

China's Economic and Financial Outlook

2019Q2 (Issue 38)

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Highlights

- In the first quarter of this year, China's economy still faced big downward pressure under the influence of both favorable and unfavorable factors. We expect that GDP will increase by approximately 6.2% in Q1, down 0.6 percentage point YoY and 0.2 percentage point lower than the previous quarter; CPI will increase by around 1.6%, which is 0.6 percentage point lower than the previous quarter.
- Looking forward to Q2, domestic policies and market environment will be improved in spite of the complicated and volatile external environment. The *Report on the Work of the Government* lays out the planning of large-scale cuts of taxes and fees, increasing infrastructure investment to strengthen areas of weakness, and making financing more accessible and affordable to businesses. Since the release of the report, the leading indicators such as the new order index and the production and operation activity expectations index are already rising. We expect China's GDP will grow by about 6.3% in Q2, which is slightly higher than that in the first quarter; and CPI will be up by about 2%.
- As for macro-economic policies, first, China will speed up the implementation of policies laid out in the *Report on the Work of the Government*, so that these policies will timely work as a cushion against the additional tariffs China and the United States exchanged in their trade frictions; second, China will pay close attention to price changes and properly control the pace and intensity of monetary and credit policies based on economic operation; third, considering the great uncertainties loom in external environmental changes such as US-China trade frictions and global economic slowdown, we suggest keeping close track of them and putting in place policy buffers and contingency plans.

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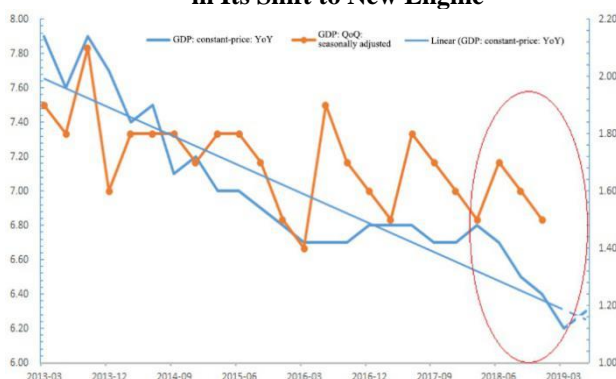
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China's Economic Growth Slowed down
in Its Shift to New Engine



China Counts on Large-scale Tax Cuts to Buoy the Economy

-- China's Economic and Financial Outlook (2019Q2)

In 2019Q1, China's economy still faced big downward pressure under the influence of both favorable and unfavorable factors. On the one hand, exports growth turned from positive to negative amid slowing global recovery and US-China trade frictions. On the other hand, with a series of policies launched and implemented, including the "six-pronged policy to boost stability", the economy saw a rising number of stabilizing factors: pickup in infrastructure investment growth, rebounding consumer confidence index, improving financing environment and capital market recovery. GDP growth is expected to be around 6.2% in Q1, down 0.2 percentage point from the previous quarter. Looking forward to Q2, domestic policies and market environment will be improved in spite of the complicated and volatile external environment. The *Report on the Work of the Government* lays out the planning of large-scale cuts of taxes and fees, increasing infrastructure investment to strengthen areas of weakness, and making financing more accessible and affordable to businesses. Since the release of the report, the leading indicators such as the new order index and the production activity expectations index are already rising. China's GDP is expected to grow at about 6.3% in Q2, slightly higher than that in Q1. As for macro-economic policies, first, China will speed up the implementation of policies laid out in the *Report on the Work of the Government*, so that these policies will work as a cushion against the additional tariffs China and the United States exchanged in their trade frictions. Second, China will pay close attention to price changes in the "hog cycle" and properly control the pace and intensity of monetary and credit policies based on economic operation. Third, considering the great uncertainties loom in external environmental changes such as US-China trade frictions and global economic slowdown, we suggest keeping close track of them and putting in place policy buffers and contingency plans.

I. 2019Q1 Economic Review and Q2 Outlook

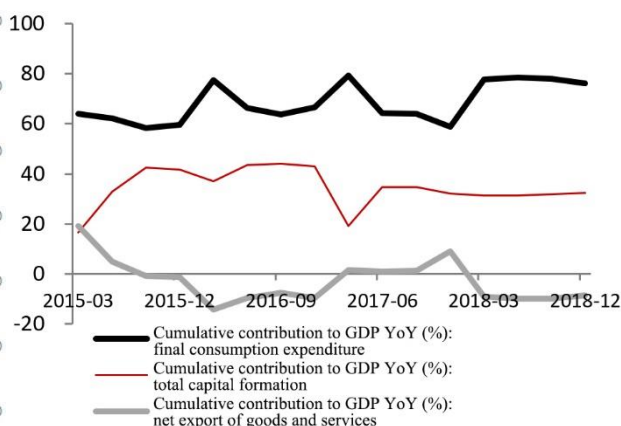
I.1 The economic growth continued to slow down in Q1 with a mix of drivers and drags

