Institute of International Finance

China's Economic and Financial Outlook

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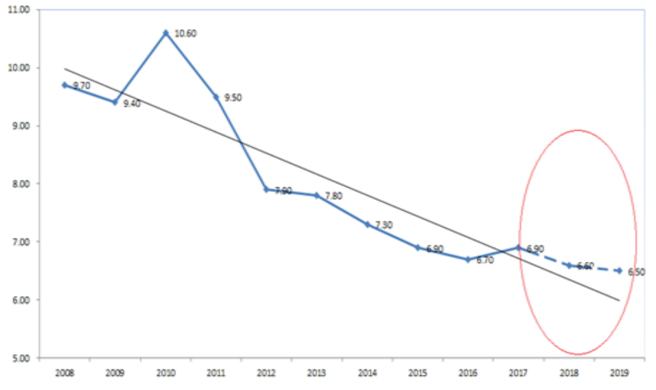
Highlights

● 2018 is an eventful year. Due to the significant changes domestically and internationally, the growth of Chinese economy remained stable but slowed down a little. The economy declined in three areas but stayed stable in other two areas. The annual GDP is expected to grow by 6.6% approximately in 2018, down 0.3 percentage point from the previous year; and the CPI is expected to grow by 2.2% around.

● The Chinese economy is expected to face a more complicated situation in 2019. There is uncertainty in the outcome of the China-US trade war, the adjustment of monetary policies of developed economies and the fluctuation in financial markets of emerging economies will continue, and the global economy has possibly entered the final phase of this round of recovery. As the Chinese economy is at an important stage of "considerable adjustments", great divergence, adjustment and integration can be seen in different sectors, regions, in areas such as the real economy and financial industry and its development. It is expected that China's GDP growth will approximately achieve 6.5% in 2019, showing a decrease from 2018.

● In response to the new changes, new issues and new challenges in the economic development, the macro-policy should adapt well to the relationship between stabilizing growth, de-leveraging and prevention of risks, and further promote the implementation of the "Six Policies to Maintain Stablization". The proactive fiscal policy should highlight tax and fee reduction and may reasonably increase the fiscal deficit ratio; the monetary policy should shift to a "released credit" from a money easy situation; the regulatory policy should keep a appropriate pace and reduce the "effect of risk disposal", that is, to continue cautiously whilst address the new and old issues.

No L-shape in Chinese Economy



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Beware of Resonance of External Shock and “Considerable Adjustments”

-- China’s Economic and Financial Outlook (2019)

In 2018, China’s economy is under a heavier downward pressure due to the significant changes domestically and internationally. The economy declined in three areas but stayed stable in other two areas. The annual GDP growth is expected to be about 6.6%. GDP is expected to grow by about 6.5% in 2019. China’s economy is still in an important stage of “considerable adjustments” and has not entered the so-called “new cycle”. The process of “considerable adjustments” may continue for another 3 to 5 years. Macroeconomic policies should pay close attention to the likelihood that external shocks resonate with considerable adjustments to trigger faster economic downturn than expected. In the future, the proactive fiscal policy should focus on reducing taxes and fees, reducing costs of businesses and increasing household income, giving full play to its unique role in expanding domestic demand, raising the fiscal deficit ratio as appropriate, speeding up the pace of “opening the front door” and properly managing the pace of “closing the back door”. The monetary policy should pursue the transformation from a money easy situation to a “released credit”, with focus on unclogging the transmission mechanism of monetary and credit policies and accelerating the construction of a “triangular” supporting framework, to provide private enterprises and small and micro businesses with easier access to financing. The regulatory policy, while sticking to the general direction, should keep an appropriate pace and reduce the “effect of risk disposal”, that is, to continue cautiously whilst address the new and old issues. We suggest “looking back” on the progress and effectiveness of the five priority tasks (i.e. cutting overcapacity, reducing excess inventory, de-leveraging, lowering costs, and strengthening areas of weakness), make timely adjustments to make these tasks better targeted and more effective, properly guide market expectations and boost the confidence, innovation and vitality of micro entities.

I. 2018 Economic Review and 2019 Outlook

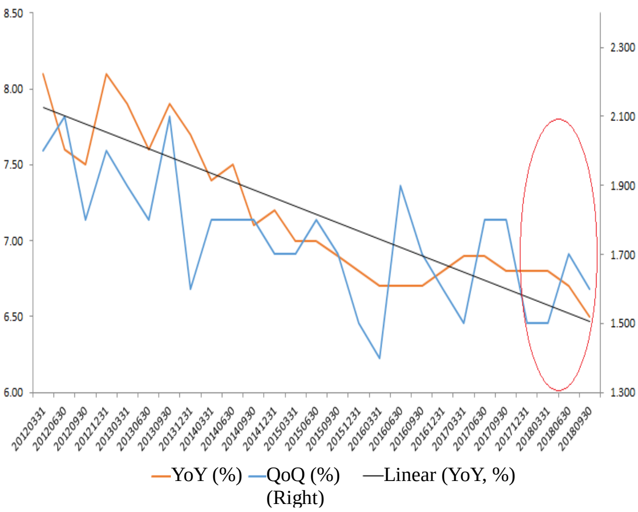
I.1 Main features of economic performance in 2018: slowdown under a mounting downward pressure

