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Highlights

● In 2018Q3, China's economy remained generally stable with continued improvements in external demand, rapid growth in profits of industrial enterprises and continued recovery in manufacturing investment and private investment growth. New industries, new products and new forms of business kept growing rapidly. There were still many positive aspects in economic growth. However, the escalating US-China trade war and the changing market expectations have weakened both demand and supply sides of the economy, and worsened inflation. GDP in Q3 is preliminarily estimated to grow by around 6.6%, down 0.1ppts from Q2.

● Looking ahead to Q4, it is expected that China's GDP will increase by 6.7% in the fourth quarter and around 6.7% for the whole year. Even though the rapid slowdown in infrastructure investment and changes in market expectations have weakened the growth momentum on both supply and demand sides. The endogenous dynamic of growth is strengthened steadily and the macro policies are adjusted, the downward pressure on China's economy will be eased.

● On the next stage, macroeconomic policies will, as announced by the July 31 meeting of the Political Bureau of the CPC Central Committee, focus on promoting the implementation of the "Six Stabilizers" tasks (remain employment, finance, foreign trade, investment, and expectations stable). Macroeconomic policies will be better coordinated, and the proactive fiscal policy and the prudent monetary policy will work together. So that tax cuts and fee reductions will be implemented effectively, and the transmission mechanism of monetary and credit policies will be smooth.

China's Economic Growth Trends



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

Liang Jing

Gai Xinzhe

Fan Ruoying

Li He

E Zhihuan (Hong Kong)

Chen Zhihua (BOCIM)

Contact: Zhou Jingtong

Telephone: 010-66592779

Email: zjtlucky@163.com

How will China's Economy Move Forward when the Trade War Meets

“Six Stabilizers” Policies?

-- China's Economic and Financial Outlook (2018Q4)

China's economy remained stable overall in 2018Q3, backed by such factors as the trade war having not started to affect Chinese exports, the ongoing pickup in growth of manufacturing and private investments and continued strong momentum of new growth drivers. China's GDP growth is estimated to be about 6.6% in Q3. However, the rapid slowdown in infrastructure investment and changes in market expectations have weakened the growth momentum on both supply and demand sides. These new developments and problems have attracted extensive market attention. Looking ahead to Q4, it is expected that China's GDP will increase by 6.7% in the fourth quarter and around 6.7% for the whole year. As the endogenous dynamic of growth is strengthened steadily and the macro policies are adjusted, the downside pressure on China's economy will be eased. In the next step, macroeconomic policies will, as announced by the July 31 meeting of the Political Bureau of the CPC Central Committee, focus on promoting the implementation of the “Six Stabilizers” tasks (remain employment, finance, foreign trade, investment, and expectations stable). Macroeconomic policies will be better coordinated, and the proactive fiscal policy and the prudent monetary policy will work together. So that tax cuts and fee reductions will be implemented effectively, and the transmission mechanism of monetary and credit policies will be smooth.

I. 2018Q3 Economic Review and Q4 Outlook

I.1 Economic review in 2018Q3: Economic performance weakened, but the quality and efficiency of growth improved

In 2018Q3, China's economy remained generally stable with continued improvements in external demand, rapid growth in profits of businesses and continued recovery in manufacturing investment and private investment growth. New industries, new products and new forms of business kept growing fast. There were still many bright spots in economic growth. However, the escalating US-China trade war and the changing market expectations have weakened both demand and supply sides of the economy and worsened inflation. GDP in Q3 is preliminarily estimated to grow by around 6.6%, down 0.1ppts from Q2. CPI is estimated to rise by about 2.2%, up 0.4 ppts from Q2. The economy showed the following main characteristics:

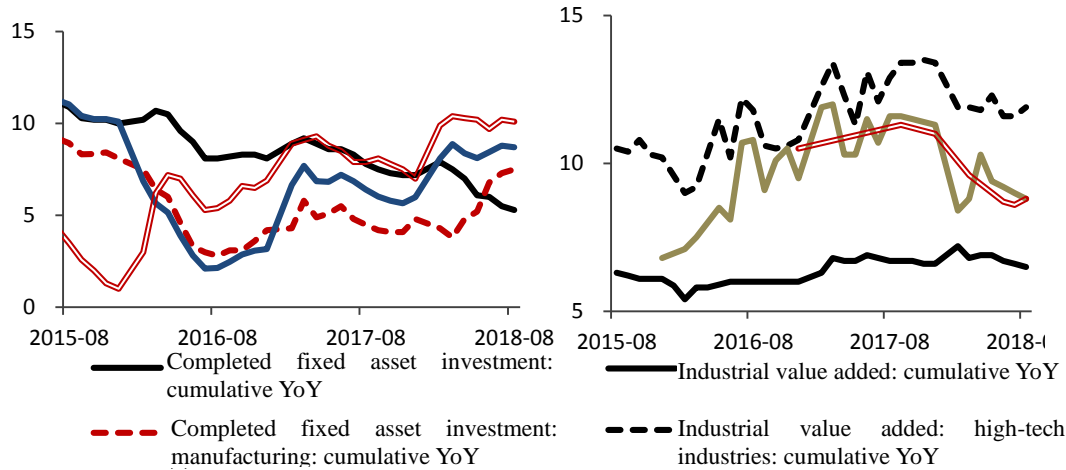
I.1.1 The quality and efficiency of growth improved, showing many positive aspects.

