

China's Economic and Financial Outlook

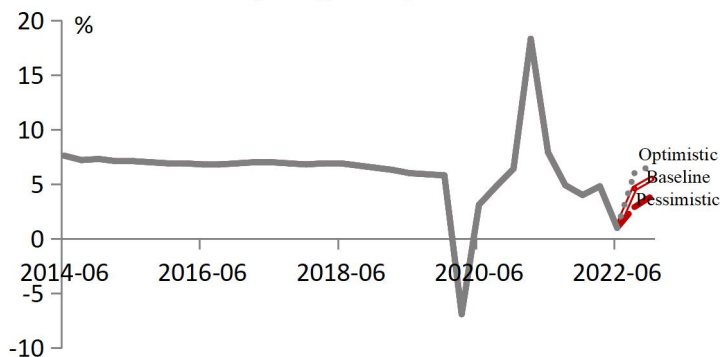
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Highlights

- 2022H1 saw mounting “triple pressures” on the Chinese economy amid a number of unexpected factors, including the Russia-Ukraine conflicts and related sanctions as well as COVID-19 resurgence in China and its virus containment policy. Market expectations worsened as both demand and supply softened. As the pandemic started to ease in May, the Chinese government took a series of policies to stabilize macro-economy, which gradually firmed up. GDP growth was 4.8% in Q1, estimated to be around 1% for Q2.
- Looking forward to H2, domestic demand will replace foreign demand as the key stabilizer of the macro-economy in a tougher and more complicated global environment. With the COVID-19 policy fine-tuned, the pandemic’s economic fallout will further abate and an array of stabilization policies will gradually work to warrant a recovery of China’s economy from quarter to quarter in H2. Given the uncertainty in COVID-19, the quarterly GDP growth in 2022Q3 is estimated to be around 3.2%, 4.6% and 6%, and the annual GDP growth in 2022 is estimated to be about 3.2%, 4% and 4.7%, under the pessimistic, baseline and optimistic scenarios, respectively.
- It is suggested to implement the *Policy Package for Economic Stabilization* in an all-out effort to keep economic growth, employment and expectations table. People’s wellbeing should be the biggest concern. The COVID-19 containment measures should be fine-tuned to minimize its economic fallout. The proactive fiscal policy should fully play its part in helping distressed businesses and expanding effective investment. The monetary policy should better unleash its structural functions to stabilize macro-economy. Investment should further work to underpin the economy, giving a multi-pronged boost to the recovery of consumer activity. Reasonable needs on both demand and supply sides will be supported to keep the real estate market on course for stable development.

China's economy will gradually stabilize and recover in H2



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All-out Policy to Stabilize Macro-economy amid Mounting “Triple Pressures”

-- China's Economic and Financial Outlook (2022 Q3)

2022H1 saw mounting “triple pressures”¹ on the Chinese economy amid a number of unexpected factors, including the Russia-Ukraine crisis and related sanctions as well as COVID-19 resurgence in China and its containment policy. Market expectations worsened as both demand and supply softened, dragging down the economic growth significantly. As the pandemic started to ease in May, the Chinese government took a series of policies to stabilize macro-economy, stepping up reopening in all sectors and spurring a gradual recovery of the economy. GDP growth was 4.8% in Q1, estimated to be around 1% for Q2.

Looking into H2, China's economy will face spillover risks from weakening foreign demand, turbulent global financial markets and heightened geopolitical conflicts, given that inflation is sweeping the globe, major economies are hastening their pace of monetary policy tightening and the world economy is at high risks of “stagflation”. Looking forward to H2, domestic demand will replace foreign demand as the key stabilizer of macro-economy. Despite its transitory downturn triggered mainly by non-economic factors, the Chinese economy still maintains good prospects and fundamentals for long-term growth. Although GDP slowed down markedly in Q2, casting a cloud over the pursuit of the 5.5% growth target set at the beginning of the year, China has solid groundwork for keeping the economy stable. Given the acceptable level of inflation, generally stable employment without large-scale layoffs, a government deficit ratio of less than 3% and a normal monetary policy maintained, there is still much room for macro-policy maneuvering. With the COVID-19 policy fine-tuned, the pandemic's economic fallout will further abate and an array of stabilization policies will gradually work to reshape market expectations, restore market confidence and warrant a recovery of China's economic growth due to the low base effect, and achieve a quarter to quarter in H2. Given the lingering uncertainty in COVID-19, however, we have made estimates under different scenarios of pandemic developments and containment measures. The quarterly GDP growth in 2022Q3 is estimated to be around 3.2%, 4.6% and 6%, and the annual GDP growth in 2022 is estimated to be about 3.2%, 4% and 4.7%, under the pessimistic, baseline and optimistic scenarios, respectively.