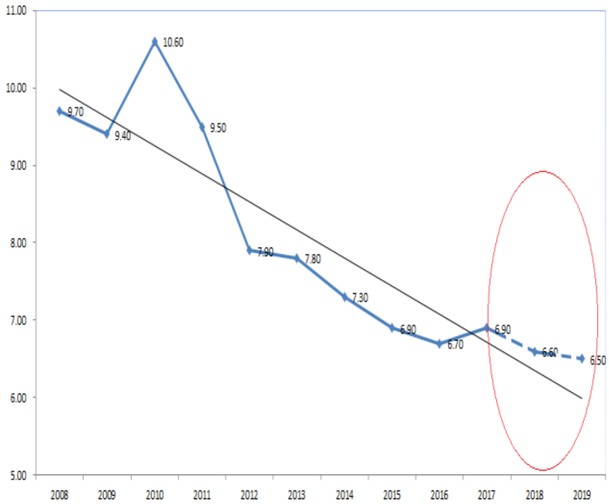
2018 marks the 40^{th} anniversary of China’s reform and opening-up and the 10^{th} anniversary of the outbreak of the last global financial crisis. It is an eventful year. Globally, the world economy has generally been continuing in recovery, albeit in a weaker momentum and showing disparities among economies. From the domestic point of view, the US-China trade war has continued to escalate. In the context of deleveraging and risk prevention, the financial supervision policy has become tighter and tighter, placing al heavier downward pressure on economic growth. Overall, the economy declined in three areas but stayed stable in other two areas:

The economy declined in three areas: First, economic growth slowed down under a mounting downward pressure. In 1Q-3Q2018, China’s GDP grew by 6.7% YoY, down 0.2 percentage points over the previous year (Fig. 1), showing a downtrend over quarters. GDP is expected to grow by about 6.6% annually (Fig. 2). **Second, the trade surplus decreased and reversed the direction of international payments.** In 1Q-3Q2018, China’s trade surplus in goods and services was USD26.6 billion, down 80% YoY. **Third, growth in profits weakened, with industrial enterprises showed**

different performance in different industries. In 1Q-3Q2018, profits of industrial enterprises above designated size increased by 14.7%, down 8.1 percentage points YoY. Industrial enterprises with stronger profitability are mainly in the energy and raw material industries (e.g. steel, coal, nonferrous metals and cement) as well as high-tech and equipment manufacturing industries. The operating conditions of ordinary manufacturing enterprises are not satisfactory or even deteriorating.

Fig.1: China's Quarterly GDP Growth Fig. 2: Chinese Economy(No L-shape)





Source: Wind, BOC Institute of International Finance

The economy stayed stable in two areas: First, stable employment. The objective of adding more than 11 million jobs set by the Chinese government at the beginning of 2018 was met one quarter ahead of schedule. **Second, stable price.** CPI rose by 2.1% in the first 10 months, up 0.6 percentage points YoY, and is expected to rise by about 2.2% annually. PPI rose 3.9%, down 2.6 percentage points YoY.

Looking back at 2018, we find the following facts: **First, the economic slowdown is due to "internal causes" rather than "external causes".** Although the US-China trade war has been escalating since the beginning of the year, China's exports have not been significantly affected by it as of October 2018. China's exports to ASEAN, EU and Japan grew rapidly. Exports to the United States also grew at a high rate (13.3%). In domestic demand, the biggest negative contributor is investment, especially infrastructure investment. The "stalling" of infrastructure investment is closely related to the tightening financial supervision. Since 2018, the government has strengthened the governance of shadow banking and off-balance sheet business and brought discipline to PPP. More and more "back doors" to marketing financing have been closed while the "front doors" are not sufficient or do not open wide enough, resulting in local governments' debt financing capacity being weakened substantially. **Second, the US factors are the biggest external uncertainty affecting China's economy in 2018.** On the one hand, the Federal Reserve's interest rate hikes and balance-sheet contraction and the resulting tight liquidity are the major cause of the global financial market turmoil. On the other hand, the United States has launched a trade war against China and other countries and imposed sanctions on Russia, Turkey and Iran, severely undermining the confidence of global investors and sending financial markets into turmoil.

1. Demand: investment and consumption growth continued to slow down, while exports maintained fast growth

The contribution of consumption to economic growth increased significantly in 2018, reaching 78%

in the first three quarters, up 13.5 percentage points YoY, the highest since 2001. The contribution of investment was 31.8% over the same period, down 1 percentage point YoY, while the contribution of net exports turned from positive to negative (-9.8%).

Consumption growth dropped to single digit, with automobile and housing markets cooling down markedly. In the first 10 months, total retail sales of consumer goods rose by 9.2% YoY, down 1.1 percentage points YoY, dropping to first single digit the first time in the last 15 years. Below are the main features: **First,** auto consumption "stalled" to shrink, compared with double-digit growth in the past. **Second,** the growth of consumption in the three major residential categories all slowed down. **Third,** the consumption of petroleum products grew fastest. **Fourth,** new forms of consumption business have further grown up.