From the beginning 2019, China's economy faced big downward pressure under the influence of both favorable and unfavorable factors. On the one hand, exports growth turned from positive to negative amid slowing global recovery and US-China trade frictions. Such reversal confirms an important conclusion that China's economy will be more challenged by a tightening external environment in 2019, unlike the situation in 2018 where downward pressure mainly came from domestic factors. Also, industrial activity slowed down due to contraction in exports. On the other hand, however, the Chinese government has launched a series of policies (typically, the "six-pronged policies to boost stability") since 2018H2 against the downward pressure on the economy, including large-scale tax cuts, strengthening areas of weakness in infrastructure, easing or tightening the monetary policy appropriately and working hard to improve the business environment.

Fig. 1: China's Economic Growth Slowed down in Its Shift to New Engine



Fig. 2: Contribution (%) of Three Demands to GDP Growth



Source: Wind, BOC Institute of International Finance

I.1.1 Demand side: The economic growth is still approaching its bottom under a sustained downward pressure

On the demand side, China's economy showed "up in one sector and down in two sectors" in the first two months of 2019. That is, investment growth picked up mainly backed by infrastructure and real estate; consumption and exports decelerated due to the weak demand at home and abroad.

First, investment growth picked up as the policies to shore up areas of weakness in infrastructure has begun to work. Chinese government issued a six-pronged policy in 2018H2 to boost stability against the downward pressure on the economy. Strengthening infrastructure was regarded as a crucial move to "stabilize investment", and supports were given in terms of project approval, capital adjustments and expedited issuance of local governments' special bonds. **By investment category, infrastructure investment and real estate investment grew faster.** Infrastructure investment turned from deceleration to acceleration, becoming a major backing for investment growth and larger economy. In addition, real estate investment grew faster than expected, thanks to the faster expansion in floor space under construction. Manufacturing investment, however, slowed down markedly due to exports contraction, PPI plunge and weaker profits of businesses. **By industry, investment in primary and secondary industries slowed down significantly, while investment in the tertiary industry gained pace.** In the first two months, investment in primary and secondary industries grew by 3.7% and 5.5%, down 9.2 percentage points and 0.7 percentage point from the annual growth rate for 2018, respectively. The tertiary industry saw a 6.5% rise, up 1 percentage point from the annual growth rate for 2018. **By region, western and northeastern regions of China saw an acceleration in investment, compared with a deceleration in eastern and central regions.** During January and February, investment in western and northeastern regions rose by 7.6% and 5.7%, up 2.9 percentage points and 4.7 percentage points from the annual growth rate for 2018, respectively. Investment in eastern and central regions expanded by 3.3% and 9.4%, down 2.4 percentage points and 0.6 percentage point from the annual growth rate for the previous year, respectively.

Second, consumption growth continued to decelerate, hitting the lowest over the same period since 2000. Specifically: **First, the three major categories of housing-related consumption slowed down notably amid the declining housing sales.** In January and February, furniture, household appliances and audio/visual devices as well as building and decoration materials saw an increase of 0.7%, 3.3% and 6.6%, down 9.4, 5.6 and 1.5 percentage points from the annual growth

rate for 2018, respectively. **Second, automobile consumption continued to shrink, yet at a slower rate.** Automobile sales fell by 2.8% cumulatively in January and February, a deceleration of 5.7 percentage points compared with December 2018. **Third, the acceleration in upgrade-related commodity consumption points to continued consumption upgrade.** Sales of communication devices, cosmetics and gold/silver jewelries grew by 8.2%, 8.9% and 4.4% cumulatively during January and February, up 9.1, 7 and 2.1 percentage points from the annual growth rate for 2018, respectively.

Third, both imports and exports weakened due to sluggish demand at home and abroad. Export growth declined significantly (-4.6%) in January and February, down 14.5 percentage points from the annual growth rate for 2018, as a result of sluggish foreign demand, US-China trade frictions, order lead time and shifts in the industrial chains. By country and region, China's exports to most of its trade partners decelerated. In particular, its exports to the United States recorded the sharpest fall. In addition, China's exports to the EU, Japan, South Korea, ASEAN, India, Brazil, Russia and Canada slipped to various degrees, mainly due to global economic slowdown, escalating global protectionism, shifts in the industrial chains (e.g. Samsung is moving its smartphone assembly lines to Vietnam) and stronger RMB. From January and February, import growth was -3.1% YoY, down 18.9% percentage points from the annual growth rate for 2018. The import decline reflects weaker domestic demand in the context of economic downturn.

