BOC Research Institute

China's Economic and Financial Outlook

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Highlights

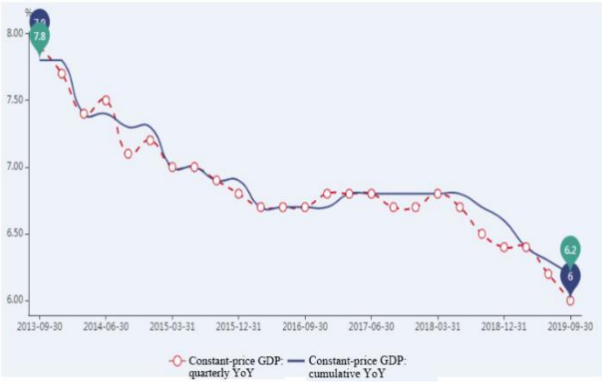
● The Chinese economy has witnessed greater complexities in both internal and external environments and higher downside pressure in 2019. Its performance remains in a reasonable range, thanks to the government's strengthened counter-cyclical policy adjustments and active implementation of the "six stabilities". The GDP growth, recorded at 6.2% for the first three quarters, is projected to be around 6.1% for the year 2019, down 0.5 percentage point from the previous year.

● China mainly faces the following risks and challenges in economy and finance: the continuous impact of Sino-US trade frictions; the short-term shock from pork price hikes; weak demand of the real economy curtailing a credit rally; and the likelihood of the bond default risk spreading to the credit market.

● Looking into 2020, we see more risks and challenges in the Chinese economy, yet with a "cautiously upbeat" tone. Given the current internal and external market environments, the natural growth rate of China's economy is likely to fall below 6% in 2020 if no major policy adjustments are made.

●To achieve the three goals of "two doubles", building a well-off society in all-round way and striding over the "middle income trap", the macro-economic policies for 2020 should keep worst-case scenarios in mind and enhance the awareness of potential challenges. It is suggested that the macro control policies be focused on ensuring stable growth, especially ensuring the GDP growth will not fall below 6%.

China's Economy on a Downtrend in 2019



Source: BOC Research Institute

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Sustaining 6% Growth Rate: the Core of Macro Policies in a Year of Critical Battles

-- China’s Economic and Financial Outlook (2020)

The Chinese economy has witnessed greater complexities in both internal and external environments and higher downside pressure in 2019. Its performance remains in a reasonable range, thanks to the government’s strengthened counter-cyclical policy adjustments and active implementation of the “six stabilities” (stable employment, financial sector, foreign trade, foreign investment, domestic investment, and expectations). The GDP growth, recorded at 6.2% for the first three quarters, is projected to be around 6.1% for the year 2019. China’s economy and finance are mainly exposed to the risks of Sino-US trade frictions, pork price hikes, subdued demand of the real economy and likelihood of the bond default risk spreading to the credit market. Looking into 2020, China’s economic growth will be a formidable task with more risks and challenges. Our overall judgment is “cautiously upbeat”. Given the current internal and external market environments, the natural growth rate of China’s economy is likely to fall below 6% in 2020 if no major policy adjustments are made. To achieve the three goals of “two doubles”, building a moderately prosperous society in all respects and striding over the “middle income trap”, the macro policies for 2020 should keep worst-case scenarios in mind and enhance the awareness of potential challenges. It is suggested that the macro control policies be focused on ensuring stable growth, especially ensuring the GDP growth will not fall below 6%.

I. 2019 Economic Review and 2020 Outlook

I.1 2019 economic performance features quarter-over-quarter slowdown under a mounting downward pressure

The year 2019 marks the 70th anniversary of the People’s Republic of China, and is also a year critical to securing a decisive victory in building a moderately prosperous society in all respects. In this year, China’s economy has encountered markedly more economic and non-economic difficulties and challenges, with greater complexities in external environment and internal conditions. The world economy has staged a turnaround from the “synchronous recovery” in the previous year to a “synchronous deceleration”. Major economies have shifted their monetary policy from “rate hikes” and “balance sheet contraction” to “rate cuts” and “balance sheet expansion (QE)”. The tit-for-tat trade conflicts and escalating protectionism, coupled with Brexit, geopolitical tensions and widespread Populism, have posed bigger risks and challenges to the global economy. Domestically, China’s economic performance remains in a reasonable range, thanks to the government’s strengthened counter-cyclical policy adjustments and active implementation of the “six stabilities”[1]. However, the Chinese economy has been slowing down from quarter to quarter under a mounting downward pressure. Generally, China’s economy featured “Two Falls, Two Rises and One Stability” in 2019.