Investment growth has hit multi-year low, contributed notably by weak infrastructure investment. Investment grew by 5.7% YoY in the first 10 months, down 1.6 percentage points YoY, the lowest growth rate since 2000. The sluggish investment growth bears a close tie to the governmental efforts to clean up PPP projects and regulate local government borrowings. Below are the main features: **First,** infrastructure investment growth "stalled". Infrastructure investment expanded by only 3.7% YoY in the first 10 months, down 15.9 percentage points YoY. **Second,** investment in manufacturing and private investment has steadily increased. **Third,** real estate investment has accelerated for the third year in a row, thanks to the marked progress in destocking. **Fourth,** investment growth showed regional disparities. The growth of investment in central and northeast China accelerated. Investment in northeast China turned from expansion to contraction. Eastern and western China saw investment growth slowing down.

Exports growth remained fast, but the trade surplus narrowed significantly. In the first 10 months, imports and exports of goods, exports of goods and imports of goods increased by 16.1%, 12.6% and 20.3% respectively in USD terms, up 4.6 percentage points, 5.5 percentage points and 2.9 percentage points YoY. Below are the main characteristics of foreign trade: **First,** trade surplus has narrowed significantly by 22.3% YoY in the first 10 months, down 1 percentage point YoY. **Second,** the trade structure continues to be refined. **Third,** the trade with countries along the Belt and Road grew faster than average. **Fourth,** private enterprises contributed a bigger share of foreign trade.

2. Supply: industrial growth showed a "high-to-low" speed transition, while the service sector growth slowed down YoY

Industrial production slowed down due to weak demand, showing a "high-to-low" speed transition. Industrial value added above the designated scale gained 6.4% YoY in the first 10 months, down 0.3 percentage points from either the same period of last year or 1H2018. Industrial value added is estimated to grow by about 6.3% annually in 2018. Compared with the previous year, the industrial sector showed fresh changes in 2018. **First, the industrial supply-demand relationship has improved in line with the supply-side structural reform progress. Some upstream and midstream industries accelerated production with profits rising sharply, putting an end to the past state of persistent downturn. Second,** operating efficiency decreased due to slower capital turnover. **Third,** a rise was seen in both number of loss-making companies and amounts of losses. **Fourth,** the middle- and high-end manufacturing industry maintained rapid growth.

The service sector had a weaker momentum of growth than a year ago, but showed a quarter-on-quarter recovery. The growth rate has been lower than 8% since July, and was only 7.2% in October, the lowest in record. **In terms of consumer services**, the growth of value added in wholesale and retail/accommodation and catering moderated due to the continued consumption slowdown, growing by 6.5%/6.7% respectively in 1Q-3Q2018, down 0.7 percentage points/0.5 percentage points YoY. **In terms of producer services,** the growth rate of value added in transport, warehousing and postal services fell to 8% in 1Q-3Q2018, down 1.2 percentage points YoY, due to the slowdown in industrial production.

Supply-side structural reform has made measurable progress, with major changes seen in some fields. First, cutting overcapacities has been progressing smoothly to improve the supply-demand relationship in industries with overcapacities. Second, the commercial housing inventory has been slashed. The unsold floor space of commodity properties decreased for three consecutive years, standing at 530 million square meters at the end of October 2018, down 12.4% YoY. **Third, the liabilities to assets ratio of businesses has declined. Fourth, the costs of businesses have been reduced. Fifth, investment grew faster in areas of weakness.** The investment in ecological protection, environmental management and agriculture has maintained rapid growth since 2016.

3. CPI-PPI divergence has narrowed: Growth of consumer prices picked up while growth of producer prices went down

The divergence between CPI and PPI numbers has narrowed markedly due to faster growth in consumer prices and slower growth in producer prices. CPI rose by 2.1% YoY in the first 10 months, up 0.6 percentage points YoY, fueled mainly by the acceleration in food prices. Food prices rose by 1.6% YoY in the first 10 months. Due to the high base in the previous year and weak overall demand in 2018, PPI growth retreated YoY to 3.9% in the first 10 months, down 2.6 percentage points YoY.

I.2 Economic outlook for 2019: beware of the resonance of external factors and “considerable adjustments”

Challenges in 2019 will be mostly from outside China. **First, the negative impact of the US-China trade war will possibly be emerged intensively, dealing a material blow to market expectations and producers’ activity. Second, the momentum of global economic recovery may weaken. Third,** the monetary policies of major economies may be divergent in the tightening process. The contraction of global liquidity and the greater disorder in international capital flows will worsen financial market fluctuations in emerging economies.