Going forward, it is suggested to implement the State Council's *Policy Package for Economic Stabilization* (the “Policy Package”) in an all-out effort to keep economic growth, employment and expectations stable and meet basic living needs. The COVID-19 containment measures should be fine-tuned to minimize its economic fallout. The proactive fiscal policy should fully play its part in helping distressed businesses and expanding effective investment. The monetary policy should better unleash its structural functions to stabilize macro-economy. Investment should further work to underpin the economy, giving a multi-pronged boost to the recovery of consumer activity. Reasonable needs on both demand and supply sides will be supported to keep the real estate market on course for stable development.

I. 2022H1 Economic Review and H2 Outlook

¹ As pointed out at the Central Economic Work Conference for 2021, China's economy is under the triple pressures of shrinking demand, disrupted supply and weakening expectations.

I.1 Economic review in 2022H1

1. Consumption crippled by COVID-19 resurgence became a major drag on the economy

Consumer activity got off to a good start in 2022. Since March, however, the coronavirus resurgence has hit many cities in China, especially Shenzhen, Shanghai, Beijing and other major consumption centers. The escalation of outbreak control measures rocked consumer activity. **First, consumption was dented mainly by high unemployment rate, a sharp fall in household income and pessimistic expectations.** The surveyed urban unemployment rate in April hit a new high since March 2020. The downbeat expectations sent the consumer confidence index into a plunge to 86.7 in April from 113.2 in March, the lowest on record since 1991 (the second lowest was 97 seen in November 2011) **Second, consumer spending on automobile and housing dropped sharply, creating a heavy drag on consumption.** Coronavirus outbreaks at major car-making bases disrupted the automobile industry chain, coupled with a fall in household income. Automobile productions and sales have been shrinking since March. **Third, sporadic outbreaks of COVID-19 generated shocks to consumer services including hotels, restaurants, cultural tourism and transportation.** From January through May, restaurants' revenue was down 8.5% YoY cumulatively, showing the sharpest decline since 2021.

2. Real estate investment remained stressed due to pandemic-induced disruptions to investment in the short run

Investment growth was relatively stable in H1 to bolster the economy. Total fixed asset investment (excluding rural households) rose by 6.2% accumulatively during the first five months of the year, down 3.1 percentage points from Q1. **Infrastructure investment gained steam, manufacturing investment remained resilient and real estate investment came under pressure.** Infrastructure investment gradually strengthened as fiscal support increases and speeds up. The short-run disruptions from coronavirus outbreaks, however, have hindered project implementation. Manufacturing investment slowed down as the pandemic stunted production and disrupted supply chains. But technological upgrading has become a major driver of manufacturing investment, benefiting from accelerated industry transition and robust growth in high-tech manufacturing investment. Real estate investment continued to soften under pressure as the property market remained sluggish amid the pandemic shockwaves and shifting market expectations. Investment growth is expected to be around 3.6% for Q2, and approximately 5.9% for H1.

3. Export growth subdued due to weaker foreign demand and domestic COVID-19 outbreaks

China has seen its exports slowing in 2022, yet still within the range of medium to high growth. By composition of exports, **first, exports to all major trade partners have slowed down. Second, main commodities exports showed divergent growth trends.** As the COVID-19 impact eased overseas, the demand grew fast for products for outdoor activities such as clothing and bags, and social and entertainment products, fueling rapid growth in labor-intensive goods exported by China. **Third, the impacts of price factors became greater.** The value of main products exported grew at a notably higher YoY rate than their quantities. Overall, exports growth is estimated at around 8% for Q2.

4. Industry staged a stronger recovery than services, yet both were under pressure

First, performance was mixed across industry sectors, with substantial slow down in manufacturing activity. Thanks to the policy measures, energy supplies were secured, the output of coal and other energy products expanded fast, but commodity prices stayed high. Mining activity maintained high growth. With industry chains and supply chains severely disrupted by the pandemic, manufacturing value added grew by 2.6% YoY from January through May, far below the two-year average recorded for the same period of last year.

Second, the confluence of high cost and muted demand put manufacturers under heavier pressure. Enterprises still feel strained from high costs amid ongoing geopolitical conflicts. Demand recovery lags behind production. Small and medium-sized enterprises are still under pressure, as shown by a PMI staying below 47% for small manufacturers and a PMI for medium-sized manufacturers that has fallen through the boom-or-bust line (50%) since March.

Third, service sectors are recovering slowly with still-low prosperity. Services requiring close contact with clients are recovering more slowly, with hotels and restaurants value added expected to register a sharper decline in Q2 than in Q1. The property market keeps cooling, with the real estate value added expected to fall faster. Information transmission, software and information technology services maintained relatively high growth, albeit decelerating significantly from a year ago. Other service sectors are estimated to slow down from Q1 due to subdued demand and supply and logistics disruptions. Overall, services value added is estimated to have increased by about 1% in Q2.