I.1.2 Supply side: The deceleration in industrial activity and stable growth in the service industry suggested a short-term downward pressure and the momentum for transformation over medium and long terms

On the supply side, **first, industrial activity slowed down on softer demand and seasonal factors.** Industrial value added above the designated scale gain a 5.3% growth in the first two months, 0.9 percentage point below the annual growth rate for 2018. With seasonal factors related to the Chinese New Year excluded, growth rate of industrial value added is revised slightly upward to 6.1%, yet still slower than annual growth in the previous year. Industrial production is estimated to grow by 5.5% or so in Q1, relatively weak and down 1.3 percentage points over the same period of last year.

Industrial activity showed three noteworthy characteristics in the first two months. **Firstly, production sped up in energy-intensive industries and some equipment manufacturing industries.** Effective removal of overcapacities and pickup in investment in infrastructure and other areas fueled the production in related industries. **Secondly, production by private enterprises accelerated notably,** which could be attributable to the government's tax cuts launched last year in support of the private sector. **Thirdly, emerging industrial sectors saw the production growing rapidly.**

Second, growth in the service sector was stable overall, with the value added of the financial industry picked up. As for consumer services, wholesale and retail as well as hotels and catering saw slower growth in value added than a year earlier due to weaker consumption growth. **As for producer services,** industrial production was weak in general. In the first two months, the Logistics Prosperity Index was weaker YoY, and transportation, storage and postal services are estimated to see slower growth in value added. Financial value added is estimated to accelerate in the context of stable and relaxing monetary policy, sufficient liquidity, stronger-than-expected stock market and expedited bond issuance. Overall, the services climate index is projected to grow at approximately 7.4% in Q1, up 0.2 percentage point over 2018Q4. Service value added is expected to rise by approximately 7.4% in Q1, down 0.1 percentage point YoY.

I.1.3 The scissors difference between CPI and PPI was reversed in an overall price pullback

Prices outline the overall supply and demand in economy. The first two months saw both consumer

and producer prices falling in a cooling economic climate. **Growth in consumer prices weakened**, as shown by CPI going up 1.6% YoY, 0.5 percentage point below the annual growth rate for 2018. Both food and non-food prices softened. Food prices were less inflated, as shown by CPI going up 1.3% YoY, 0.5 percentage point below the annual growth rate for 2018. Non-food prices grew by 1.7%, a 0.5 percentage point pullback from the annual growth rate for 2018, mainly due to moderation in housing, transportation and communication, and healthcare prices. **The high base in 2018 and the weak overall demand led to a setback in PPI.** PPI rose by 0.1% in the first two months, 3.4 percentage points below the annual growth rate for 2018. It should be noted that historical data show PPI more volatile than CPI. During economic downturn with weakening market demand, PPI growth is usually slower than CPI growth. During economic upturn with strong market demand, PPI usually outpaces CPI (thus PPI is taken as a leading factor and CPI as a lagging factor in macro-economic climate analysis). Now the scissors difference between CPI and PPI was reversed, with PPI growing slower than CPI. It suggests weak demand and significant downward pressure on the economy.

1.2 China's economy will firm up in Q2 on policy support

Looking forward to Q2, China's economy will remain in a tight global environment given the uncertainty of the outcome of China-US trade talks, high probability of global economic downturn, Brexit and geopolitical impact. Thus China is likely to see sluggish growth in foreign trade. Domestically, however, both policy and market environments are improving. Overall, China's GDP is projected to grow at approximately 6.3% in Q2, a slight pickup over Q1. The economy is expected to pick up pace throughout 2019 to finish the year with an annual GDP growth rate of around 6.4%.

On the demand side, consumption and investment will accelerate, while exports will decelerate. Consumption growth will rally. First, the individual income tax reform increases the disposable personal income, thereby boosting the real purchasing power and spending ability. **Second**, relevant authorities may re-launch pro-consumption policies to encourage automobile and household appliance purchases in rural areas and subsidize purchases of new energy vehicles, giving a boost to the sales of automobile and household appliances. **Third**, the city-specific policy on real estate, coupled by further relaxation of the residence registration policy and decline in mortgage rates, will release part of the suppressed demand. Housing-related consumption is likely to firm up.¹ Overall, consumption growth is projected to be approximately 8.5% in Q2, a pickup over Q1.

Investment growth will keep recovering, yet modestly. Specifically, manufacturing investment will recover and infrastructure investment will pick up further. The cooling land market, however, will weigh on real estate investment. **First**, profits of industrial enterprises and manufacturing investment will bottom up thanks to the favorable factors such as demand recovery, PPI pickup, profit improvements driven by tax cuts and more effective transmission from easy monetary policy to loose credit. **Second**, the *Report on the Work of the Government 2019* has laid out requirements to raise deficit-to-GDP ratio and expand budgetary deficit, substantially scale up special bond issuance and gradually lower capital contribution requirements for infrastructure projects, which will boost the infrastructure investment growth. **Third**, the declines in leading indicators including real estate sales, land purchases and housing starts, together with frequent land auction failures in the previous year, indicate a heavy downward pressure on real estate investment. Overall, fixed asset investment is expected to grow by around 7% in Q2, 1.1 percentage points above the annual growth

¹ Notably, the rising household sector leverage in recent years has restrained consumption growth. China's household sector leverage reached 50.3% in 2018Q2. According to PBOC data, the mortgage-to-income ratio of Chinese households rose to 60.5% at the end of 2017 from 22.6% at the end of 2008, up 38 percentage points. The debt-to-income ratio in the household sector rose to 112.2% at the end of 2017 from 43.2% at the end of 2008, up 69 percentage points.

rate for 2018.