“Two Falls”: First, the GPD growth rate has dropped to its post-1990 low amid economic downturn. China’s GDP grew by 6.2% in 2019Q1-Q3, 0.4 percentage point lower than the growth rate in 2018 (Figure 1), showing a downward pressure mounting from quarter to quarter. Based on

[1]At its meeting held on July 31, 2018, the Political Bureau of the CPC Central Committee called for actions to ensure stable employment, stable financial sector, stable foreign trade, stable foreign investment, stable domestic investment and stable expectations.

the October macro data released recently, GDP growth rate for 2019Q4 is likely to fall below 6%, and the annual GDP growth is projected at around 6.1%. The mounting downward pressure on China's economy comes from the tightening external environment and the domestic economic reshuffle. The tightening external environment includes the slowing global economy and escalating Sino-US trade war. The domestic "reshuffle" is driven by both the structural factor of shifting from old growth drivers to new ones and the policy factors including deleveraging, risk prevention and property market regulation.

Figure 1: China's Quarterly GDP Growth

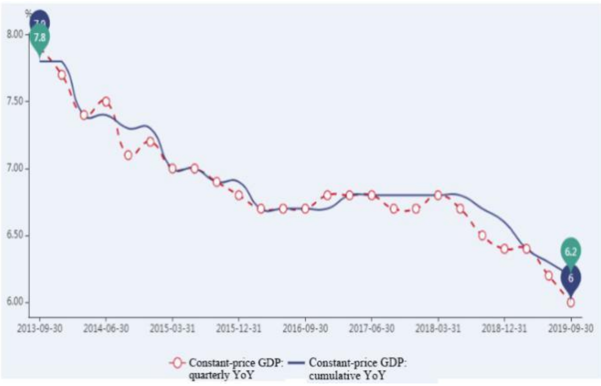
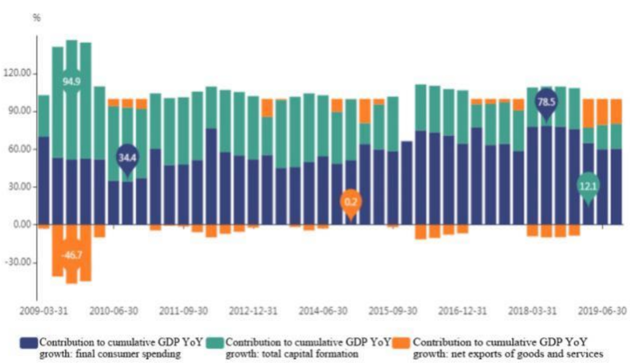


Figure 2: Contribution (%) of Three Demands to GDP Growth



Source: Wind, BOC Research Institute

Second, industrial enterprises have seen their profits turn negative as profitability weakens. Profits of industrial enterprises above designated scale nationwide fell by 2.1% cumulatively in 2019Q1-Q3, compared with a 14.7% increase in the same period last year. Loss-making enterprises recorded 11.4% in cumulative growth of losses, up 5.6 percentage points year-on-year (YoY). Unlike strong profit growth in energy and raw material industries such as steel, coal and nonferrous metals as well as new and high technologies and equipment manufacturing in 2018, industrial enterprises have experienced deterioration in profits in front-end, mid-range and back-end industries in 2019. Government revenue grew by 3.3% in Q1-Q3, down 5.4 percentage points YoY. Per-capita disposable income of urban households grew by 5.4%, down 0.3 percentage point YoY.

"Two Rises": First, trade surplus has expanded sharply with a rise in foreign exchange reserves. As imports registered a sharper decline than exports, the surplus of trade in goods and services expanded significantly in 2019 rather than narrowed, standing at USD141.8 billion, 5.1 times that of the same period last year. The difference between current accounts and direct investment as a percentage of GDP rose to 1.67% in 2019Q1-Q3 from 0.75% in 2018Q1-Q3. Official foreign exchange reserves amounted to USD3.1 trillion at the end of October, an increase of USD32.5 billion from the end of last year.

Second, the "pork shortage" has fueled the consumer price hikes. CPI rose by 2.6% in the first ten months, up 0.5 percentage point YoY, expected to gain 2.7% or so for the year, which is still lower than the 3% target. The major contributor to CPI inflation is the pork price hikes. The pork price surged by 29.7% YoY in the first ten months, skyrocketing even by 101.3% in October alone. The pork price increase also has driven up the prices of beef and mutton, which rose by 10.2% and 11.7% respectively in October 2019. Food price went up by 7.4% accumulatively in the first ten months of 2019, up 5.8 percentage points YoY. Non-food price gained 1.4% accumulatively, down 0.8 percentage point YoY. In a sharp contrast with CPI, PPI has entered the negative growth territory due to receding growth in prices of production materials, down 0.2% cumulatively in the first ten months.

"One Stability": Employment is stable, as shown by the surveyed unemployment rate and number of unemployed people. 11.93 million urban jobs were added nationwide in the first ten months of 2019, reaching the government target of at least 11 million jobs two months ahead of schedule. Surveyed urban unemployment rate and surveyed unemployment rate in 31 large cities were both 5.1%, below the target of around 5.5%. There were 1.33 million unemployed people registered in 2019Q1-Q3, basically unchanged when compared with last year.