Domestically, China’s economy is still in the “major adjustments” stage and has not entered the so-called “new cycle”. Details are provided below: **First,** the transition from old engines to new ones will gain pace across industries. **Second,** wide regional disparities will emerge. Southern regions will see high economic activity, faster restructuring and sound overall performance, while the northern regions will suffer difficult transition and investment slowdown, with the business environment in urgent need of improvements and the overall performance being relatively weak. **Third,** the traditional financial services will seek transformation under pressure, while emerging financial services will moderate from “rush” to “walk”. The two forces will move from the stage of simply competing with each other to the phase of competing and cooperating with each other under the theme of well-regulated development. **Fourth,** from the perspective of development stage, China’s economy is in a critical period of getting over the “middle-income trap”. Sweeping changes in the market, rising costs, intensifying competition and tougher supervision have all brought a huge impact onto the traditional development model. After years of rapid development, emerging industries have encountered a dilemma: importing is difficult, and innovation is even more difficult.

In addition, a series of powerful new measures have been taken to tackle new economic problems and challenges emerging in 2018. These policies will begin to work and underpin the steady economic growth in 2019. **First, macro policies have begun to adjust and relax. Second, the recovery of infrastructure investment is expected to reverse the downturn of investment growth. Third, stronger efforts will be made to improve the business environment.**

1. New policies will shore up solid growth in consumption.

The following factors will give impetus to consumption growth in 2019: **First, the latest individual income tax (IIT) reform will boost people's income.** The latest IIT reform has raised the minimum threshold for IIT to RMB5,000 per month. Tax brackets have been widened for the tax rates of 3%, 10% and 20%, with additional deductions introduced for six items of expenditure, including dependent children's education and continuing education. **Second, the consumption system, mechanism and policy environment will be further improved.** The improved consumption policy system, system of standards and credit system help bring out the spending potential of individual consumers. **Third, individual consumers will have stronger confidence and willingness to spend.** However, there are also some hurdles to the growth of consumer spending. **First, the surge in household-sector leverage ratio has curbed the consumer spending power. Second, after years of sustained fast growth, the market focus of consumer goods such as cars and mobile phones has gradually shifted from the increment to the stock.** Overall, consumption is expected to grow by about 9% in 2019, slightly slower than in 2018.

2. Investment growth may accelerate on pro-investment policies issued frequently

In 2019, the factors supporting investment growth include the following: **First, a series of pro-investment policies have been issued in succession.** On July 31, 2018, the Political Bureau of the CPC Central Committee included investment on the list of "six stabilizers". The policy is expected to work progressively. **Second, strengthening areas of weakness, especially infrastructure, will become a priority task in the supply-side structural reform.** As local governments have introduced plans to strengthen areas of weakness one after another, infrastructure investment is expected to recover gradually. **Third, private enterprises have received stronger supports from all sides.** Central authorities and local governments have made vigorous efforts to support private enterprises with a series of new measures. Private-sector investment is expected to grow steadily or even faster. However, there are also some factors adverse to the acceleration in investment growth. **First, the growth of real estate investment may slow down. Second, the sources of investment funds are still limited.** Overall, investment is expected to grow by about 6% in 2019, a slight rise over 2018.

3. The momentum of foreign trade growth will be weakened by combined domestic and foreign factors

The growth of foreign trade will be dragged down by the following factors in 2019: **First, the momentum of global growth will be moderated by a number of uncertainties and destabilizing factors. Second, the rise of trade protectionism and the increase of trade barriers will curtail the recovery of global trade.** WTO lowered its forecast for 2019 global trade in goods from 4% to 3.7% at the end of September 2018. **Third, China's foreign trade orders have decreased.** The number of exhibitors and the value of transactions at the Autumn Canton Fair decreased by 1.1% and 1% respectively YoY. In particular, the orders with the United States fell by 30.3%. **Fourth, the US-China trade friction has not been properly resolved.** If no agreement will be reached soon, the trade friction between the two major economies may further escalate in early 2019, which will deal a heavier blow to China's foreign trade growth.

Below are favorable factors for foreign trade growth: **First, the policies to stabilize foreign trade were issued frequently. Second, the RMB depreciation makes China a more competitive exporter.** At the end of October, RMB fell in value by 6.8%, 1.2%, 6.4% and 0.9% against USD, EUR, JPY and GBP respectively, which helps offset part of the negative impact of trade protectionism. **Third, China has taken the initiative to expand imports.** Taking the opportunity of the China International Import Expo, China will reduce the institutional cost of imports and cut tariffs to better meet the needs of domestic producers and consumers. In general, China's exports are expected to grow by about 6% and imports by about 10% in 2019.

4 . The growth of industrial and service sectors will edge down amidst the ongoing transition from old to new engines of growth

There will be some favorable factors for the industrial sector in 2019: **First, the government continues to improve the business environment.** The fiscal policy will still focus on tax and fee reduction. The monetary policy will focus on unclogging the transmission mechanism and channeling funds into the real economy to provide the private sector of the economy as well as small and micro businesses with easier access to financing. **Second, the industry structure upgrading remains the prevailing trend.** The market will become further concentrated in industries with overcapacities and emerging industries will keep growing fast. **Third, macro policies will be fine-tuned pro-cyclically as appropriate.** Infrastructure investment growth will recover steadily. **Fourth, the goal of cutting overcapacities is about to be fulfilled.** The goal of removing excessive industrial capacities will be met for the steel industry in 2018 ahead of schedule, and be substantially met for the coal industry in 2019. At the same time, industrial production also faces some unfavorable factors. **First, as the momentum of global recovery weakens and the foreign demand for Chinese goods slows down,** exports will become a weaker driver of industrial production. **Second, with sluggish growth in domestic consumption, real estate investment growth may continue to slow down. Third, midstream and downstream enterprises have seen their profits growing markedly slower in 2018.** Overall, industrial value added is estimated to grow by about 6.2% in 2019.