First, the profits of industrial enterprises continued to improve as a result of the supply-side structural reform. Given the high base of 21.2% in the same period last year, the profit growth of industrial enterprises still reached 17.1% from January through July this year.

Second, the growth of manufacturing and private investments accelerated, and the

endogenous dynamic was strengthened. From January through August, manufacturing investment and private investment increased by 7.5% and 8.7% respectively, up 0.7 ppts and 0.3 ppts over 2018H1 (Figure 1).

Figure 1: Manufacturing and Real Estate Investments Bucked the Trend (%) Figure 2: Emerging Industries Grew Rapidly (%)



Source: Wind, BOC Institute of International Finance

Third, new growth drivers kept expanding. From January through August, the added value of high-tech manufacturing, equipment manufacturing and strategic emerging industries increased by 11.9%, 8.8% and 8.8% year on year (YoY), respectively, 5.4 ppts, 2.3 ppts and 2.3 ppts faster than that of industrial enterprises above the designated scale (Figure 2). New industrial products grew rapidly. From January through August, the output of new energy vehicles, industrial robots and integrated circuits (ICs) increased by 56%, 19.4% and 13.4% respectively. Investment has flowed faster to high-tech industries and areas of weakness to be strengthened. From January through August, investment in high-tech industries rose by 11.9% YoY, of which investment in IC manufacturing, optical fiber cable manufacturing and optoelectronic device manufacturing grew by 64.7%, 60.7% and 58.2% respectively. The investments in environmental protection and health increased by 34.9% and 11.1% respectively.

Fourth, new and upgraded consumption continued to grow. From January through August, the online retail sales of physical goods increased by 28.6%, accounting for 17.3% of the total retail sales of consumer goods, up 3.5 ppts over the same period last year. Online retail sales of non-physical goods rose by 27.2%. Retail sales of cosmetics and home furniture increased by 12.6% and 10.2% YoY, respectively, 3.3 ppts and 0.9 ppts faster than total retail sales of consumer goods.

I.1.2 As domestic demand (investment and consumption) continued a downward trend, supply (industrial production and services) began to decline, the economy faced a downward pressure

The growth in consumption and investment weakened further in 2018Q3. From January through August, total retail sales of consumer goods grew by 9.3% YoY, down 0.1 ppts from H1 or 1.1 ppts YoY. The continued slowdown in consumption growth bore a tie to the moderation in automobile and residential consumption, also contributed to by such factors as weaker growth in residents' income and increase in household leverage ratio.

Fixed asset investment maintain low as consequence of slowing infrastructure investment. From January through August, investment expanded by 5.3% cumulatively, down 0.7 ppts/2.5 ppts from H1/YoY respectively. Therefore, despite the overall recovery of the rest of the world and the relatively stable exports of China (with exports growing by 12.2% YoY from January through August, faster than the same period last year), industrial production slowed down on weakening domestic demand, including investment and consumption.

I.1.3 CPI rebounded slightly and PPI dropped YoY

CPI growth exceeded 2% in Q3, standing at 2.1% in July and 2.3% in August. On the one hand, the prices of fresh vegetables, eggs and pork increased rapidly due to heat waves, floods and epidemics. The food inflation in August reached 1.7%, 1.2 ppts higher than that in the previous month. On the other hand, non-food inflation accelerated. In particular, as the rising housing rent and peak season for tourism, the costs of housing, transportation and communications, education, culture and entertainment expended. PPI dropped from high base recorded over the same period last year. PPI rose by 4% from January through August, down 2.4 ppts YoY.

I.1.4 Three major changes deserve attention

First, the overshooting of housing prices had a “crowding out” effect on other fields of consumption. Consumer spending on housing/daily supplies and services closely related to real estate accelerated significantly, growing at 12.4%/11.7% in 2018H1 respectively, up 4.1 ppts and 5.2 ppts YoY. But the growth in consumer spending on education, culture and entertainment/other supplies and services moderated to 7.2%/7.1% respectively, below the growth rate (8.7%) of national consumer expenditure per capita. **Second, the unemployment rate picked up.** The surveyed urban unemployment rate was 5% in August this year, up 0.2 ppts from the end of June. Close attention should be paid to the impact on employment of such changes as trade war, overcapacity reduction, environmental protection policies and investment growth deceleration. **Third, the losses of businesses have expanded.** From January through July, the losses of industrial enterprises above the designated size increased by 5.5% YoY, up 1.9 ppts over H1.