Current account surplus will continue to narrow due to suppressed exports over the short term and likely improvements in imports. **First**, foreign demand continues to soften. **Second**, there still exists an uncertainty over the outcome of China-US talks, in spite of the material progress achieved. Given this, the exports to the United States are estimated to further decline over the short term. **Third**, shifts in the industrial supply chains are underway amid the global trade frictions. Processing trade has seen negative YoY growth in imports and exports for three straight months, taking up a smaller share of total foreign trade and reflecting to some degree China's industry structural adjustments and the shifts in global supply chains. Domestic demand will recover to some extent to bolster the ongoing improvements in imports. Current account surplus is expected to further shrink due to expanding imports and contracting exports.

On the supply side, policies will work to boost industrial activity and back stable growth in the service sector. Looking forward to Q2, **industrial production growth is likely to rally.** Main contributors are as follows: First, investment growth shows recovery. In particular, infrastructure investment will continue to accelerate as the government policies to boost stability are paying off. It helps speed up industrial growth. Equipment and other manufacturing industries will remain on a fast track. Second, the government steps up tax cuts. According to the *Report on the Work of the Government*, corporate taxes and employers' social security contributions will be reduced by nearly RMB2 trillion. Moreover, China will work hard to improve the business environment and foster a better environment for private-sector economic development, helping enhance profitability of businesses and shore up their expectations and confidence. Third, businesses will have better access to financing. The monetary policy will focus on improving its transmission mechanism to make financing more accessible and affordable to small and micro enterprises, and to lower the effective interest rates. Overall, industrial value added is projected to grow at approximately 6% in Q2, down 0.6 percentage point over a year earlier, but showing recovery from Q1.

In the consumer services sector, as consumption will hardly recover notably, the overall growth will remain stable in wholesale and retail as well as hotels and catering. In the real estate market, stability remains the top priority for policymakers. Though the real estate market is likely to be deregulated somewhat in some third-tier and fourth-tier cities, the overall policy orientation to strict regulation will remain. The rebuilding of rundown urban areas may cool down to some extent and the steady push for legislation on real estate tax will also soften the expectations for housing price growth. Property sales growth will remain low, and real estate value added is estimated to grow modestly. In the producer services sector, with industrial production on the upswing, growth in transportation, storage and postal services as well as leasing and commercial services will gradually stabilize. Financial value added is likely to pick up amid easing monetary and regulatory environment and ongoing financial market reform and opening-up. 5G commercialization has moved onto the fast track. The development and application of 5G are expected to fuel rapid growth in information transmission, software and information technology services. Overall, value added of the service sector is projected to grow at approximately 7.6% in Q2, slightly up 0.2 percentage point over Q1.

From the perspective of inflation, price growth will pick up, yet overall at a moderate and controllable level. Price growth will pick up in Q2 mainly due to the fading of seasonal factors. Market demand will be stronger than a quarter earlier as the policies to boost stability are paying off. The market liquidity will be sufficient in general under the easing monetary policy. Consumer prices will stage an upswing mainly on pork price gains. With the outbreak of African swine fever shattering the confidence of hog farmers, the breeding sow stock has declined over months, which is likely to usher in the "hog cycle" earlier than expected. CPI is projected to rise by about 1.9% in Q2, up around 0.3 percentage point over Q1. PPI growth is expected to recover thanks to firming-up investment in infrastructure and other areas. PPI is projected to rise by about 0.8% in Q2, up around

0.7 percentage point over Q1.

II. 2019Q1 Financial Review and Q2 Outlook

In 2019Q1, with the policies to stabilize financial markets were issued successively and began to work gradually, the growth in aggregate financing to the real economy stabilized, RMB loans continued to grow rapidly, the costs of financing were within a downtrend, and loan rates were closer to benchmark. Financing is gradually more accessible for Private enterprises and small and micro businesses. Financial markets were stable, with stock and foreign exchange markets going stronger together. However, the monetary policy transmission was still blocked, medium- and long -term loans showed sluggish growth, the internal drivers of credit expansion were weak and bonds were still at a high risk of default.