5. CPI rising from low and PPI retreating from high, with higher pressure of imported inflation

China's inflation was generally mild in 2022H1, a sharp contrast to the red-hot inflation in other major economies. From January through May, CPI and PPI rose by 1.5% and 8.1% YoY cumulatively. First, CPI rose from low due to disruptions from COVID-19 and pork prices hitting bottom. Second, PPI dropped from high on the confluence of China's policies launched to secure supply and stabilize price and the high base last year. Third, the global surge in energy and food prices added to the pressure of imported inflation.

1.2 Economic Outlook for 2022H2:

1. More pro-growth and pro-consumer measures are implemented, which are likely to spark a slow recovery in consumption

Consumption stands to gradually recover in H2 if the pandemic gets tamed. **First**, as the government is currently taking all possible measures for businesses in distress, the economy will get back onto the recovery trajectory to pave the way for a consumption recovery. **Second, local governments are launching pro-consumer campaigns, including distributing consumer coupons for green or energy-efficient products and electronics.** Pro-consumer policies are set to further strengthen and work as expected in H2. **Third, automobile consumption is on track to recover gradually on policy stimulus and supply chain restoration.** The halved purchase taxes on vehicles will give a strong boost to auto sales in H2. Consumption is projected to grow around 3.2% YoY in Q3 and 2.1% annually under optimistic scenarios, about 2% YoY in Q3 and 1% annually under baseline scenarios, and around 1.7% YoY in Q3 and 0% annually under pessimistic scenarios.

2. Infrastructure investment will recover at a faster pace, making investment more crucial for economic recovery

First, the fiscal policy will be more proactive to accelerate the rebound in infrastructure investment. Infrastructure investment is set to further gain pace as the issuance of special government bonds will accelerate and turn into physical workload. **Second, real estate investment will improve on the policy support for the battered housing market, coupled with last year's low base.** Given the ongoing relaxation of property market curbs, mortgage rates are expected to still have downside room. **Third, manufacturing investment is losing steam due to subdued foreign demand and slow recovery of domestic demand.** Taking into account all the above factors, consumption is projected to grow around 5% YoY in Q1-Q3 and 4.6% annually under optimistic scenarios, about 5.8% YoY in Q1-Q3 and 6% annually under baseline scenarios, and

around 6.4% YoY in Q1-Q3 and 6.9% annually under pessimistic scenarios.

3. Export growth to be further strained by slowing foreign demand and weaker substitution for other exporting nations

In the short run, China's exports receive a boost from pro-trade policy, RMB depreciation and ongoing recovery of production and supply chains. On the whole, however, China's export growth will remain under pressure H2. **First, foreign demand weakens in a slowing global economy that sees hot inflation and tightening monetary policies.** High inflation will erode consumers' purchasing power and dampen their confidence. The EU, the US and other developed economies keep tightening the monetary policy, which will continue to cool the financing climate and investor confidence in the real economy and further weaken demand. **Second, China faces a loss of orders from some sectors to other export-oriented economies undergoing rapid growth in exports.** Going forward, the elevated prices of raw materials will squeeze out the profits of exporters and there will still be major uncertainties in the world's political and economic landscapes, suggesting a continuing shift of export orders to Southeast Asian countries. Overall, exports are projected to grow about 5.5% in Q3 and 6.3% annually under optimistic scenarios, about 2.2% in Q3 and 4.5% annually under baseline scenarios, and around 1% in Q3 and 3.6% annually under pessimistic scenarios.

4. Production will likely to recover persistently as the pandemic eases.

The industrial recovery is on a firmer footing. **First, with the pandemic expected to further ease, production will recover on continuing improvements in demand. Second, industrial activity will receive a boost from both demand and supply sides as the pro-growth policy continues to work.** A series of producer relief measures are in place, including tax cuts and rebates, postponement of social security contribution payments, debt service deferral and assurance of unimpeded cargo movements. Recovery of demand will be quickened by a raft of policies launched to stabilize investment, boost consumption and secure foreign trade, thus increasing the effective demand across industry chains. **Third, midstream and downstream manufacturers show good growth prospects as industry chains and supply chains are becoming increasingly resilient.** The pro-growth policies have translated into faster growth in infrastructure investment and gradual improvements in the real estate sector. Midstream machinery and general-purpose equipment are likely to expand faster. Industrial value added is projected to grow around 4% in Q3 and also 4% annually under pessimistic scenarios, about 5.8% in Q3 and 5% annually under baseline scenarios, and around 6.5% in Q3 and 5.3% annually under optimistic scenarios.

Services are set to recover slowly as the COVID-19 fallout abates. Information transmission, software and information technology services will remain in a boom and the housing market may gradually stabilize. Work and production resumption brings producers and consumers back on track. A marginal recovery is likely in wholesale and retail, transportation and storage services. But consumer activities and services requiring physical presence are still held back by the COVID-19 uncertainty. Services value added is projected to grow around 2.5% in Q3 and also 2.8% annually under pessimistic scenarios, about 4% in Q3 and 3.5% annually under baseline scenarios, and around 6% in Q3 and 4.4% annually under optimistic scenarios.