In terms of consumer services, the growth in traditional service industries, such as wholesale and retail as well as accommodation and catering, will be stable with a downtrend due to the still-weak momentum of consumption growth. The tough curbs on real estate will remain a steadfast overall policy. **In terms of producer services,** the growth rate of transport, warehousing and postal services as well leasing and commercial services may continue to pull back in the context of moderating industrial growth. Overall, the value added of the service sector is expected to increase by about 7.6% in 2019.

5. The overall price level is stable, but the swine fever epidemic and imported inflation require special attention

Inflation is expected to remain in a reasonable and controlled range in 2019. **First, the momentum of growth is limited on the demand side of the economy. Second, prudence will remain the defining feature of the monetary policy**, so there is no monetary ground for a surge in inflation. **Third,** the inflation pickup in 2018 was mainly driven by short-term factors such as extreme weather and disasters, which are expected to gradually ease in 2019. It is worth noting that the uncertainty about whether the African swine fever epidemic can be controlled or not is likely to further fuel inflation. CPI is expected to increase by about 2.3% in 2019. Considering the marked improvement in supply-demand relationship and the task of cutting overcapacity approaching its end, we expect PPI growth to further slow down to about 3% in 2019.

II. Financial Review in 2018 and Outlook for 2019

In 2018, China has lowered the reserve ratio requirement four times in line with the major changes in the economic and financial situations at domestic and abroad, strengthened refinancing and rediscounting for small and micro enterprises, created support tools for private enterprise bond financing, and restarted the counter-cyclical adjustment factor to the foreign exchange risk reserve and the pricing model for the central parity of RMB against USD. The financial market was generally stable, RMB loans grew rapidly and the money market interest rates dropped significantly. However, the growth of aggregate financing to the real economy was sluggish, businesses suffered a lack of affordable financing and the financial market fluctuations widened.

II.1 Main financial features in 2018: The slower expansion of financing made financing difficulty again

1. Financial market supply was tightening, and off-balance-sheet financing dropped remarkably.

In 2018, as the previously issued tough regulatory policies began to work and the financial service sector stepped up deleveraging, the distraction of financing from its intended purpose has been curbed. However, the radical deleveraging and risk prevention policies have also blocked many enterprises' access to financing, and led to a marked contraction in total credit. RMB lending grew steadily. The money and credit supply showed the following characteristics:

M1 growth continued to decline (Fig.3) and growth of corporate current deposits was weak. The tougher supervision has forced corporate financing needs back onto the balance sheet of banks. In the shift from old to new financing channels, enterprises found themselves at a rising liquidity risk due to the longer accounts receivable period and slower growth of demand deposits. M1 grew by 2.1% YoY, the second lowest growth rate ever.

Fig. 3: Major Financial Supply Indicators Weakened

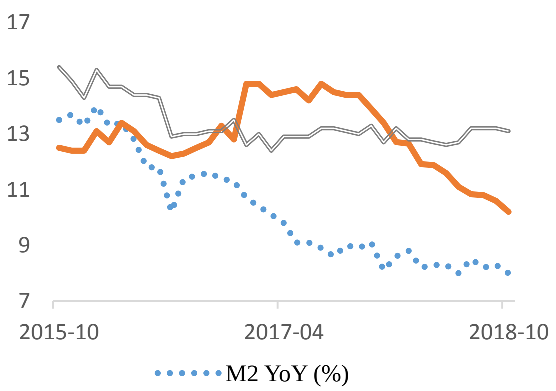
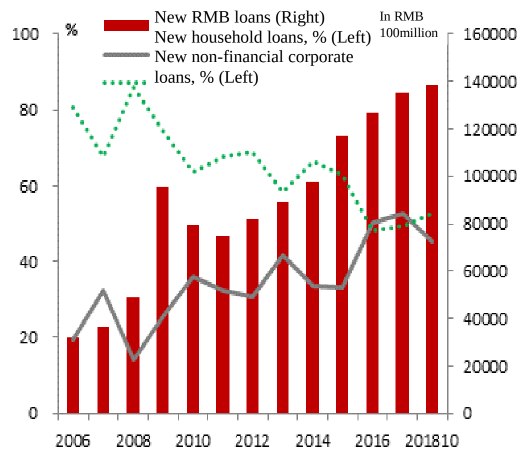


Fig. 4: Breakdown of New RMB Lending



Source: Wind, BOC Institute of International Finance

The significant decline in off-balance-sheet financing was the primary contributor to the weaker growth in aggregate financing. Incremental financing to the real economy amounted to RMB16.1 trillion in the first 10 months, down RMB2.8 trillion from the same period of 2017. Specifically, off-balance-sheet financing (trusts, entrusted loans and undiscounted bank acceptances) fell by RMB2.57 trillion in total, primarily dragging on the growth of incremental financing to the real economy. Direct financing (stock financing + bond financing) took up a larger share, of which bond financing registered a relatively large increase. New bond financing was RMB1.72 trillion in the first 10 months, an increase of RMB1.42 trillion YoY.