1. Supply side: the three demands show mixed performance, with net exports becoming a bigger contributor

Of the three demands, consumption contributed the largest share of 60.5% to economic growth in 2019, the lowest level since 2015 (Figure 2), down 17.5 percentage points YoY. Over the same period, investment contributed 19.8%, down 12 percentage points YoY, while net exports turned from a negative contributor to a positive one (19.8%). The mixed performance of the three demand contributors (domestic demand contributed less while foreign demand contribute more) resulted from weaker domestic demand in 2019, rather than faster growth in exports.

Investment growth has hit a historic low, with manufacturing being the largest drag. In the first ten months of 2019, fixed asset investment grew by 5.2% cumulatively, the lowest on record. Specific characteristics are as follows: **First,** infrastructure investment was weaker than expected. Infrastructure investment increased by 4.2% cumulatively from January to October, 2.34 percentage points faster than one year ago. However, infrastructure had a "too large demand to be funded", weighing on the growth in infrastructure investment. **Second,** manufacturing investment remained stagnant. Manufacturing investment increased by 2.6% accumulatively from January to October, down 6.5 percentage points YoY. **Third,** real estate investment remained resilient. Real estate investment grew by 10.3% cumulatively from January to October, 0.6 percentage point faster than the previous year. **Fourth,** investment growth showed obvious regional disparities. Central China saw the fastest growth in investment nationwide with a cumulative growth rate of 9.3% in the first ten months of 2019. Northeastern China saw investment growth falling into the negative territory.

Consumption growth moderated in general, with automobile consumption remaining in the negative territory. Total retail sales of consumer goods grew by 8.1% accumulatively from January to October in 2019, down 1.1 percentage points YoY. Below are main characteristics: **First,** automobile consumption was the main drag on consumption growth in 2019. Automobile consumption dragged down consumption growth by 0.9 percentage point cumulatively from January to October. Ex-automobile consumption grew by 9% cumulatively. **Second,** urban consumption slowed down significantly while rural consumption was basically stable. Total retail sales of consumer goods grew by 9% cumulatively in rural areas from January to October, 1.1 percentage points higher than the growth rate of urban consumption. **Third,** non-discretionary consumption remained stable but discretionary consumption decelerated.

Exports weakened, with exports to major trade partners slowing down. Global economic slowdown has been more noticeable in 2019, coupled with the continued substantial impact of Sino-US trade frictions. Exports and imports grew by -0.2% and -5.1% cumulatively from January to October, down 12.6 percentage points and 25.3 percentage points YoY, respectively. **First,** exports to the United States fell sharply, grew by -11.3% from January to October in 2019, down 24.6 percentage points YoY. **Second,** exports to emerging economies grew fast. Exports to ASEAN grew by 10.4% from January to October in 2019. **Third,** the trade structure continued to improve. General exports rose by 8.5% from January to October in 2019, with its share expanding by 1.9 percentage points to 58.2%.

2. Supply side: Manufacturing and services slowed down synchronously

Industrial production in 2019 has been continuously dragged down by subdued demands at home and abroad. Industrial value added of enterprises above designated scale gained 5.6% in the first ten months, down 0.8 percentage point YoY. The industrial sector's contribution to GDP growth fell from 32.5% for the same period last year to 30.9% in 2019Q1-Q3. Industrial value added of enterprises above designated scale is expected to grow by about 5.5% annually in 2019, down 0.7 percentage point or so from last year.

Below are the main characteristics of industrial performance in 2019:

First, the industrial sector has felt markedly bigger adverse impact of a tightening external environment, including Sino-US trade frictions and global economic slowdown. Sino-US trade frictions have escalated with fluctuations since 2018. Delivery value of industrial exports grew by only 1.8% in the first ten months of 2019, down 6.8 percentage points YoY.

Second, profits turned down substantially in mining, petroleum processing, chemical products, non-metallic mineral products, ferrous metals machining and automobile, driving industrial profit growth into negative territory. Profit growth of industrial enterprises turned negative in 2019 amid softening demand and PPI growth, standing at -2.1% in Q1-Q3, down 16.8 percentage points YoY.

Third, growth in services further weakened due to subdued consumer and producer spending. Service value added has further slowed down in 2019, growing by 7% YoY in Q1-Q3, down 0.7 percentage point YoY. The service sector is expected to end the year with an annual growth rate of about 7%, down about 0.6 percentage point YoY. **On the one hand, consumer services registered slower overall growth and smaller contribution to cumulative YoY GDP growth.** Retail and wholesale, accommodation and catering services and real estate together contributed 14.3% of cumulative YoY GDP growth in 2019Q1-Q3, down 1.3 percentage points YoY. **On the other hand, contribution of producer services picked up on a rally in financial sector growth.** Transportation, storage and postal services, financial services, information transmission, software and information technology services and leasing and commercial services together contributed 30.6% of cumulative YoY GDP growth in 2019Q1-Q3. It was mainly driven by a rally in financial services growth, which rose 7.1%, up 3.3 percentage points YoY in 2019Q1-Q3.