II.1 Financial market characteristics: the policies to stabilize financial markets worked and make financing more accessible to businesses

II.1.1 Credit crunch began to reverse as aggregate financing and M1 growth firmed up, despite M2 deceleration

Money supply remained stable overall, with softer growth in M2 and faster expansion in M1 and aggregate financing. As at the end of February 2019, the broad measure of money supply M2 grew by 8% YoY, down 0.1 percentage point from the end of 2018. M2 growth reached all-time low, mainly due to fading effects of single-month seasonal factors and massive new cash withdrawal through open market operations in February (RMB410 billion). Aggregate financing to the real economy rose by 10.1% YoY, up 0.3 percentage point from the end of the previous year, putting an end to previously continuous decline trend and indicating a reversal of credit crunch that had aroused public concerns. Stabilized aggregate financing growth led to the increase in demand deposits of businesses. As at the end of February 2019, M1 grew by 2% YoY, up 0.5 percentage point from the end of 2018 (Fig. 3). Acceleration in aggregate financing and M1 and deceleration in M2 reflected overall stability of money supply, supporting the improvements in enterprise financing without a deluge of strong stimulus policies. The difficulties for the corporate financing channels in 2018 have been mitigated.

Loans and bond financing rose significantly, while equity financing lingering at lows. New aggregate financing to the real economy in the first two months of 2019 stood at RMB5.31 trillion, up RMB1.05 trillion YoY, mainly thanks to the rapid increase in RMB loans, enterprise bonds and local governments' special bonds. The primary stock market was still dormant, in sharp contrast with the hot secondary market in 2019. China's faster move to launch the Nasdaq-style high-tech board is expected to spark the passion for IPOs in 2019.

Fig. 3: Major Financial Supply Indicators

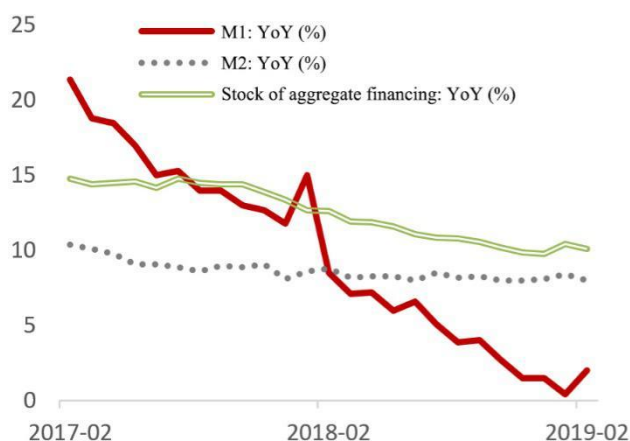
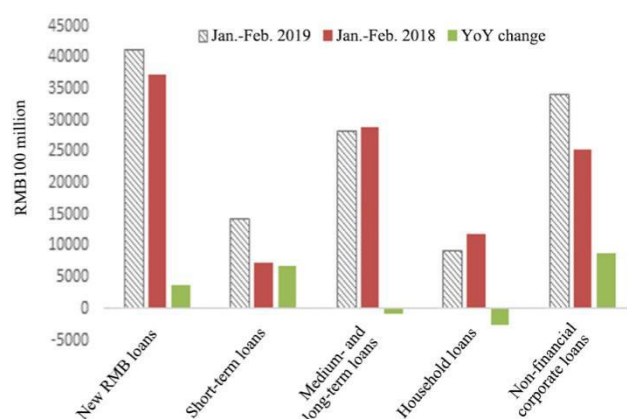


Fig. 4: Structure of New RMB Lending



Source: Wind, BOC Institute of International Finance

RMB loans grew steadily with a structure, but the structure had positive and negative parts. Cumulative new RMB loans reached RMB4.1 trillion (excluding loans to non-bank financial institutions) in the first two months, an increase of RMB374.8 billion YoY. The positive part is that non-financial corporate loans took up a larger share and household loans accounted for a smaller percentage, helping stabilize investment and constrain bubbles and, in particular, curb the rapid increase in leverage of the household sector. The negative part is the coexistence of fast growth in short-term loans and sluggish momentum of medium- and long-term loans (Fig. 4).

II.1.2 The 1-year term deposit rate remained low, with the monetary policy transmission further smoothened

In Q1, money market was steady, and market liquidity kept reasonably sufficient. First, the monetary policy kept abundant market liquidity. Second, the 1-year term deposit rate in the money market remained low. PBOC kept market liquidity reasonably sufficient by adjusting the criteria for small and micro loans eligible for reserve requirement cuts under the inclusive finance initiative and lowering the reserve requirement ratio of financial institutions. The 7-day interbank market pledge-style repo rate (DR007) among depository institutions averaged about 2.56%, a marked decline from 2.75% in 2018Q4. However, market interest rates have picked up since March due to seasonal factors. Third, the monetary policy transmission has been smoother to bring down lending rates markedly. The lending rates fell noticeably as earlier policies to support private enterprises and small and micro businesses paid off gradually.