RMB loans grew rapidly, while medium- and long-term loans grew sluggishly. RMB loans grew rapidly in 2018 on the return of off-balance-sheet financing to the balance sheet, among others (Fig. 4). By sector, new loans to the business sector as a percentage of total new loans increased to 52.5% in the first 10 months from 49.6% in 2017, while the household sector saw its share falling to 45.2% from 52.7% in 2017. Leverage growth slowed down in the household sector. By term structure, incremental medium- and long-term loans took up a smaller share.

2. Money market interest rates have dropped markedly, but the policy transmission mechanism has yet to be unclogged.

First, money market interest rates have dropped significantly. On November 22, the 7-day weighted average unsecured lending rate between depository institutions (DR007) was 2.64%, down 50 bps from the end of last year. **Second,** the liquidity term mix has improved. In 2018, PBOC increased its supply of medium- and long-term liquidity and lowered the reserve ratio requirement four times in January, April, July and October respectively. MLF totaled RMB4,074 billion in 1Q-3Q2018, with a term of one year. **Third,** the monetary policy transmission mechanism needs to be further unclogged. The interest rate movements varied across markets is not consistent. Lending rates did not move in lockstep with money market rates.

3. The bond market was trending up and more default risk events occurred

In 2018, in spite of the rising number of bond defaults, the bond market as a whole was improving mainly due to stronger risk aversion in the market, the moderately easy liquidity and the continued reform and opening-up of the bond market. **First,** the scale of bond issues expanded, but the bonds issues of unlisted companies decreased. **Second,** both price and yield of bonds dropped. In terms of issue interest rate, the weighted average interest rate of inter-bank certificates of deposit issued in November stood at 3.459%, down 129 bps YoY, which is the sharpest fall of all. Bonds issued by listed companies recorded the second sharpest decline in issue price, while bonds issued by unlisted companies registered a relatively small drop. In terms of yield, the yields of 1-year and 10-year treasury bonds and 3-year AAA-rated bonds of listed companies all went down. **Third,** term spread widened and credit spreads became divergent. On November 22, the 1-year/10-year treasury bond yield spread was 90 bps, up 81.3 bps from the end of last year. The credit spreads of unsecured bonds varied with rating: credit spread narrowed for high-rating unsecured bonds and widened for low-rating ones. **Fourth,** credit risk incidents increased significantly.

4. The stock index fluctuated lower and the capital market reform continued to deepen

In 2018, the overall performance of the stock market was sluggish and highly volatile. **First, the stock index trended down.** Since October, A-shares have fallen to its low in the year (the Shanghai Composite Index hit a fresh low of 2449 since 2015 on October 19) resonating with global stock market fluctuations, followed by continuous issuance of favorable policies to stabilize the market. **Second, both turnover and market capitalization have contracted significantly.** As of October 2018, the cumulative turnover of Shanghai and Shenzhen stock markets was RMB76.98 trillion, down 31.49% from the previous year. As for changes in market value, as of November 22, the total market cap and tradable market cap of A shares in Shanghai and Shenzhen were RMB46.4 trillion and RMB37.5 trillion respectively, down 17.83% and 16.26% respectively from the end of last year. **Third, the share pledge risk has triggered concerns.** The market downturn, stock price drop and the share pledge crisis of listed companies have formed a vicious circle. Thanks to the concerted efforts from various sides, however, risks have been significantly mitigated. **Fourth, capital market reforms have gone deeper and deeper.** A series of policies were introduced or implemented, including relaxing restrictions on foreign investment, issuing China Depository Receipts (CDR), setting up the Technology Innovation Board and piloting the registration system.

5. Internal and external factors worked together to quicken RMB depreciation.

The RMB has fallen in value against the US dollar in 2018. The central parity rate of RMB against USD was 6.9306 on November 23, down 5.72% from the end of 2017. **First, RMB exchange rate swung in both directions markedly. Second, the market was more tolerant of exchange rate fluctuations. Market entities remained rational in the settlement and sale of foreign exchange.** The deficit of foreign exchange settlement and sales was USD30.98 billion in the first 10 months, down 72% YoY. **Third, the RMB depreciation represented the combined effect of internal and external factors.** RMB was weaker than in 2017 due to China's economic downturn, trade surplus contraction, escalated trade war and rising risks in emerging markets. In particular, RMB depreciation was accelerated in Q3. **Fourth, PBOC attaches greater importance to management of expectations.** To avoid herd behaviors in the onshore foreign exchange market, PBOC resumed the foreign exchange risk reserve requirements and the counter-cyclical factor successively to smooth out excessive market fluctuations effectively. In the offshore market, the offshore exchange rate movements were effectively managed by issuing offshore central bank bills.

