding principle that "houses are for living in, not for speculation". In terms of strengthening real estate regulation, the strictest ever purchase restriction policy for first-tier cities and hot second-tier cities will not be loosened in the short term. Third- and fourth-tier cities still assume the task of de-stocking and also will support home buying for own use. In terms of increasing property supply, China will increase land supply by expanding the trading of collectively owned land designated for development purposes and officially permitting the housing construction on own land by non-property developers, and continue to explore the development of shared ownership housing. In terms of meeting the housing demand, China will attach greater importance to the house rental market this year and issue laws and policies based on research and study to regulate the house rental market development and protect tenants' rights and interests, and gradually form the situation that both house rental and purchase market are running well, and housing demand can be meted. In terms of improving housing support, China will launch a new renovation plan this year to start the construction of 5.8 million property units in rundown urban areas and step up efforts to supply public-rental housing.

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