I.2 Economic outlook for 2010: "cautiously upbeat"

The year 2020 marks the end of China's 13th Five-year Plan, and is also a year critical to achieve the goal of "two doubles" and securing a decisive victory in building a moderately prosperous society in all respects. Economic growth will be a formidable task with many risks and challenges ahead. Overall, we are "cautiously upbeat" about China's economy. The cautious part lies in the following: First, the substantial impact of the Sino-US trade frictions and tit-for-tat tariffs will continue to linger (the impact of tit-for-tat tariffs will last for 2 to 3 years). Second, real estate investment will pull back from high as the government adheres to the policy that "houses are for living in, not for speculation" and tightens real estate financing across the board. Third, there will be less policy room for tax and fee reduction, limiting further proactiveness of the fiscal policy, and the counter-cyclical adjustments of the monetary policy will be less effective. The upbeat part is based on the following: First, global monetary easing continues with rate cuts and more international capital flows in, helping improve liquidity and financing of businesses. Second, as automobile consumption recovers and new consumption[2] continues to strengthen, consumption will further boost its fundamental role.

[2] New consumption covers tourism, culture, sports, education, housekeeping services, health care, elderly care, housing, automobile and green fields.

1. Infrastructure investment will work as a stabilizer, while manufacturing investment will remain stagnant

Infrastructure investment is expected to remain the priority of government spending in 2020. We expect more special government bonds to be issued and infrastructure investment growth to further pick up in the foreseeable future. The real estate regulation will uphold the guiding principles of "houses for living in, not for speculation" and implementing city-specific policies. Real estate investment will slow down due to the tightening of policies and property developer financing. Manufacturing investment will remain under significant downward pressure. On the one hand, demand recovery is sluggish; on the other hand, the poor profitability of manufacturers is unlikely to improve remarkably over the short term. Growth in fixed asset investment is expected to be stable and titled to the downside in 2020, with an estimated annual rate of 5.6% or so.

2. The policy to ensure "stable consumption" will continue to strengthen, with consumption in automobile and other key fields considered the key to stability

Consumption is expected to stabilize as long as the pro-consumption policy works well. **First,** the policy effects sending automobile consumption into drastic fluctuations in 2019 will fade away in 2020. The government policy is expected to phase out restrictions on, and thus boost, automobile consumption. **Second,** consumption upgrades will remain a prevailing trend. In the future, internet consumption, experience-based consumption and individualized consumption will be more pervasive, and new consumption scenarios will emerge in succession. In 2020, total retail sales of consumer goods are estimated to grow stably at an annual pace of around 8%.

3. The low comparison base increases the likelihood of a mild recovery in foreign trade growth

2020 will see no turnaround in the external environment of China's exports. The stagnant world economy, ongoing trade protectionism and global industry chain shifts will continue to weigh on the growth in China's international trade. However, there also will be some favorable factors for China's foreign trade growth. **First,** emerging economies are expected to gain growth momentum in 2020 to boost the growth in China's exports to ASEAN and other emerging economies. **Second,** as Sino-US trade frictions are eased at present, the world's largest two economies are expected to reach a "phase-one" trade deal. These factors, together with the low base of exports in 2019, are expected to lift exports growth to around 1% in 2020.

4. Industrial production will remain under pressure, with weak demand being a drag on services growth

2020 will see industrial production still advancing in twists and turns. Overall demand will remain weak. **In terms of structural shift,** the structural improvements and upgrades will continue into 2020. High-tech manufacturing will advance faster than industrial average, yet still a limited contributor to the growth of industrial economy. **In terms of inventory cycle,** finished goods inventories generally have three-year growth cycles. Industrial finished goods inventories have been slowing down since 2019 began, hitting a pace of 1% in Q1-Q3, near the all-time low. Restocking is expected to occur in 2020H2 to help stabilize industrial production. Overall, industrial value added of enterprises above designated scale is expected to grow by about 5.3% in 2020, down about 0.3 percentage point from 2019.

5. CPI growth will move higher and then turn lower, with PPI expected to turn from negative to positive

Looking ahead to 2020, CPI growth will move higher overall, expected to stay fast at first and then slow down. First, the carryover effects will remain generally high in 2020H1, and weaken in a faster pace in H2 (Figure 3). Second, new inflation factors will remain in H1, including the Spring Festival factors at the year beginning and the time lag of pork supply growth. Despite the rising hog/grain price ratio, the number of live hogs will continue to fall. The situation will drive up the price hikes of other meats and spur a rapid rise in food prices. Considering the gradual supply improvements and comparison base, pork price hikes will gradually slow down and CPI growth is expected to decelerate at a faster pace. Annual CPI growth is projected to be around 3.3% for the year.