I.2 Economic Outlook for Q4

Looking ahead to Q4, we expect China's economy to remain stable overall under an eased downward pressure. With regard to external environment, the global economy will keep recovering steadily in the near future, but trade frictions will increase the uncertainty of the global economy. Major economies will reverse their easy monetary policies while emerging markets will still have a high level of economic and financial vulnerabilities, posing risks to sustained recovery of the global economy. Locally, China's infrastructure is expected to pick up as local government bond issues step up under the adjusted fiscal and monetary policies. The supply-side structural reform will advance further. The supply-demand relationship in industries with overcapacities will improve significantly. The operating costs of enterprises will continue to decrease and the profits of enterprises will maintain rapid growth. The industry structure will continue to optimize. New industries, new products and new types of business will grow at a faster pace. Residents' upgraded consumption and service consumption will keep growing rapidly. Thus the quality of economic development will improve continuously. However, the rising debt burden in the household sector weighs on the accelerated growth of consumption. The furtherance of such policies as overcapacity cuts, de-leveraging and environmental protection will inevitably place a downward pressure on the economy. Inflation will grow faster moderately. GDP is expected to grow by about 6.7% in Q4, up 0.1 ppts from Q3, or around 6.7% for the whole year, down 0.2 ppts from the previous year.

I.2.1 On the demand side, growth in exports will slow from the peak and imports will maintain rapid growth. Q4 will pose major uncertainties to China's foreign trade in consequence

of the trade war and the cyclical slowdown in the global economy and trade. The US imposed a 10% tariff on USD200 billion worth of imports from China from September 24 and will raise the tariff rate to 25% on January 1, 2019. That is a much bigger size than the previous USD50 billion tariff list, which may affect China's exports in Q4 to some extent. In addition, the WTO report shows that its World Trade Outlook Indicator (WTOI) in Q3 was 100.3, further down from 101.8 in Q2 and approached to the critical value. Since Q3, the EU manufacturing PMI has been continuing its downward trend seen this year, and emerging market trade has been hit by severe exchange rate turbulence. Against the backdrop of further monetary tightening in the US and Europe in Q4, the weaker global trade outlook will affect China's exports. Policy changes will underpin growth in imports. The faster public spending and strengthening infrastructure investment will accelerate the rise in imports of upstream products and prices of bulk commodities. In addition, the first China International Import Expo (CIIE) will be held in Q4 and see a large number of import orders signed to boost the steady growth in imports.

Consumption growth will hardly improve significantly. On the one hand, the government will continue to implement the Ten Initiatives for Boosting Consumer Spending and raise the basic expense deduction standards for individual income tax, which, together with rising per-capita disposable income, help tap the consumption potential. **On the other hand**, the household debt burden has increased obviously in recent years due to more home purchases and changing consumption behaviors. The new loans to the household sector averaged RMB4.7 trillion in January-August of the past three years, much higher than the average of RMB2.6 trillion over the same period of 2013-2015, which will stifle the growth of consumption. Consumption growth in Q4 is expected to slightly outpace that in Q3, albeit still weaker than one year ago. Among the tangible consumer goods, automobile that takes up a large share in consumption will see slowdown in sales due to the withdrawal of preferential auto purchase tax policy. Meanwhile, consumption will continue to grow rapidly in online retail, upgraded goods and services.

Investment growth is expected to pick up. First, infrastructure investment will stabilize and recover in Q4. Recently the local government bond issues have accelerated, with a total of RMB1.64 trillion issued in July and August, exceeding the total amount issued in H1. At its July 31 meeting, the Political Bureau of the CPC Central Committee called for stronger efforts to shore up weaker areas in the infrastructure sector. Public expenditure will be accelerated. This will help secure investment funds for infrastructure projects. Second, growth in manufacturing investment will continue to improve on sustained rapid growth in profits of industrial enterprises **as well as** the governmental efforts to unclog the monetary policy transmission mechanism and encourage financial institutions to support financing for the real economy. Third, real estate investment will sustain rapid growth. The expectations of housing price hikes remain in spite of the continued strict curbs on property market and tightening of related financing. Some areas with faster de-stocking and stronger demand have entered the stage of inventory replenishment.

I.2.2 On the supply side, industrial production will edge up. First, fiscal and financial policies will work together to increase support for the real economy. The fiscal policies will focus on tax cuts and administrative fee reduction. The financial policies will focus on unclogging the transmission mechanism of monetary and credit policies. The business environment of enterprises will improve. Second, domestic demand may improve on relaxed macro policies and pickup in infrastructure investment. Third, as the industrial structure continues to be optimized, high-tech industries and strategic emerging industries will sustain rapid growth. Overcapacity cuts will boost the capacity utilization ratio in steel, coal and other industries. Relevant industries will enjoy acceleration in value added growth and substantial growth in profits. However, the escalating US-China trade war will hurt export growth and may deal a blow to related industrial enterprises. Continued deleveraging and environmental protection policies will still affect industrial production

in the short term. Overall, the growth of industrial added value in Q4 is expected to pick up from Q3.

I.2.3 CPI will ramp up at a faster but controlled pace and the PPI will continue to slow down.