II.1.3 The bond market slowed down significantly, from “running” to “walking”

The bond market ratcheted up, yet at a significantly slower pace than in 2018, due to relatively ample liquidity and a bigger weight of bonds in institutional investors’ portfolios. **First**, expedited local government bond issuance drove a recovery in unsecured debt financing. **Second**, bond issuance rates dropped at various degrees, leading to volatile interest rate of enterprise bond issuance. **Third**, treasury bond yields trended down with narrower fluctuations. **Fourth, although credit risk had mitigated**, default events still happened.

II.1.4 The A-share market turned bullish amid faster capital market reform

2019 has seen China’s stock market went from the world’s worst performers in 2018 to the best. Like we forecast in our last quarterly report, China’s stock markets started a bull run in 2019 as the earlier “six-pronged policy to promote stability” paid off, the Fed’s monetary policy was eased and the US-

China trade frictions took a favorable turn.

The latest A-share market bull run was driven by the following factors: **First**, investors were more upbeat. **Second**, the equity market liquidity was improved substantially. **Third**, the policy support worked effectively. In addition, the capital market reform gained pace. The capital market system has been further improved in 2019 as the financial supply-side structural reform was launched, coupled by the strong push for the Nasdaq-style high-tech board for pilot registration-based IPOs.

II.1.5 The foreign exchange demand and supply landscape further turned for the better, with exchange rate expectations improved notably

Since 2019 began, RMB value has been on the rise markedly against USD. USD/RMB exchange rate dropped from 6.8658 at the end of December 2018 to 6.6877 on March 21, 2019, with approximately a 2.59% appreciation of RMB. **First**, the USD index didn't any significant decline, which was not a contributor to RMB appreciation. **Second**, China-US interest rate spread was stable overall, also not a contributor to RMB appreciation. **Third**, as shown by the balance of banks' foreign exchange settlements and sales on behalf of customers and the balance of banks' cross-border receipts and payments on behalf of customers, the massive net inflow of short-term capital was the major cause of the supply-demand curve reversal in the domestic foreign exchange market. **Fourth**, the net inflow of short-term capital was driven principally by the rising current account surplus. **Fifth**, market expectations continued to improve. To sum up, the RMB appreciation against USD seen since the beginning of the year resulted from the huge short-term capital inflows caused by the rising surplus in trade in goods and improving market expectations.

II.2 Financial forecast for Q2: financial supply-side structural reform will regain momentum

Looking forward to Q2, there will be bigger room for monetary policy adjustments amid a less risky external environment for China's financial development, thanks to the smooth progress of China-US trade talks and slower or even suspended interest rate hikes in major economies. In addition, the demand for financing is likely to further recover on effective implementation of the "six-pronged policy to boost stability", accelerated financial supply-side structural reform and stronger confidence in both business and household sectors. M2 growth is expected to stay at lows and the growth in aggregate financing will further stabilize. Interest rates will possibly decline. Businesses will further expand their direct financing from stock and bond markets. The stock market will continue to recover. RMB exchange rate will be stable in general.

II.2.1 With low M2 growth, RMB loans will grow at a stable and fast pace

Given the effective policies to stabilize financial markets and domestic investment and the monetary policy that is neither too tight nor too loose, money and credit supply is estimated to grow steadily fast in Q2. **First**, it is highly probable for M2 growth to remain low as the room for its recovery is limited. The *Report on the Work of the Government* for 2019 pointed out that increases in M2 money supply and aggregate financing should match nominal GDP growth to keep major indicators within an appropriate range. China's target for GDP growth in 2019 is 6% to 6.5%. Given the current inflation rate of 1.6%, M2 growth is reasonably estimated to be 8% to 9.5%. **Second**, equity and debt financing is expected to ratchet up. In the foreseeable future, financing from stock and bond markets is estimated to further expand as PBOC steps up implementation of the "triangular" financial framework and the bond market reform and opening-up is strengthened. **Third**, RMB loans will continue to grow rapidly.

II.2.2 Liquidity will remain reasonably sufficient, with low market interest rates

Looking forward to Q2, the monetary policy will be remaining prudent, and market interest rates are likely to stay at lows. **First**, given the still-high downward pressure on the macro-economy, the

monetary policy needs to create a favorable monetary and financial environment for steady growth. **Second**, making financing more accessible and affordable to businesses will be the priority in future work. The monetary policy should provide stronger counter-cyclical adjustments to maintain reasonably sufficient liquidity and reasonably stable market interest rates. **Third**, the Fed is close to the end of its rate hike cycle and has sent a flock of dovish signals in 2019, putting an end to rate hikes in its March interest rate decision (seeing no hike by the end of 2019). It has eased the external impediment to China's monetary policy moves.