5. The confluence of rising pork, oil and grain prices feeds into CPI inflation, with the PPI-CPI inflation divergence set to narrow significantly

Looking ahead to H2, **on the one hand, the confluence of rising pork, oil and grain prices will result in a bigger rise in CPI.** The pig cycle has virtually reached the tipping point for an upturn. The bottoming-out of pork prices will put a solid floor under food prices. The persistent rise in global energy and food prices is adding to the pressure of imported inflation. **On the other hand,**

PPI inflation stands to further abate amid weaker momentum in global commodity prices and fading carryover effects. Taking into account the above factors, CPI and PPI are expected to rise around 3.1% and 4.2% YoY in Q3, and about 2.4% and 5% in annual terms, respectively.

II.1 Financial review in 2022H1: Financial market became more volatile under the influence of both foreign and domestic factors

China's financial market has been grappling with more complexities from within and outside since 2022. On the global front, the international situation is grimmer and more complicated. The global COVID-19 pandemic keeps evolving, coupled by the Russia-Ukraine conflicts and the escalating inflation storm. A number of economies are tightening their monetary policies, sparking another global wave of interest rate hikes. The abrupt change in global liquidity conditions has triggered a surge in government bond yields of major countries, widespread sell-offs in global stock markets and a run-up in commodity prices. On the domestic front, sporadic COVID-19 outbreaks hit major cities, including Shanghai and Beijing. Local governments have taken strict measures to tame the coronavirus. These domestic and overseas factors challenged China's push for economic stability, dealing a heavy blow to small and medium-sized enterprises and less resilient sectors and populations.

China's financial policymakers made persistent, forward-looking efforts to prop up the economy. One RRR cut and two LPR reductions were launched together with structured support facilities including relending for sci-tech innovation. Money and credit supply grew steadily. Financial policies have set the stage for macro-economic stabilization.

China's financial market remained generally stable, yet slightly more volatile. The stock market saw a slight setback, RMB exchange rate declined with fluctuations and interest rates were stable with a downside bias. From the financial perspective, apart from the challenges from subdued credit demand and volatile financial market, we should also look at new opportunities brought by the central government's stimulus packages.

1. Business financing dropped notably on muted real-sector demand for funding

From January through May, new aggregate financing to the real economy totaled RMB15.76 trillion, up RMB1.66 trillion YoY. **The surge in bond financing was the primary contributor to continued acceleration in aggregate financing.** The increment in government bonds and enterprise bonds together was RMB1.83 trillion more than that for the same period of last year. The soaring government bond issuance was driven by the forward-looking fiscal policy and the accelerated allocation of special government bond quotas. The soaring enterprise bonds related to lower issuance costs in a market with **sufficient** liquidity. **New RMB lending shrank from a year ago.** New RMB loans fell by RMB106.1 billion YoY, partly due to the pandemic-induced plunge in real-sector demand for financing. **Equity financing continued to pick up YoY.** Domestic equity financing of non-financial enterprises totaled RMB444 billion, up RMB44.2 billion YoY. Driven by the registration-based IPO reform, the stock market's support for corporate financing will creep up. **Off-balance-sheet financing kept tapering.** Off-balance-sheet financing (trust loans, entrusted loans and undiscounted bank acceptances) fell by RMB543 billion, a moderated YoY decline of RMB126.7 billion.

The credit structure continued to improve to further increase support for key fields and weaker links. First, the balance of credit to small and micro businesses, inclusive finance, industrial enterprises and high-tech manufacturers kept growing fast. As of 2022Q1, the outstanding medium- and long-term loans to micro and small businesses, inclusive finance, green businesses, industrial enterprises and high-tech manufacturers grew by 24.6%, 38.6%, 20.7% and 31.9%, respectively. **Second, real estate loans recorded the lowest growth on record.** As of

2022Q1, the growth of outstanding real estate loans further decelerated to 6%, the lowest on record, down 4.9 percentage points YoY. **It is particularly worth noting that as COVID-19 inhibited corporate demand for borrowing, medium- and long-term loans registered significantly subdued growth.** From January through May, 2022, new medium-and long-term corporate loans amounted to RMB4.77 trillion, accounting for 43.86% of total new loans, representing a sharp decline of RMB1.01 trillion and 10.49 percentage points, respectively.