PPI growth is expected to turn from negative to positive in 2020, yet still at a low level. First, PPI carryover effect will be low, moving around zero within a narrow band. Second, new drivers of industrial product price hikes are still insufficient amid the slowing overall economic demand. Third, the prior-year base is low. PPI is expected gain around 0.2% in 2020, up about 0.5 percentage point YoY.

Figure 3: CPI and PPI Carryover Effects in 2020

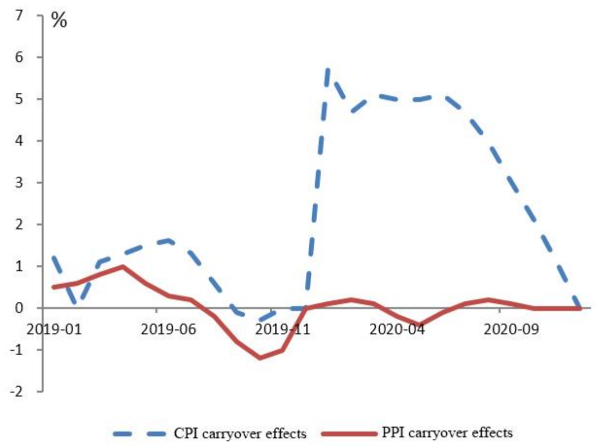
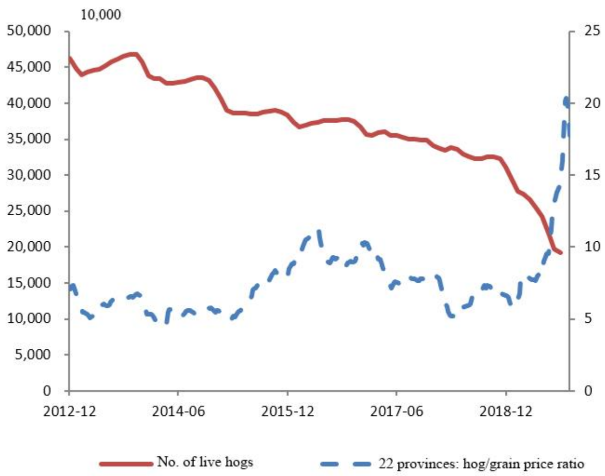


Figure 4: Live Hogs and Hog/Grain Price Ratio



Source: Wind, BOC Research Institute

II. 2019 Financial Review and 2020 Outlook

In 2019, financial work was focused on implementing the policy for ensuring a "stable financial sector", opening the financial market wider and advancing the supply-side structural reform in the financial sector. On the one hand, the loan prime rate (LPR) formation mechanism was improved and the reserve requirement ratio (RRR) was cut for three times to boost the support targeted at private enterprises and micro and small businesses. In addition, perpetual bonds were issued and the Nasdaq-style high-tech board, known as STAR Market, was launched. On the other hand, China's financial opening-up has gone deeper into a new phase. Shanghai-London Stock Connect was kicked off. The market access threshold for foreign financial institutions was lowered significantly. QFII and RQFII investment quota limits were removed. China's bond and equity markets were included in a number of international indices. China's financial market ran steadily in general while the country stepped up its financial reforms and opening-up. Monetary loans grew steadily. Private enterprises and micro and small businesses had easier access to financing. Interest rates in the money market were low. Enterprises saw their costs of funding declining. The A-share stock market went up with fluctuations and the RMB exchange rate was stable.

II.1 Main features of 2019 financial performance: the financial market ran steadily

1. Money supply and aggregate financing picked up with improvements in financing of the real

economy

In 2019, money supply and aggregate financing to the real economy picked up due to stronger counter-cyclical adjustments of the monetary policy and enhanced financial support for the real economy. As of the end of October 2019, the stock of aggregate financing to the real economy and M2 grew by 10.7% and 8.3%, up 0.5 percentage point and 0.4 percentage point YoY, respectively.

Medium- and long-term loans took up a larger percentage, with inclusive finance loans registered stronger YoY growth. In the first ten months of 2019, cumulative new medium- and long-term loans accounted for 66.9%, up 1.7 percentage points from 2018. The rally in share of medium- and long-term loans was mainly attributable to financial institutions' strong support for the real economy. Small and medium-sized enterprises had more access to financing as the inclusive finance business of financial institutions grew rapidly. As at the end of Q3, main financial institutions registered RMB16.99 trillion in balance of inclusive finance loans, up 16.8% YoY.

2. Money market interest rates remained low with higher volatility

Interest rate performance in various markets showed the following characteristics in 2019: **First,** the average money market interest rate remained low. DR007 averaged 2.61% and 2.67% in H1 and H2 2019 under a prudent monetary policy, down 34 bps and 10 bps YoY, respectively. **Second,** PBOC drove down lending rates for the real economy by reforming and improving the LPR formation mechanism. As shown by LPR quotations, one-year LPR stood at 4.25% and 4.2% in August and September respectively, indicating a mild decline. **Third,** financing rates for the real economy registered a limited drop. The weighted average lending rate of financial institutions was 5.62% in 2019Q3, down merely 2 bps from the end of 2018.