II.2.3 The bond market will enter a fluctuation interval, with long-term rates to “fall and then rise again”

Higher expectations are placed on the bond market reform and development in Q2 under favorable factors, including weak economic fundamentals, institutional investors' larger bond allocations and, in particular, faster pace of the financial supply-side structural reform. Bloomberg announced to include Chinese RMB-denominated government and policy bank securities in the Bloomberg Barclays Global Aggregate Index in April, which will attract more money to the bond market. However, the following factors will weigh on the bond market: **First**, the bond supply expands. **Second**, the current long-term yields are close to the all-time low, having limited room for further falls. **Third**, the risk of default hovers over the bond market. Overall, the bond market will enter a fluctuation interval, with limited downward space for long-term rates. It is still possible to see a modest rally in H2 following inflation recovery and economic strengthening.

II.2.4 The stock market is very likely to consolidate, yet remain bullish in the medium and long terms

Looking forward to Q2, we are cautiously optimistic about the A-share market movements. The recent A-share market rally was principally fueled by market sentiments and expectations and ample liquidity. But the China's economy has not been fundamentally improved over the short term. Technically, A-share market will face a strong resistance at 3000 to 3100 in the near future. It is very likely to consolidate around the range in the short term, yet still in a medium- and long-term bull run.

The following positive factors will influence the future A-share market developments: **First**, liquidity will remain reasonably sufficient. **Second**, A-share market itself is attractive. **Third**, the government attaches great importance to capital market development. As the capital market reform goes deeper, market participants will become more and more confident in the market performance. Unfavorable factors include the following: **First**, the softer momentum of global growth will adversely affect China's economy performance and financial markets. **Second**, the US stocks' record-long bull run maybe followed by a pullback, which may trigger global resonance of stock market fluctuations and pose a major challenge to the A-share market.

II.2.5 RMB/USD exchange rate will swing widely, and the China-US trade talks deserve extra attention

The factors impacting RMB exchange rate are mixed in Q2. Extra attention should be paid to the Chin-US trade negotiations. USD/RMB exchange rate will fluctuate broadly around 6.7 before negotiations, expected to further improve if such negotiations turn out to be a success. **First**, as both demand and supply sides of the macro-economy are still weak, economic growth is estimated to slow down further in 2019, especially in H1. **Second**, the monetary policy will continue to ease. **Third**, trade surplus will shrink. Trade surplus may further shrink on the weakening foreign demand. The surplus-related factors contributing to the RMB appreciation against USD since the beginning of the year may become unsustainable. Appreciation is driven mainly by external factors, such as technical pullback of USD index, US economic deceleration, moderation in US-China trade frictions and the Fed's slower pace to hike interest rates and shrink balance sheet. **First**, the USD index stages a

technical pullback. **Second**, the US economy slows down from peak. **Third**, the Fed slows down its rate hikes and balance sheet contraction. **Fourth**, China and the United States are likely to come to an agreement over trade frictions, with the trade tensions expected to defuse continuously.

Table 1: Main Indicators and Forecast of China’s Economy and Finance in 2019Q2 (%)

Indicator	2016 (R)	2017 (R)	2018 (R)	2019		
				Q1 (E)	Q2 (F)	Full year (F)
GDP	6.7	6.8	6.6	6.2	6.3	6.4
Industrial value added above designated size	6.0	6.6	6.2	5.5	6.0	6.1
Value added of the service sector	7.8	8.0	7.6	7.4	7.6	7.6
Fixed asset investments	8.1	7.2	5.9	6.5	7.0	8.5
Total retail sales of consumer goods	10.4	10.2	9.0	8.3	8.5	9.0
Exports	-7.7	7.9	9.9	-2.0	-2.5	3.0
Imports	-5.5	16.1	15.8	-1.0	-1.5	5.0
Consumer Price index (CPI)	2.0	1.6	2.1	1.6	1.9	2.2
Producer price index (PPI)	-1.4	6.3	3.5	0.1	0.8	1.5
Broad money supply (M2, ending balance)	11.3	8.1	8.1	8.2	8.4	8.5
Aggregate financing to the real economy (Stock)	12.8	13.4	9.8	10.3	10.4	10.5

Source: BOC Institute of International Finance

III. Macro-economic Policy Orientations

The macro-economy is likely to firm up in Q2 as it is gaining momentum for growth, but the downward pressure remains. As for macro-economic policies, particular attention should be paid to three respects: First, China will speed up the implementation of policies laid out in the *Report on the Work of the Government*, so that these policies will mostly work in Q2 as a cushion against the additional tariffs in the US-China trade frictions. Second, China will pay close attention to price changes and properly control the pace and intensity of monetary and credit policies based on economic operation. Third, given the major uncertainties in the US-China trade frictions, global economic slowdown and other external environment factors, we suggest keeping close track of them and putting in place policy buffers and contingency plans.