Food prices may remain on the track of pickup in Q4. Soybean prices will rise on Trump's tariff hit and frost weather in some areas. The spreading swine fever epidemic will also keep pork prices up. Rainfalls caused by recent typhoons will also push up food prices. The uncertainties in US sanctions against Iran place an upward pressure on crude oil prices. Imported inflation will mount to a bigger pressure. In addition, the rising labor costs and rents will also drive up consumer prices. The CPI growth is expected to gain pace in Q4. However, the inflation will be relatively controllable as the demand can hardly improve significantly and the monetary policy will not be loosen markedly. The price of related industrial products may remain high due to implementation of policies on overcapacity cuts and environmental protection. But PPI growth will generally remain in a downward trend given the high base of last year.

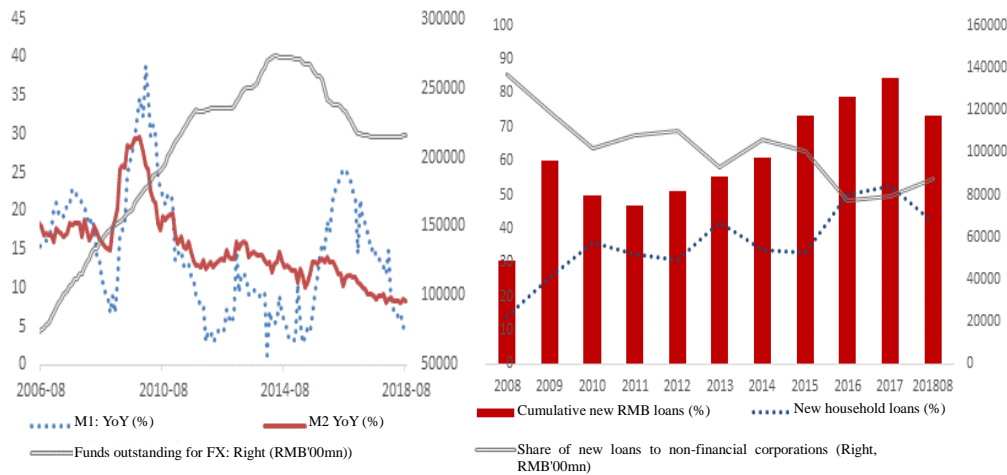
II. Financial Review in 2018Q3 and Outlook for Q4

Financial policies were adjusted in Q3 in response to new changes in the macroeconomic situation, including the third reserve requirement ratio (RRR) cut, unclogging of the monetary policy transmission mechanism, resumption of the foreign exchange risk reserve and the counter-cyclical factor for the RMB/USD central parity rate quotation. Financial policy adjustments have begun to work to turn "easy monetary environment" into "easy credit environment". Money and credit supply have maintained reasonable growth. The deceleration in total financing to the real economy has moderated. The midpoint of the interest rate corridor in the money market goes down, and corporate financing costs are in decline. In addition, China's stock market and foreign exchange market also have fluctuated due to rising uncertainties in the global economy, escalating US-China trade war and financial turmoil in emerging economies.

II.1 Financial review in 2018Q3: Monetary easing took effect to ensure financial stability

II.1.1 M2 growth rebounded slightly while the off-balance-sheet financing declined moderately.

The broad money supply (M2) picked up while the narrow money supply (M1) continued to decline. At the end of August, M2 grew by 8.2% YoY, down 0.3 ppts from the end of last month, but up 0.2 ppts from the end of Q2. The slight gain in M2 growth is mainly due to the slightly loose and generally prudent monetary policy and the stable funds outstanding for foreign exchange, coupled by the stronger derivative effects of deposits. Against the backdrop of a slight rebound in M2 growth, M1 growth was still weakening. At the end of August, M1 grew by 3.9% YoY, down 2.7 ppts from the end of Q2, the slowest pace since 2015H2. The continued moderation in M1 growth is mainly attributable to the weaker growth in corporate deposits, which are principally demand deposits, showing no signs of marked improvements in cash flows in the real economy (Figure 3).

Figure 3: Changes in Growth of M2 and M1 Figure 4: New RMB Loans and their Mix


Source: Wind, Bank of China Institute of International Finance

The newly increased financing to the real economy contracted smaller, and off-balance sheet financing declined slower. The slowing drop in off-balance sheet financing and the increase in debt financing are the main contributors to improvements in contraction of total financing to the real economy. In August, trust loans and undiscounted bank acceptances fell by RMB68.8 billion and RMB79.9 billion, respectively, a weaker contraction than last month. It is noteworthy that the deceleration in growth of total financing to the real economy financing and the shrinking of off-balance-sheet financing are the inevitable result of economic deleveraging and the fundamental requirement of “feeding money back into the real economy”, which is conducive to reducing the debt burden of enterprises and shortening the financing chain.