2. Enterprises saw their financing costs steadily dropping as interest rates moved lower across the board.

First, policy rates were reduced early in the year and then remained stable. PBOC lowered 1-year MLF and 7-day reverse repo rate to 2.85% and 2.1% respectively in January, both among historical lows. Since then, the two policy rates have remained unchanged as bellwethers. **Second, money market rates were low.** DR007 and R007 broke though the 7-day reverse repo rate of 2.1% in Q1. In early April, however, DR007 and R007 stayed significantly below the 7-day reverse repo rate due to coronavirus resurgence and waning corporate demand for financing. **Third, corporate lending rates further declined.** Financial institutions' weighted average RMB lending and general lending rate hit a new low of 4.65% and 4.98% in 2022Q1, down 0.11 percentage point and 0.21 percentage point from the end of 2021, respectively.

3. RMB rose first and then fell against a gradually strengthening US dollar

RMB began the year with a steady rise and then depreciated with fluctuations through the rest of H1. From January through March, RMB rose to a four-year high of 6.3107 on Russia-Ukraine conflicts, among others. Since April, however, RMB has weakened with wider two-way swings under spillover effects from the US Federal Reserve's monetary tightening. RMB spot exchange rate was 6.6936 on June 24. The RMB depreciation that started in Q2 was mainly driven by the following factors:

First, a strong US dollar came as the principal external cause. The US Dollar Index has moved higher and higher amid the Fed's faster pace of monetary tightening, including more aggressive rate hikes and commencement of balance sheet reduction, putting downward pressure on RMB.

Second, short-term capital outflows created immediate shocks. First, the actual 10-year US Treasury yield kept rising, with the interest rate spread between China and the US inverted and showing signs of widening. The China-US interest rate spread showed an inversion of -0.3322% on June 24, which peaked at -0.7198% in mid-June YTD. Such inversion, together with other factors, led to a cumulative deficit of USD56.38 billion under capital and financial accounts from January through April, putting immediate downward pressure on RMB.

Third, the COVID-19 resurgence and international situation affected market expectations. The coronavirus resurgence and lockdowns had significant adverse impact on China's economic fundamentals, sparking expectations of RMB depreciation. According to observations of exchange rate expectations implied by 1-year NDF², the market expectations of a weaker RMB increasingly strengthened since mid-April. The implied volatility of exchange rate expectations in the 1-year NDF averaged -0.677%, markedly below the average of -0.252% for the period of January to March.

4. Government bond yields fluctuated at a low level, with bond issuance notably mixed.

The 10-year government bond yield has generally **fluctuated** at a low level in 2020 YTD amid

² Implied exchange rate expectation = RMB central parity rate / (1-year NDF - mean of 1-year NDF bid and offer / 100000) - 1

COVID-19 resurgence and monetary easing. The 10-year government bond yield closed at 2.80% on June 24. Overall, the bond market has shown the following characteristics: **First, the local government bond issuance expanded significantly, versus a sharp fall in credit bond issuance.** Boosted by the forward-looking fiscal policy and faster issuance of local government bonds, the local government bond issuance totaled RMB4.73 trillion as of June 24, up 41.54% YoY. However, corporate bond issuance fell 12.9% YoY to RMB1.45 trillion due to waning demand for financing in the real economy stifled by COVID-19. In an ample liquidity environment, financial institutions became less willing to issue bonds for additional funding. Financial bond issuance reached RMB4.44 trillion, down 6.07% YoY. **Second, term spread widened mildly, with credit spread swinging with a downward bias.** Short-term CGB yield dropped fast and term spread widened in general due to lower money market rates. As of June 24, the CGB term spread (between 10-year and 1-year CGB yields) stood at 0.83%, up 21 bps YoY, or up 30 bps from the beginning of the year. Because of less credit bond issuance and ample liquidity, credit spread (between the yield of 3-year AA commercial papers and mid-term notes and the yield of 3-year CDB bonds) was 0.67%, down 24 bps YoY, or down 41 bps from the beginning of the year. **Third, credit risk abated in the bond market.** A total of 12 enterprise bonds were defaulted from January through May, 2022, down 108% YoY.

5. A-shares staged a deep V-shaped recovery on the confluence of various factors.

2022H1 began with a bear run in A-shares fueled by COVID-19 resurgence, geopolitical risks and global inflation expectations. SSE Composite Index fell through the mark of 30,000 points in late April. In May, SSE Composite Index and SZSE Component Index gained more than 4.5% each on major stimulus packages, leading the stock markets in major economies. SSE Composite Index closed at 3,349.75 on June 24, 2022, down 7.97% from 3,639.78 recorded at the end of 2021.

Overall, A-shares staged a deep V-shaped recovery in H1, mainly due to the following factors: **First, the economy strained by coronavirus resurgence made investors more risk-averse.** Domestic investment and consumption data failed expectations in H1 due to COVID-19 lockdowns. Risk aversion escalated across market amid the slowing investment in real estate and infrastructure and the negative growth of consumption. **Second, ongoing geopolitical conflicts added to market panic.** H1 saw irrational sell-offs in A-shares as Russia-Ukraine conflicts escalated in an intensifying game of great powers. **Third, the market bounced back on an economic recovery spurred by stimulus packages.** As the pro-growth policies strengthened, the uncertainties inhibiting market expectations abated, sending A-shares into a rocky rebound from the lackluster performance that started from the beginning of 2022.