III.1 The fiscal policy will be more proactive in an era of “large-scale tax cuts”

According to the *Report on the Work of the Government*, the fiscal policy in 2019 will be more proactive to, for example, cut taxes on a large scale, raise the deficit ratio and size and expand local governments’ special bond issuance. **First**, the focus of fiscal policy shifts from increasing revenue to tax cuts, further implementing tax cut measures effectively. **Second**, general expenditures will be slashed substantially to create room for raising deficit-to-GDP ratio (from 2.6% to 2.8%) and expanding budgetary deficit scale, and establish a comprehensive government budget performance management system as soon as possible. **Third**, proceeds of special bonds will be matched with infrastructure projects and the finance and yields of the projects will be properly assessed. **Fourth**, the capital contribution requirements for infrastructure projects will be lowered as appropriate, with the PPP mode advanced in a well-organized manner.

III.2 The monetary policy will seek to strike a balance between growth stability and risk prevention and build policy synergies

Given the sluggish economic recovery, weak effective investment of enterprises, financing difficulties of small, medium and micro enterprises and risks in local government debt and other fields at present, the monetary policy needs to continue to be counter-cyclical to prevent risks while ensuring stability of growth. **First**, open market operations will be strengthened to maintain the stability and continuity of the prudent monetary policy. **Second**, there is a necessity and room for further reserve requirement cuts, which, if carried out, must be of proper degree. **Third**, the monetary policy transmission mechanism will be further improved. The key to interest rate liberalization will be an effective transmission mechanism for the central bank's policy rates. Either market rates or deposit and loan interest rate should be linked more closely to policy rates. **Fourth**, efforts will be made to prevent risks without compromising stability of growth.

III.3 Pursuing supply-side structural reform with a focus on “consolidating, strengthening, upgrading, and ensuring unimpeded flows”

According to the *Report on the Work of the Government*, China will continue to pursue supply-side structural reform in 2019, focusing on “consolidating, strengthening, upgrading, and ensuring unimpeded flows”.

First, as for “consolidating”, more market-based and law-based measures will be adopted to advance the five priority tasks. Environmental, quality, energy efficiency and safety policies will be launched to phase out outdated capacities according to laws and regulations. Capacity replacement and other market-based methods will be used to step up the removal of more overcapacities, so as to unleash higher-quality capacities and improve the quality of supply.

Second, as for “strengthening”, the business environment will be improved to strengthen the dynamism of micro market entities. In 2019, the efforts to improve business environment will focus on cutting red tape and improving services, promoting impartial regulation and reducing business-related charges. Principally, the negative list on market entry will be further shortened to promote across-the-board implementation of the policy of “entry unless on the list”. The government will continue interdepartmental oversight conducted through the random selection of both inspectors and inspection targets and the prompt release of results, and promote credit rating-based regulation and the Internet + Regulation reform initiative. The government will also deepen market-oriented reforms in the electric power sector and advance the reform of the toll roads system.

Third, as for “upgrading”, China will continue to pursue innovation-driven development to upgrade industrial chains. The government will increase support for basic research and application-oriented basic research, strive to create new competitive strengths with technological innovation and economies of scale, and foster new industrial clusters. The government will speed up efforts to pursue Internet Plus initiatives, strengthen R&D and the application of big data and artificial intelligence technologies, and foster clusters of emerging industries like next-generation information technology, high-end equipment, biomedicine, new-energy automobiles, and new materials.

Fourth, as for “ensuring unimpeded flows”, China will establish a unified and open, competitive and orderly modern market system. The Central Economic Work Conference held in December 2018 decided to “enhance the financial system's ability to serve the real economy and form positive interactions between domestic market and producer entities, economic growth and employment expansion as well as financial sector and real economy”. In addition to industries with overcapacities and manufacturing, the supply-side structural reform will extend further to more sectors, notably the financial sector.

III.4 Real estate regulation will be more city-specific to steadily establish a long-term mechanism

China will focus on the city-specific approach for real estate regulation in the future, giving bigger weight to the balance between preventing risks over the long term and boosting stability over the short term. That is, the policy combination of “city-specific policy + withdrawal of governmental intervention + creation of a long-term mechanism” will be pursued to ensure steady development of the real estate market. **First**, the government’s market regulation methods will be optimized on a city-specific basis. As the China’s economy is under a significant downward pressure, the real estate market volatility should be kept within a reasonable range. **Second**, the legislation on real estate tax will be advanced steadily under a reasonable timetable, so as to get the pace and intensity right. The real estate tax is a crucial part of the long-term real estate development mechanism to be created. It helps rein in rampant housing-market speculation and reduce social stratification caused by wealth immobility. It is imperative to launch the real estate tax. Given the substantial effects of levying real estate tax on all parties, which are unpredictable, uncontrollable and likely to have a major negative impact on the economy, the policy should be well timed and launched without increasing the overall tax burden of households.