RMB loans grew rapidly and the credit structure was optimized. RMB loans have grown rapidly this year on multiple factors, including the return of off-balance-sheet financing to the balance sheet. Structurally, the increase in household leverage is decelerating. In the first eight months, new loans to households totaled RMB4.94 trillion, down RMB59.5 billion YoY, accounting for 42% of new RMB loans, down 10.7 ppts from 2017 (Figure 4). Loans to non-financial corporations grew steadily and rapidly. In the first eight months, loans to non-financial corporations increased by RMB6.43 trillion, up RMB1.17 trillion YoY.

II.1.2 The average level of the market interest rate has gone down markedly, with financing costs varying across channels

Since Q3, the monetary policy has attached greater importance to “locking the short and unlocking the long” to keep the liquidity reasonably sample. On the one hand, liquidity was recovered through open market operations. In Q3 (as of September 21), PBOC made RMB300 billion of net liquidity withdrawal through open market operations. On the other hand, the central bank released medium- and long-term liquidity by means of MLF, PSL and the third RRR cut in the year.

First, the money market witnessed a marked decline in the midpoint of interest rate corridor. A series of RRR cuts and open market operations have notably driven down the midpoint of interest rate corridor in the money market. Shibor rates generally declined for most terms.

Second, different financing channels for enterprises showed different trends. The interest rates of notes financing fell significantly. The interest rates of trust product issues dropped while

remaining generally stable. The banks' lending rates were basically stable. Private lending rates picked up. In September, the yield to maturity of the one-year mid-term note was 3.68%, down 90 bps from June. In June, the weighted average interest rate of RMB loans was 5.97%, basically flat with March. The weighted interest rate of RMB loans is expected to drop to 5.93% at the end of September.

Third, the bond market yields became divergent with the term spread widening. The coupon rates of bonds of different issuers showed divergent trends due to clogged monetary policy transmission mechanism and rising risk of default, which pushed up credit premium. Treasury bonds, local government bonds, interbank certificates of deposit and bonds of listed companies declined in overall stability, while the bonds of unlisted companies were issued at rising coupon rates. In September (as of September 21), the coupon rates of treasury bonds, local government bonds, inter-bank certificates of deposit and bonds of listed companies averaged about 3.34%, 3.9%, 3.91% and 5.08%, down 15 bps, 6 bps, 122 bps and 71 bps from June, respectively. The average coupon rate of bonds issued by unlisted companies was 7%, up 66 bps from June. This was mainly caused by the surfacing default risk of some bonds issued by unlisted companies.

II.1.3 The capital market expectations have changed significantly, with the risk of bond default on the rise

The capital market expectations have changed significantly since Q3 due to escalation of the trade war and slowdown in domestic demand indicators. The stock market indices and IPOs have weakened. The bond market index rose and then fell and debt default events increased.

First, the stock market fell in volume and price. As of September 20, the Shanghai Stock Exchange Composite Index closed at 2,729, down 4.1% from the end of Q2, flat with the lowest point in the 2015 stock market crash. The share turnover ratio calculated based on free float dropped to 0.89%, flat with the level in the bear market in 2013. In August, non-financial corporations raised RMB14.1 billion in the stock market, down 66.3% from the monthly average of RMB41.9 billion in H1, flat with that during the stock market downturn in 2014H1. Compared with previous bear market periods, the current volume and price fall in China's stock market is the combined result of many factors, including the tight liquidity in consequence of financial deleveraging, unexpected escalation of trade war, weaker-than-expected economic fundamentals and funds flowing from stock to bond market.

Second, the bond market went up with fluctuations. As of September 20, China Bond Composite Index - Net Price was 100.06, up 0.28 point from the end of Q2. **Local government bonds and unsecured bonds of listed companies were issued at a significantly faster pace.** In August, the local government bonds, super-short-term commercial papers and medium-term notes issued stood at RMB883 billion, RMB279.9 billion and RMB175.6 billion respectively, up 275%, 33% and 44% from the monthly average in H1. In addition, due to the tightening of other financing channels, the number of defaults on credit bonds further increased. As of September 19, a total of 70 bonds had been defaulted, up 42 from the end of H1.

II.1.4 The unilateral RMB depreciation expectations have been reversed, showing the counter-cyclical factor's effective role in stabilizing the market

In Q3, the foreign exchange market showed some pro-cyclical movements due to the strengthening US dollar index and trade frictions, among others. RMB depreciated more sharply than in Q2. As the central bank raised the foreign exchange risk reserve ratio on August 10 and restarted the counter-cyclical factor on August 24, the RMB exchange rate has stabilized since the end of August and reversed the expectations of unilateral depreciation. **First**, RMB depreciated more sharply. As at September 14, the CFETS RMB Index, the BIS Currency Basket RMB Index and

the SDR Currency Basket RMB Index stood at 93.05, 96.67 and 92.55, down 4.8, 4.5 and 6, respectively, the sharpest quarterly drop. **Second**, external factors and expectations were the major contributors to the sharp RMB depreciation. The market concerns over RMB depreciation rose again on the Federal Reserve's rate hike announced on June 14, Trump's approval for tariffs on RMB50 billion worth of imports from China on June 15, coupled by the continued rise in the US dollar index. As of August 24, the RMB/USD exchange rate fell by 7.1% from 6.39 in June 14. **Third**, the government devoted greater effort to stabilize expectations. To offset the irrational expectations of unilateral RMB depreciation, PBoC has resumed the foreign exchange risk reserve requirements and the counter-cyclical factor successively. These moves have effectively smoothed out excessive market fluctuations and stabilized the expectations of exchange rate decline. After August 24, the RMB/USD exchange rate remained stable within the range of 6.80-6.89.