3. The bond market became more volatile, running through the year with W-shaped fluctuations

The combined effect of favorable and unfavorable factors, including economic downturn, ample liquidity, resurgence of inflation and rise in default risk, sent the 10-year treasury bond yield into wider fluctuations. The yield even soared steeply at some points, showing a W-shaped curve through the year. The 10-year treasury bond yield closed at 3.1747% on November 22, 2019, down 22 bps YoY. The resistance to long-term interest rate decline in 2019 had its root cause in such factors as inflation escalation and prudent monetary policy[3]. Below are main characteristics of bond market performance in 2019: First, bond market financing increased, with local government issues expanding significantly. Bond issues totaled RMB40.3 trillion in 2019 (as of November 22), representing 92% of the annual total of 2018. Local government bond issues totaled RMB4.3 trillion, surpassing the 2018 level (RMB4.16 trillion). Second, the risk of bond defaults remained severe. 148 bonds had been defaulted in 2019 (as of November 22), with a defaulted amount of RMB118 billion. Either number or value of defaulted bonds exceeded the 2018 level (121 bonds with a defaulted amount of RMB121 billion). Defaulting issuers were still mainly private enterprises.

4. The A-share market began with a sharp rise, followed by a gentler fall, amid faster capital market reform and opening-up

The equities market showed the following characteristics in 2019: **First,** A-shares began with a sharp rise followed by a gentler fall, showing significant fluctuations. From the beginning of 2019 to mid-April, the Shanghai Stock Exchange (SSE) Composite Index surged from 2465 by 32.7% to 3271 on improved investor sentiment, effective policy supports and foreign capital inflows. In the second

[3]Money supply adhered to a prudent overall tone in 2019 without any significant easing. It was notably mirrored by PBOC's RRR cuts in parallel with its withdrawal of liquidity through open market operations. As of November 15, 2019, PBOC withdrew about RMB625 billion of liquidity through open market operations.

stage ranging from mid-April to November 22, the market performance weakened with fluctuations due to higher downside pressure on the economy and twists and turns in Sino-US trade frictions. The SSE Composite Index closed at 2885 on November 22, down 11.8% from mid-April. **Second,** foreign capital inflows gained pace markedly. As of November 22, 2019, foreign capital influxes amounted to RMB887.6 billion under Hong Kong and Shenzhen stock connect programs. MSCI, FTSE Russell, S&P Dow Jones and some other international indices included A-shares in their global indices and raised the inclusion factor successively.

5. RMB exchange rate declined with fluctuations, with market expectations remaining stable after it fell below 7 against USD

RMB exchange rate against USD initially rose, then fell and eventually picked up in 2019 amid the deteriorating external circumstances, downside economic pressure and twists and turns in the Sino-US trade war. RMB value even touched a ten-year low of 7.17 on September 3 and then bottomed out (Figure 5). The exchange rate market showed the following characteristics: **First,** the exchange rate fluctuated widely. RMB exchange rate against USD registered a largest daily drop of 1.44% in 2019, notably higher than that (0.89%) recorded in 2018, mainly due to such factors as another escalation in the Sino-US trade war. **Second,** the balance of foreign exchange (FX) settlement and sales kept narrowing as the market expectations on RMB exchange rate changed. FX settlement and sales by banks as agents finished October with a deficit (USD4.236 billion), which shrank for four consecutive months (Figure 6). The expansion in inbound securities investment was an important contributor to the contraction in FX settlement/sales deficit.

Figure 5: Spot Exchange Rate of RMB against USD

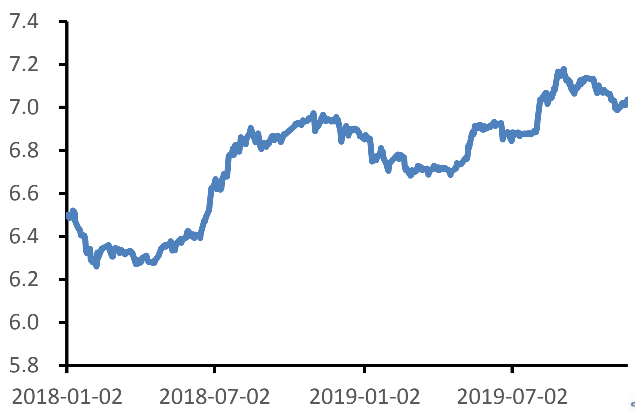
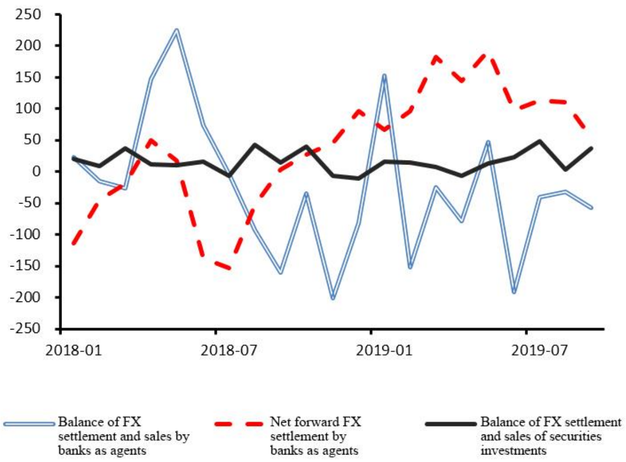