II.2 Financial outlook for 2019: Explore structural opportunities exist in a complex environment

Looking ahead to 2019, the "Six Policies to Maintain Stabilization" will work to correct the over-tight financial supply. M2 and growth of aggregate financing to the real economy will stabilize at private businesses and small enterprises are likely to have easier access to financing. The stock market is stabilizing and expected to rebound, showing a "high-to-low" recovery throughout the year. The debt burden of local governments will increase. Financial markets such as the exchange rate may fluctuate beyond expectations in the context of the Fed's interest rate hikes.

1. Authorities' coordinated efforts to restore credit are expected to improve the availability of financing to private businesses and small enterprises.

As the "Six Policies to Maintain Stabilization" are implemented continuously, individual business entities will have stronger confidence in 2019 to fuel a slight pickup in credit demand. **First,** M2 and the aggregate financing to the real economy will stabilize at lows. With the central bank speeding up the "triangular support framework", enterprises will get more financing from the stock and bond markets. Meanwhile, the monetary policy will remain prudent, with M2 expected to grow by 8.5% in 2019 and the stock of aggregate financing to the real Economy to grow by 10.2% YoY. **Second,** RMB loans will expand steadily. As the government increases its support for infrastructure investment, the over-fast decline in infrastructure investment will be improved. New RMB loans are expected to be about RMB16 trillion in 2019.

2. Liquidity will remain reasonably ample, with money market interest rates expected to further decline

First, the downward pressure on the economy will increase in the future due to such factors as the US-China trade war and weak economic momentum, requiring a relatively loose monetary policy environment. The monetary policy is expected to remain prudent, providing a favorable environment for continued decline of money market interest rates. **Second,** the eased inflationary pressure will bring down medium- and long-term interest rates. As for CPI, future demand is unlikely to improve as the earlier disturbance factors has gradually subsided and the property market and auto market have cooled down. As for PPI, oil prices are in decline and have weak momentum for future pickup. The combined effect of the two factors will ease the inflationary pressure and drive down medium- and long-term interest rates.

3. US-China interest spread is more probable to widen but the bond market is still expected to continue to stabilize with a positive outlook.

First, the mounting downside pressure to economy and still-loose liquidity favor the bond market growth. It will still take time for a series of policies to work. The monetary policy will remain prudent and neutral to bolster the bond market. **Second,** new policies to step up bond market development are expected. With the government increasing its support for infrastructure investment, the bond market will become an important source of infrastructure financing in 2019. The government will further encourage bond market development, and is expected to lower the risk weight of local government debts as appropriate and issue other policies to boost investors' willingness to hold local government bonds.

4. The stock market will fortify its bottom in fluctuations and the market sentiment will be restored

In 2019, A shares will show a trend of leveling first and turn stronger later. **First, the** "Six Policies to Maintain Stabilization" **will begin to work gradually.** The economy is expected to stabilize in the second half of 2019 to weather earlier downside pressure, which is conducive to bottoming out of the stock market. **Second, the market sentiment will be restored.** As the investor pessimism caused by the escalated US-China trade frictions has been substantially released, the market is expected to stabilize in the future. **Third, liquidity will improve from quarter to quarter.** With the gradual implementation of the policy of mitigating equity pledge risks, the liquidity of private enterprises will improve. Insurance and wealth management funds have begun to enter the market gradually, expected to flow in as incremental funds throughout 2019.

5. RMB/USD exchange rate will fall within a controllable range

Given the shock waves of international risks and the divergent trends in domestic and foreign monetary policies, the RMB exchange rate is expected to be steadily declining against USD in 2019. **First,** the US interest rates will remain in the up-cycle to strengthen the USD index. **Second,** the impact of escalated US-China trade war on China will be gradually released. **Third,** China's economic growth might slow down in 2019, a negative factor for RMB/USD exchange rate. But there are still some stabilizing factors for the foreign exchange market: **First,** China will receive more capital inflows as its market opens wider. The overall supply and demand of foreign exchange will remain stable. The central bank's toolbox includes many tools to stabilize the exchange rate. Thus RMB exchange rate is expected to be more stable in the future. **Second,** the US economic expansion has entered the later stage. The potential risks in the US economy have a disturbing effect on the Fed's interest rate hikes.

Table 1: Main Indicators and Forecast of China's Economy and Finance in 2019 (%)

Indicator	2016 (R)	2017 (R)	2018 Q1 (R)	2018 Q2 (R)	2018 Q3 (R)	2018 Q4 (E)	2018 Annual (E)	2019 (F)
GDP	6.7	6.9	6.8	6.7	6.5	6.5	6.6	6.5
Industrial value added above designated size	6.0	6.6	6.8	6.6	6.0	6.1	6.3	6.2
Value added of the services sector	7.8	8.0	7.5	7.8	7.9	7.9	7.8	7.6
Fixed asset investments	8.1	7.2	7.5	5.2	4.5	8.0	6.0	6.5
Total retail sales of consumer goods	10.4	10.2	9.8	9.0	9.1	8.8	9.2	9.0
Exports	-7.7	7.9	13.7	11.4	11.9	15.0	13.0	6.0
Imports	-5.5	16.1	19.4	20.6	20.4	20.0	20.0	10.0
Consumer Price index (CPI)	2.0	1.6	2.1	1.8	2.3	2.3	2.2	2.3

Producer price index (PPI)	-1.4	6.3	3.7	4.1	4.1	3.1	3.7	3.0
Broad money supply (M2, ending balance)	11.3	8.2	8.2	8.0	8.3	8.0	8.0	8.5
Aggregate financing to the real economy (Stock)	12.8	13.4	11.9	11.1	10.6	10.1	10.1	10.2

Source: BOC Institute of International Finance

III. Macroeconomic Policy Forecast

In 2019, macroeconomic policies should pay special attention to the resonance of external shocks and "considerable adjustments". In the future, China will further implement the policies on "Six Stables" (i.e. keep employment, financial sector, foreign trade, foreign and domestic investments and expectations stable) to tackle new changes, new problems and new challenges in the economy.