II.2 Financial Outlook for Q4

II.2.1 Money supply and aggregated financing to the real economy will keep growing reasonably, with the finance structure further improved structurally

In Q4, as the "Six Stabilizers" policies begin to work, the credit transmission mechanism will be further streamlined to bring about more positive structural changes in financial market. **First**, the credit scale will expand steadily. Recently, all commercial banks have said that, to keep the financial sector stable, they would play the "lead goose" role in supporting enterprises to cope with the pressure from tightening financing channels. Bank credit is expected to keep expanding. However, the persistent pressure on the liability side of banks (sluggish growth in capital replenishment and deposit) will drag bank credit expansion to some extent. New loans issued in the year are estimated to be close to RMB16 trillion, an increase of more than RMB2 trillion over 2017. **Second**, the credit flows will continue to be improved. As the government increases its support for infrastructure construction, banks will steadily increase their medium and long-term lending to enterprises, reversing the contraction of medium and long-term loans to enterprises that ran through the first three quarters. In addition, residential mortgage loans will also steadily decline, when property sales are decreasing. **Third**, the contraction of total financing to the real economy will decelerate. With the new regulations for asset management and banker's wealth management implemented, the off-balance-sheet financing will shrink in a slower pace. Meanwhile, bond financing will further expand, yet insufficient to fully offset the contraction in off-balance sheet financing. The downtrend in total financing is expected to continue. The new total financing to the real economy in the year will be about RMB17 trillion, down about RMB3 trillion from 2017. The growth in outstanding total financing to the real economy is expected to slow down to 10% in 2018.

II.2.2 Market liquidity will remain reasonably ample, with interest rates staying at low level in the money market

First, interest rates in the money market will remain low. In Q4, China will maintain a prudent and neutral monetary policy and refrain from using a deluge of stimulus or tightening the liquidity, which is conducive to keeping liquidity reasonably sufficient in the money market. In addition, Q4 is usually the peak season for public spending, which is also conducive to expanding money supply and quickening money turnover. **Second**, banks' lending rate will drop steadily. Declining interest rates in the money market drives down banks' costs of funds, which is conducive to banks lowering their lending rates. **Third**, Bond issues will show continued divergence in interest rates, with lower-rating bonds issued at higher rates. The policies issued to stabilizing the financial sector, domestic investment and expectations are expected to further drive down the interest rates of bond issues, but some low-rating bonds still pose a high risk of default and their interest rates will remain relatively high. **Fourth**, the long-term interest rates are "easy to rise and difficult to fall".

Because of the recent higher upward pressure on prices and rapid increasing in housing rent in some cities, inflation expectations will rise in the near future, making long-term interest rates easy to rise and difficult to fall.

II.2.3 The stock market is about to stabilize and bottom out, and the bond market will be stable with good momentum

In Q2, the capital market is expected to be more stable than in Q3, with the stock market is bottoming out steadily and the bond market is showing good momentum. **First**, uncertainty will subside after the US tariffs was applied on an additional USD200 billion of Chinese goods. When the US tariffs on USD200 billion worth of imports from China take effect in Q4, their impact will turn from an uncertain guess to a definite result. The macro-regulation will be better targeted and the signals will be clearer, and the relevant market expectations will be more stable. **Second**, compared with the USD50 billion tariff list, the market participants may be less sensitive to the USD200 billion tariff list. Earlier the market was sensitive because of unexpected trade frictions escalating to imposition of additional tariffs. At present, all parties concerned generally expect the USD200 billion tariff list to come, and the market would be less sensitive than before when it comes into effect as “all bad news has happened”. **Third**, the impact of local government bond issues will weaken. There will be limited room for new bond issues in the remainder of the year due to the Q3 rapid expansion in local government bond issues. The pressure from local government bond supply in Q4 will be markedly smaller than in Q3. The impact on the bond market will gradually fade away. **Fourth**, the monetary policy is likely to remain prudent while slightly easy. Banks will have a bigger demand for bond allocations accordingly.