Figure 6: Size of FX Settlement and Sales by Banks as Agents (USD100 million)



Source: Wind, BOC Research Institute

II.2 Financial forecast for 2020: looking into the impact of new changes in global capital flows

Looking ahead to 2020, the global financial market will experience more uncertainties. On the one hand, financial markets are the first to benefit from relatively ample liquidity brought by the global wave of monetary easing. But it will make the financial system more vulnerable in the long run. Sino-US trade conflicts and geopolitical tensions will still touch a raw nerve with the financial market sensitive to risks. From banks' perspective, the lack of effective credit demand remains the biggest drag on credit supply. On the other hand, China's stronger efforts on financial sector reforms and opening-up will help boost market confidence and attract capital inflows, making China a hot spot for investment in global financial markets.

1. Money supply and aggregate financing will grow steadily, but the lack of effective credit demand will remain the biggest drag on credit supply.

Looking ahead to 2020, money supply and aggregate financing will continue to grow steadily. **On the supply side,** the monetary policy is expected to be more focused on structural adjustments while strengthening counter-cyclical regulation, which will help banks to increase credit supply. In addition, the recent capital inflows via capital accounts to China will boost enterprises' access to financing in bond and equity markets.

On the demand side, consumption, investment and exports all have slowed down in 2019 under higher downside pressure on the domestic economy. Enterprises are more cautious about investment, having low demand for financing. Meanwhile, huge demand for financing will come from hot spots of economic growth, including infrastructure investment, new industries, new consumption, and economic integration of the Yangtze River Delta, Guangdong-Hong Kong-Macao Greater Bay Area and Hainan Free Trade Zone. We expect M2 to grow by about 8.6%, the stock of aggregate financing to grow by around 10.8% and new RMB loans to reach RMB18 trillion or so in 2020.

2. Money market interest rate will edge down slightly, with the monetary policy transmission mechanism further unblocked

Money market interest rates will remain low in 2020. The monetary policy transmission mechanism will be further unblocked as the interest rate reform continues to move on. **First,** the mounting downside pressure on the economy at present further underlines the importance of ensuring stable growth. Thus the monetary policy will strengthen counter-cyclical adjustments, helping keep interest rates low in the money market. **Second,** the global wave of interest rate cuts expands the space for China's monetary policy operations. Over 30 economies have lowered interest rates since 2019 began. The US Federal Reserve has reduced interest rates for three times, with more rate cuts expected to come in 2020. **Third,** LPR will further play its role to guide downwards the financing costs for the real economy.

3. The bond market will fluctuates at a high level, and the long-term rate will show a downward trend

The bond market is expected to fluctuates at a high level in 2020, and the 10-year treasury bond yield rate will show a downwawrd trend. The main driving factors are as follows: **First,** the monetary policy will remain prudent amid economic downturn. **Second,** foreign investors will remain eager for allocations to China's bond market. As at the end of September 2019, overseas institutions held RMB2.1 trillion in China's domestic bonds, the highest on record. The main unfavorable factors are as follows: **First,** the higher volatility of short-term interest rates causes disturbances to the decline in long-term interest rates. Haunted by a lingering shadow of the Baoshang Bank incident, Shibor and other short-term interest rates have become markedly more volatile since June 2019. **Second,** inflation pickup will become a drag on long-term interest rates. Pork shortage will further expand with an all-time low stock of live hogs, worsened by the rising demand as the Spring Festival is coming. Thus prices will be inflated to curb the long-term interest rate decline.

4. A-share market will go up with fluctuations amid the wrestling of many factors

A-share market will go up with fluctuations in 2020 amid the wrestling of favorable and unfavorable factors. The main favorable factors are as follows: **First,** market liquidity will remain ample in the context of strengthened counter-cyclical adjustments of the monetary policy. **Second,** incremental funds will continue to enter the stock market. As MSCI, FTSE Russell, S&P Dow Jones and other international indices include more A-shares, there will be continuous influxes of incremental funds. The main unfavorable factors are as follows: **First,** China's economic fundamentals will still be too weak to support a big bull in the capital market in 2020. **Second,** the continuous increase in CPI in H1 will affect market expectations for the degree of monetary easing. Overall, the capital market is likely to edge up slightly with fluctuations in 2020, expected to perform better in H2 than in H1.