III.1 Focus on tax and fee reduction: The fiscal policy will give stronger impetus to domestic demand

First, the government will take further steps to cut taxes and fees effectively. The VAT reform will be accelerated to reduce the corporate tax rates by shifting from three tax brackets to two brackets. **Second, effective investment will be strengthened in key fields and weaker areas.** Government spending will stay close to national plans and major strategies to step up investments in backbone transport networks (e.g. railways and highways in the central and western regions), agricultural infrastructure (e.g. major water conservancy projects), key ecological and environmental protection projects, technological upgrading, and livelihood (e.g. elder care). **Third, the "front door" will be opened faster to ensure the reasonable financing function of the financing platform.** Infrastructure projects will be funded by speeding up government spending, promoting the transfer of state-owned land use rights and PPP. Infrastructure expenditure will be reasonably arranged within the budget. **Fourth, raising the deficit ratio to 3% is suggested.**

III.2 Leverage on macro-prudential countercyclical adjustments to make financing more accessible for private businesses and small and micro enterprises

First, it is still necessary to reduce required reserve ratio, albeit in an appropriate pace and magnitude. Second, regulatory flexibility will be further increased through macro-prudential countercyclical adjustment. The exchange rate expectations will be guided to keep the RMB exchange rate basically stable at a reasonable level. **Third, China will help enterprises defuse liquidity risks and channel funds into weaker sectors of the national economy, including small and micro enterprises and green economy. Fourth, policy guarantee agencies will fully function to mitigate risks.**

III.3 the policy on the five priority tasks will be assessed and adjusted as appropriate to boost the confidence, innovation ability and vitality of economic entities

Deleveraging: More attention will be paid to the intensity and pace of deleveraging. "Debt-to-equity swap" will be advanced in a market-based manner. Deleveraging will be aligned with the reform of SOEs to increase their efficiency. **Cutting overcapacities:** More attention will be paid in the future to guiding enterprises toward clean, efficient, safe and green production under applicable environmental, safety and technical standards. High-quality industrial capacities will be fostered by eliminating backward capacities. **De-stocking:** De-stocking will be aligned with efforts to build a long-term mechanism for real estate development. Differentiated credit policies will be used to ensure stability of the real estate market. **Reducing costs and strengthening weaker areas will be crucial elements of the supply-side structural reform in 2019.** They will not only further energize various economic entities, but also boost domestic demand and stabilize growth with vigor.

III.4 Working hard to effectively implement the pro-trade policies and properly dealing with protectionism and trade frictions

First, China will take steps to ensure the existing policies work effectively, improve trade liberalization and facilitation policies, further speed up customs clearance, reduce customs clearance fees and clean up and standardize fees charged on trading companies. Second, forward-looking measures will be taken at appropriate time to ensure preparedness for trade frictions and resilience to foreign trade uncertainties. **Third,** China will speed up the building of foreign trade transformation bases, expand new space for foreign trade, such as the Belt and Road Initiative, strengthen economic and trade cooperation with the EU, Japan and ASEAN and develop new strengths in international competition. **Fourth,** China will create a good business environment, support the development of new foreign trade forms and new models and vigorously develop cross-border e-commerce and market procurement trade. **Fifth,** China will take the initiative to expand imports, promote the balanced development of foreign trade, encourage expanded imports of consumer goods, medicines and rehabilitation, nursing and elder care devices and continue to host the China International Import Expo. **Sixth,** China will deepen the reform and innovation of FTZs and cause the regional comprehensive economic partnership agreement (RCEP) negotiations to be concluded as soon as possible.

III.5 Properly handling the local government debt issue and steping up improvements in relevant supervision and risk early warning mechanisms

Local hidden debts are expected to become the focus of local government debt risk prevention in 2019. **First, the local government debt issue will be solved progressively through revenue expansion, expenditure reduction and replacement.** A local taxation system will be gradually established to streamline spending obligations and broaden financing channels. Strict restrictions will be imposed on construction of new government buildings and other infrastructures that do not generate cash flows. Based on corporatizing the local government financing vehicles, PPP will be further regulated to rearrange for projects and replace shorter-term or higher-cost debts. **Second, local governments' balance sheets will be prepared and published to establish a data collection system and an early warning mechanism.** A foreign government debt data collection system will be created. Efforts will be strengthened to establish the early warning system and the emergency response mechanism for local government debt risks.

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