II.2.4 The market expectations will stabilize and the RMB/USD exchange rate will fluctuate within a wide range

Under the combined effects of policies and international risks, the RMB/USD exchange rate will probably fluctuate widely within a controlled range in the near future. **First**, the external impact on RMB depreciation expectations tends to weaken. As the market gradually absorbs the expectations of Federal Reserve's rate increases, the expectation of RMB depreciation will tend to weaken. **Second**, there will be a higher pressure on the current account balance. Vigilance should be kept against the risk that the trade deficit will drive down foreign exchange reserves. **Third**, China's foreign exchange market will maintain overall stability in the supply-demand relations. From January through July 2018, banks recorded a surplus of USD4.4 billion in foreign exchange settlement and sale, compared with a deficit of USD109.3 billion over the same period of 2017. The supply-demand relationship in the foreign exchange market was more balanced than one year ago. Moreover, the central bank has a clear intention to keep the foreign exchange market stable, which, coupled by a large number of PBOC policy tools available to stabilize the exchange rate, is conducive to shoring up the RMB value. Overall, RMB is expected to fluctuate widely within a controlled range in the near future, in the context of continued shocks from external risks and the resumption of counter-cyclical regulation.

Table 1: Forecasts for Main Economic and Financial Indicators of China in 2018 (%)

Indicator	2015 (R)	2016 (R)	2017 (R)	2018				
				Q1(R)	Q2(R)	Q3 (E)	Q4 (F)	Annual (F)
GDP	6.9	6.7	6.9	6.8	6.7	6.6	6.7	6.7
Industrial value added of enterprises above designated size	6.1	6.0	6.6	6.8	6.6	6.0	6.2	6.3
Value added of the services sector	8.2	7.8	8.0	7.5	7.8	7.5	7.8	7.7
Fixed asset investments	10.0	8.1	7.2	7.5	5.2	4.1	5.0	5.2
Total retail sales of consumer goods	10.7	10.4	10.2	9.8	9.0	8.9	9.2	9.2
Exports	-2.9	-7.7	7.9	13.7	11.8	10.0	7.0	10.5
Imports	-14.3	-5.5	15.9	19.3	20.5	19.0	20.0	19.0
Consumer Price index (CPI)	1.4	2.0	1.6	2.1	1.8	2.2	2.3	2.1
Producer price index (PPI)	-5.2	-1.4	6.3	3.7	4.1	4.3	4.2	4.1
Broad money supply (M2, ending balance)	13.3	11.3	8.2	8.2	8.3	8.3	8.5	8.5
Aggregated financing to the real economy (stock)	12.4	12.8	12.0	10.5	10.4	9.8	10.0	10.0

Source: BOC Institute of International Finance

III. Macroeconomic Policy Forecast

At present, the operation of China's economy is steady but also facing some new problems and challenges. The 31st of July meeting of the Political Bureau of the CPC Central Committee attached greater importance to the coordination of upcoming macro policies in pursuit of “Six Stabilizers”, as part of striving high-quality development of the economy.

III.1 Keep employment stable: Put the stability of employment as the first one.

The employment situation of our country is steady at present. However, there is a pressure on employment from the overcapacity reduction, stricter environmental compliance requirements and escalating US-China trade frictions. The economic structure upgrading also put a pressure on structural employment adjustments. First, maintaining macroeconomic stability is to avoid major up and down. Second, employment changes should be tracked to strengthen the real-time monitoring of the employment status of key industries and key populations in all regions. Financial institutions will be guided to help enterprises experiencing temporary difficulties due to trade frictions and shrinking market. Third, job-transfer training, re-employment training and

unemployment security services will be provided for people who have lost their jobs due to overcapacity reduction and trade frictions, thereby ensuring stability of employment. Fourth, the proactive fiscal policy and the prudent monetary policy will work together to further enforce tax cuts and fee reductions effectively, ensure the stability of the existing policy on social security contributions and guide funds to better promote real economy growth.

III.2 Keep the financial sector stable: Policy adjustments turn “easy monetary environment” to “easy credit environment”

In the future, China will maintain good control over the floodgates of monetary supply and remain steadfastly in de-leveraging while properly managing the intensity and pace of regulatory policy implementation, thereby channeling money into weaker areas of the national economy and reducing the financing costs of the real economy. **First**, enhancing the open market operation keeps market liquidity reasonably ample. In Q4, rising liquidity demand pushed interest rates higher in the context of accelerated local bond issuance, and requiring stronger open market operations to keep liquidity reasonably ample. **Second**, clearing out the transmission mechanism boots funds into weaker areas of the national economy, such as small and micro businesses and green economy. China will continue to implement preferential policies such as lending rate cuts for small businesses and encouraging banks to grant loans to small and micro businesses. The risk weight of local government bonds will be reduced moderately, thereby guiding financial institutions to allocate more local government bonds and solve the problem of infrastructure investment shortage. **Third**, financial regulatory policies will be stabilized to protect the financial and social stability. On the one hand, as for the existing supervisory measures, the “look-back” should be strengthened to evaluate the results achieved and the existing deficiencies, and promoting smooth transition of shadow banking. On the other hand, ongoing efforts will be made to against illegal financing activities and illegal financial institutions. With regard to the frequent failures of P2P lending platforms emerging at present, supervision should be enhanced to protect investors in accordance with the law and safeguard the financial and social stability.