6. The carbon market began to work in promoting emissions reduction, with the supervision over data quality becoming increasingly stringent

As of June 24, 2022, the turnover of carbon emission allowances (CEA) in the national carbon market was close to 194 million tons with a total value of more than RMB8.46 billion. In terms of CEA price, the market price moved between RMB55/ton and RMB60/ton in H1, up about 20% from the opening price of RMB48/ton on the launch date (July 16, 2021). **Overall, the national carbon market appears steady, sound and well-ordered, the CEA price moving higher stably. The carbon market plays a notable role in promoting emissions reduction and accelerating the transition to a green, low-carbon development of enterprises.**

To enhance management of data quality in the national carbon market and better manage the market activity, the Ministry of Ecology and Environment issued the *Circular on Key Work to Effectively Manage Corporate Reporting of Greenhouse Gas Emissions* in 2022 in March 2022, setting forth work arrangements for the reporting, examination and publication of the greenhouse gas emissions report for 2021. In addition, the Ministry of Ecology and Environment is pushing for

release of the *Interim Regulations on Trading of Carbon Emission Allowances* to clarify the duties of major carbon emitters and examination technology service providers in management of carbon emission data quality.

II.2 Financial Outlook for 2022H2: financial market to continue with an upswing on stimulus policy and economic improvement

Looking into H2, China's financial sector is poised for an upswing on the rebound of economic fundamentals and reasonably ample liquidity. From the perspective of economic fundamentals, the reopening of China's economy will show bright prospects as the pandemic eases and supply chains are restored, giving a boost to the financial market. From the perspective of policy, the recent stimulus package launched by the State Council will bolster economic growth and boost market confidence. From the perspective of liquidity, PBOC is expected to keep liquidity reasonably sufficient by means of RRR cut, structural instruments and interest rate reduction. From an international perspective, China's financial market is still attractive to global investors as major economies are slowing and international financial markets remain rocky. Overall, we see a further expansion in lending in China in H2 with the general interest rate staying low, the capital market turnover and price picking up steadily and long-term capital inflows continuing into H2 to keep RMB value relatively stable. However, the lingering uncertainty in COVID-19 will still be a threat to the stability of economic and financial fundamentals. Other major economies' continuous rate hikes may spark short-term capital outflows and disrupt the stability of RMB exchange rate and capital market.

1. Corporate demand for financing will rebound faster, main financial metrics to stabilize and pick up in terms of growth rate

Looking ahead to H2, the financing environment will remain sufficient to bolster economic growth. First, the growth in money supply and aggregate financing will likely remain high. On the one hand, the quickened stimulus packages provide a reassuring environment for corporate financing, which, tougher with growing demand for corporate financing, will lead to a remarkable expansion of new lending. On the other hand, the growth of M2 and aggregate financing weakened obviously in 2021H2 to present a low comparison base, thus expected to maintain fast growth through 2022H2. **Second, the credit structure will improve faster.** Financial institutions will continue with strong support for key sectors and weaker areas of the economy. Credit growth will likely stay as high as above 20% for micro and small businesses eligible for inclusive finance, green businesses and technological innovation. **Third, the growth of real estate loans is set to gradually stabilize.** Since Q2, many cities in China have adopted such measures as relaxing purchase restrictions and lowering the down payment requirement in support of first-time home buyers and home upgraders. The housing market will see the financing environment gradually stabilizing in H2.

2. Liquidity set to remain ample and keep corporate financing costs stable

Looking forward to H2, first, money market rates will likely stay low. If the monetary market rate continues to hike substantially after breaking through the policy rate, PBOC may cut RRR and step up implementation of the structural monetary policy, thus keeping the money market rate low around the policy rate and the liquidity reasonably sufficient. **Second, lending rates still have downside potential.** After a significant reduction in Q2, LPR still shows the possibility of small cuts going forward that will bring down lending rates. **Third, effective interest rate may be stable with a downward bias.** As the YoY increase in CPI may further widen in H2, the effective interest rate is likely to be stable with a downward bias as long as the money market rate remains low or even moves higher.

3. The RMB exchange rate will move in both directions, with no ground for sustained depreciation.

Looking into H2, RMB will remain under downward pressure, mainly because the market expects the Fed to further tighten its monetary policy. To further tame inflation, the Fed announced a rate hike of 75 bps in June 2022 and another hike of 50 to 75 bps is also very likely ahead. This will put RMB under persistent external pressure in H2. However, it is also worth noting that many factors that will help RMB firm up. Recently China has created significant policy tailwinds to bolster RMB, including lowering the reserve requirement for foreign currency deposits to release USD liquidity, encouraging financial institutions to enhance their capability of managing foreign exchange risk and gradually leading the market toward reasonable expectations. In addition, the IMF has further raised RMB's weighting in the SDR currency basket, making RMB assets more appealing to global investors.