III.3 Keep foreign trade stable: exploring the compensation mechanism for trade frictions and pushing trade facilitation to a higher level

The “keep foreign trade stable” policy will be implemented to enhance trade facilitation. **First**, China will strengthen trade friction impact detection and establish a compensation mechanism for affected foreign trade companies. China will strengthen the dynamic monitoring of exporters to the US market and keep an eye on the impact of counter-tariffs on imports from the US on Chinese importers. China should make good use of the increased tariff revenue from counter-measures and establish a special fund for compensation for trade frictions, so as to alleviate the adverse effects on the employment of enterprises and personnel with all side’s eyes open. **Second**, appropriating preferential policies will be granted for key high-quality enterprises that have been hit hard by the international market woes but still having bright prospects for development, so as to help them overcome temporary difficulties, diversify their export markets and reduce their dependence on the US market. **Third**, China will continue to deepen foreign trade facilitation reforms such as “single window” for foreign trade, paperless customs clearance, and “single-form customs clearance” to align with first-class international practices in terms of import/export charges, time needed to complete customs procedures and costs of customs clearance and finally ease the burden on foreign trade firms. **Fourth**, China will consider to reduce export drawback rates according to the comprehensive tax burden of enterprises, speed up export rebate, reduce the export inspection rate and increase credit to foreign traders, especially SMEs.

III.4 Keep foreign investment stable: creating a relaxed and orderly environment for foreign investment

First, China will promptly formulate and promulgate the enactment of the Foreign Investment Law to provide better legal protection for foreign enterprises, safeguard foreign investors' participation in market competition in terms of intellectual property rights, industry policies and unbiased law enforcement and show global investors a stable Chinese market ruled by law, making China still the preferred destination for foreign enterprises seeking offshore investment. **Second**, China will introduce international third-party assessment to build a unified national system of business environment assessment drawing upon the good practices of international organizations, such as the World Bank, and taking into account China's specific conditions, so as to objectively analyze local weaknesses in building a first-class business environment and create a stable, fair, transparent and predictable business environment for foreign investors. **Third**, China will launch the overall plan for the Hainan free trade port as soon as possible, accelerate important negotiations such as the EU-China investment agreement and the China-Japan-South Korea free trade agreement and strive for early entry into agreements to further expand foreign investors' access to Chinese market.

III.5 Keep domestic investment stable: promoting the transition to high-quality investment with focus on the yield and efficiency of investment

China will unleash the key role of investment in improving the supply structure and boosting the yield and efficiency of investment. **First**, discipline will be brought to PPP development so that elaborating the local government investment function. In the future, China should further clarify the scope of government investment, establish a regular review and adjustment mechanism, keep optimizing the destination and structure of investment and reasonably arrange the models of government investment. **Second**, government should enrich the capital sources of investment and ensure unobstructed access of investment projects to financing. Large and medium-sized banks should play the role of "lead goose" to increase credit support for ongoing projects, reasonably determine the interest rates for real sectors of the economy and drive down financing costs. China will push for innovation in the bond market, diversify bond products and support debt financing by key projects. **Third**, China will support the transformation of regions where investment declined, promote coordinated development of regional investments and pay extra attention to regions, for which preferential regional and industrial policies should be granted as appropriate. China will encourage the central and western provinces to improve local conditions to become better destinations for industrial transfer and guide well-organized industrial transfer from the eastern region at a faster pace.

III.6 Keep expectations stable: preparing to protect the financial market from external shocks

The market is expected to probably experience irrational changes in a future time. Externally, such shocks as US-China trade frictions, divergent monetary policies of major economies and financial turmoil in emerging markets will continue to escalate, worsening the instability of financial markets. Internally, some economic entities are not prepared enough for the pain of economic de-leveraging. Once some economic indicators weaken, pessimistic expectations will be on the rise. In the future, it is necessary to attach greater importance to keeping expectations stable. **First**, preparedness should be in place to prevent external shocks from impacting the financial market too heavily. Contingency policies should be made in place to isolate the Chinese market from the Fed increases interest rates, the escalating US-China trade frictions and financial turmoil in emerging markets, properly manage capital flows, shore up the market confidence in RMB exchange rate and guide the RMB exchange rate expectations to remain stable. **Second**, measures should be taken to stabilize market expectations and enhance investment confidence. China will be bolder to realize internal and external opening-up simultaneously, stabilize investors' confidence

by creating a more convenient, efficient and fair business environment and make the market more attractive to investors at home and abroad. **Third**, the finance sector should support enterprises in real sectors of the economy in keeping investment and employment stable. Financial stability is conditional upon, and an assurance for, stability of the real economy. Commercial banks should unleash the driving role of credit support to economic growth, support the real economy to revitalize the stock and optimize the increment, ensure the continuity and stability of credit supply and give a steady boost to the investment willingness and ability of enterprises in real sectors of the economy.

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Institute of International Finance
1 Fuxingmen Nei Street, Beijing, 100818 China
Post code: 100818
Tel: +86-10-66592779
Fax: +86-10-66030183