4. Bond yields may be range-bound at low levels, lacking upward momentum

Looking ahead to H2, **in terms of economic fundamentals**, economic recovery may gain pace as coronavirus gets tamed across the country to bolster the bond yields. **In terms of capital flows**, the Fed may continue to hike rates if the US inflation remains stubbornly high. The China-US interest rate spread will be further inverted. The bond market may face some pressure from capital outflows going forward, but China's bond market is expected to feel limited impact. **In terms of policy**, liquidity will remain reasonably sufficient with still-low money market rates, and yields are estimated to stay low across the board. Overall, the bond yields obviously lack momentum for the upside. The CGB yield as the benchmark for bond market will probably fluctuate around 2.8%. However, it is particularly worth noting that the bond market may see the default risk escalating on COVID-19 resurgence and distressed businesses.

5. Stock market firms up on policy tailwinds and upbeat expectations

A-shares are poised for a bumpy upswing in H2. **First**, the domestic economic climate will keep improving as the pro-growth policies are stepping up. Investors are obviously more upbeat on the economic prospects and their risk appetite will bottom out to stoke a recovery of the stock market. **Second**, structural opportunities will emerge in some sectors involved in growth stabilization or supported by policy (such as infrastructure, building materials, utilities, automobile and housing-related sector) and undervalued sectors with a bright future (such as electric vehicles, photovoltaics, wind energy, defense and computers). **Third**, external disruptions to A-shares have a diminishing marginal effect. On the one hand, external supply chains will be restored and commodity prices may retreat from highs in H2. External disruptions to A-shares will ebb. On the other hand, as the high-quality capital market reform moves on in a well-ordered fashion, the A-share market is significantly more resilient to risks and becoming less sensitive to external disruptions, expected to buck the trend and stage a comeback. However, investors should still pay close attention to possible disruptions from the COVID-19 resurgence, slowing global growth and the Fed's rate hikes.

6. CCER market is gaining momentum amid faster innovation in carbon finance products

The development and use of carbon futures, carbon options and other financial derivatives are expected to speed up in H2, with a boost from policy support and incentives. Meanwhile, as an effective supplement to the national and local carbon markets, the China Certified Emission Reduction (CCER) market is set to become a major channel for China and its enterprises to achieve carbon neutrality. Also, CCER is recognized worldwide and will be at the forefront of China's participation in the global carbon market. Now China has developed a policy framework for trading related to voluntary greenhouse gas emission reductions, including project approval,

certification of emission reduction, CCER registration management and trading management. In 2022H2, preparatory work such as resumption of CCER project filing and issuance of emission reductions will advance in an orderly manner. The national carbon market and the national CCER market will likely be highly integrated.

Table 1: China's Main Economic & Financial Indicators and Forecasts in 2022H2 (%)

Indicator	2019 (R)	2020 (R)	2021 (R)	2022 (baseline scenario) (F)			
				Q1 (R)	Q2 (E)	Q3 (F)	Full year (F)
GDP	6.0	2.2	8.1	4.8	1.0	4.6	4.0
Industrial value added of enterprises above designated size	5.7	2.8	9.6	6.5	0.8	5.8	5.0
Value added of the services sector	7.2	1.9	8.2	4.0	1.0	4.0	3.5
Fixed asset investments (cumulative)	5.4	2.9	4.9	9.3	5.9	5.8	6.0
Investment in real estate development (cumulative)	9.9	7.0	4.4	0.7	-4.6	-3.7	-2.6
Total retail sales of consumer goods	8.0	-3.9	12.5	3.3	-6.7	2.0	1.0
Exports	0.5	3.6	29.9	15.8	8.0	2.2	4.5
Imports	-2.7	-0.6	30.0	9.8	1.2	2.4	3.9
Consumer Price index (CPI)	2.9	2.5	0.9	1.1	2.3	3.1	2.4
Producer price index (PPI)	-0.3	-1.8	8.1	8.7	6.7	4.2	5.0
Broad money supply (M2, ending balance)	8.7	10.1	9.0	9.7	11.0	10.5	10.8
Aggregate financing to the real economy (stock, ending balance)	10.7	13.3	10.3	10.5	10.5	10.3	10.5
1-year MLF	3.25	2.95	2.95	2.85	2.85	2.85	2.80
1-year LPR	4.15	3.85	3.80	3.70	3.70	3.70	3.65
RMB/USD spot exchange rate	6.97	6.54	6.37	6.35	6.70	6.65	6.60

Note: We have made estimates under different scenarios of pandemic developments and containment measures. The annual GDP growth in 2022 is estimated to be about 3.2%, 4% and 4.7%, under the pessimistic, baseline and optimistic scenarios, respectively. This table only shows the baseline scenarios. For forecasts under all scenarios for individual indicators, please refer to the analysis above.

Source: BOC Research Institute

III. Macro Policy Suggestions

III.1 Fine-tuning the pandemic containment measures, coordinating COVID-19 response well with the pursuit of economic and social development

First, strictly implementing the “Nine No’s” requirements for COVID-19 containment. The virus containment work should be more scientific, precise and targeted to avoid simplistic or one-size-fits-all approaches, refrain from making local governments take redundant policy steps and ensure unimpeded flows across industry chains and supply chains.

Second, the day-to-day monitoring and emergency management mechanism should be improved. In emergency response to coronavirus, a whitelist of key businesses should be in place to ensure the continuity of their production, shipping and supply chain operations. Stronger support should be provided for market entities directly hit by the virus, including paying lockdown subsidies and distributing grants for job retention, to keep market entities afloat.

Third, offline government services should go online for higher efficiency. The government services should be further digitalized with more online service channels and remain unimpeded by the pandemic. Businesses should be provided with platforms for online streamlining, online recruitment and bank-enterprise pairing, thus helping create online marketing channels and resume production and sales as soon as possible.

III.2 the proactive fiscal policy will be more proactive in an all-out effort to support distressed businesses and expand effective investment

First, VAT credit refunds, postponement of tax payments and government purchasing should be used to reduce costs and boost growth of businesses. The policy requirements for VAT credit refunds should be refined. The social security contributions for three covers should be suspended for the hardest hit sectors and some micro, small and medium-sized enterprises. The scope of job retention grants under the unemployment insurance scheme should be expanded. The threshold for SMEs' participation in government purchasing should be lowered.

Second, the issuance and use of special government bonds should be accelerated. Credit funds and proceeds of special government bonds should be effectively linked to speed up the pairing of money and projects. Based on the nine categories of investment, the special government bonds should moderately expand the scope of supported fields, with a focus on clean energy and new infrastructure, to expand effective investment.

Third, given the mounting fiscal pressure on local governments, it is advisable to raise the fiscal deficit ratio as appropriate or issue special CGBs. China's budget deficit continued to widen from January through May due to the COVID-19 shocks, land market gloom and accelerating tax cuts and refunds. In H2, China should additionally issue special CGBs or raise the fiscal deficit ratio as appropriate to beef up the fiscal capacity for stabilizing growth, meeting basic living needs and ensuring lower-tier government operations.

III.3 Monetary policy tools should play a stronger role in adjusting both monetary aggregate and monetary structure to bolster the macro-economy

First, the financing climate should be reassuring to stabilize market expectations. RRR cut and other policy tools should be used at the right time according to economic developments, thereby providing sufficient liquidity for the real economy and bolstering its growth. Stronger support should be provided for the sectors, micro, small and medium-sized enterprises and self-employed individuals hit hard by COVID-19.

Second, targeted efforts should be made to beef up liquidity support for key sectors. The structural monetary policy tools should play a **stronger** guiding role. Special-purpose relending and rediscounting tools should be scaled up at appropriate time to step up support for key fields and weaker areas, including micro and small businesses eligible for inclusive finance, technological innovation and green businesses, to cement the foundation for economic growth.

III.4 Further tapping into investment to bolster the economy, giving a multi-pronged boost to consumption recovery

The policy to boost domestic demand should still focus on investment, especially in infrastructure to put a floor under growth. The proceeds of special government bonds should be turned faster into physical workload. The COVID-19 response plan for the infrastructure industry should be rationalized to lessen its coronavirus impact on project implementation. In addition, the policy toolkit should include extending the relief and support policies for businesses to beef up their confidence and expectations and boost their desire to invest for medium to long terms.

To address the weaker consumer spending due to falling income, raising the threshold for individual income tax is recommended as a stopgap to ease individuals' tax burden. Jobless people should be monitored on an ongoing basis. Unemployment allowances should be distributed for a certain period to meet the basic living needs of low-income earners.

III.5 Supporting reasonable needs on both supply and demand side to stabilize the property market

On the supply side, property developers' reasonable financing needs should be supported, with their liquidity profile closely watched. Financial institutions should be encouraged to issue M&A loans to property developers prudently in a well-ordered fashion. The regulatory policies including the "three red lines" should be dynamically recalibrated to leave more time for adjustment and adaption of developers. **On the demand side,** the real estate regulation policy will uphold the guiding principles of "houses for living in, not for speculation" and city-specific policies, and more duties regarding property curbs should be delegated to local governments. To better meet the reasonable housing needs without fuelling speculation, the demand-side restrictions should be lifted where possible in a bid to boost confidence in the property market and release the home-buying demand.

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