5. RMB exchange rate: less volatile with more stabilizing factors

Looking ahead to 2020, in spite of the uncertainties in Sino-US trade frictions, there will be notably more favorable factors for RMB exchange rate under mounting downside pressure on the world economy. **First,** the Sino-US trade war shows signs of abating to help stabilize financial market expectations. **Second,** foreign investors increase their holdings in domestic financial assets. The interest rate spread between US and Chinese bonds continues to widen as negative-rate assets expand worldwide. Moreover, financial capital inflows are further facilitated by China's removal of QFII and RQIFF investment quota limits and other financial opening-up policies implemented in succession. Considering the long duration and complexity of the Sino-US trade conflicts, however, the exchange rate market will probably fluctuate more widely than expected.

III. Risks and Challenges Requiring Attention in Current Macro-economic and Financial Fields

III.1 Continuousimpact of Sino-US trade frictions

The long-term and complex power game between the United States and China will have sustained impact on the Chinese economy in the future. **First,** the exchange of tariffs between the United States and China will continue to affect China's imports, exports, corporate investments and producer activities. **Second,** China is under greater pressure from the outbound shifts of industry chains and supply chains. **Third,** China feels bigger pressure on the research and development of key and core technologies. **Fourth,** the risk of financial market volatility increases. The twists and turns in Sino-US trade frictions have notably enlarged the stock market volatility in both countries. Moreover, investors in China's stock market show obvious irrational signs, further adding to the volatility.

III.2 Short-term shock of pork price hikes

CPI growth will accelerate significantly due to pork price hikes in 2020. However, the structural divergence between food prices and non-food prices will continue. **First,** the African swine fever may have longer impact on pork supply than expected, resulting in a longer "pig cycle" than before and pushing up food prices. **Second,** CPI growth will remain high in 2020, especially in H1, likely to raise the inflation expectations, dampen market sentiment and confidence and change the behaviors of consumers and investors.

III.3 Weak demand of the real economy will curtail credit rally

The greater urgency of ensuring stable growth necessitates stronger counter-cyclical financial supports. But the current sluggish demand of the real economy obviously curbs credit growth. **First,** under the mounting downside economic pressure and other factors, non-financial enterprises suffer major difficulties in production and operation and have insufficient credit demand. **Second,** overcapacity cuts and production cuts for environmental compliance place a big pressure on conventional industries, which have less demand for financing. **Third,** NPL ratio rises due to poor production efficiency of enterprises. The wholesale and retail trade industry, for example, recorded an NPL ratio of 4.5% in 2018, much higher than the average NPL (2.4%) of industrial enterprises.

III.4 The risk of bond defaults may spread to the credit market

Bond market defaults were still frequent in 2019, expected to spread to other financial markets in the future. Particular attention should be paid to the default risk among manufacturers and private enterprises. **First,** operating conditions of enterprises are unsatisfactory or even deteriorate. Profits of industrial enterprises fell by 2.1% YoY in 2019Q1-Q3, putting an end to the positive profit growth that continued through the past three years. **Second,** industrial enterprises, especially manufacturers and private enterprises, see their accounts receivable turnover slowing down. Industrial accounts receivable had an average turnover of 54.6 days at the end of September 2019, up 7.7 days YoY.

IV. Macro-economic Policy Suggestions

IV.1 The fiscal policy should be more proactive to raise the government deficit ratio to 3% or higher

First, the government deficit ratio should be increased. To counter the lingering downside economic pressure, the fiscal policy should further keep worst-case scenarios in mind and give top priority to ensuring stable growth in 2020. The general public budget deficit ratio can be raised from 2.8% this year to 3% or even higher.

Second, reducing taxes and fees and expanding infrastructure investment to strengthen weaker areas should be the two pillars of the fiscal policy. Given the continuous weakening of overall demand, expanding special local government bonds is an important policy tool for short-term counter-cyclical adjustments. The local government fund deficit is estimated to increase to RMB3.24 trillion in 2020 from RMB2.15 trillion in 2019. In addition, the special government bonds should be leveraged to fund the infrastructure investment and bolster investment growth. In addition, tax and fee reductions should be further improved and refined, including both broad-based tax cuts and structural tax cuts.

IV.2 Monetary policy: adjusting the basic orientation of the monetary policy for reasonable and moderate growth in monetary credit

First, interest rate cuts and RRR cuts should be employed to ensure reasonable and moderate growth in monetary credit. Considering various factors, we suggest two to three RRR cuts in 2020. As for interest rate reduction, LPR, MLF and other tools should be used to bring down interest rates and reduce excessive volatility in money market interest rates.

Second, crackdown on accounts receivable defaults should be strengthened to remove obstacles to monetary policy transmission caused by non-market factors. Accounts receivable defaults are a major problem facing many SMEs, and a significant obstacle to monetary policy transmission. The government is suggested to speed up collection of overdue accounts receivable and toughen punishments against defaults, make clear the payment conditions and deadlines and continue to strengthen the crackdown on accounts receivable problems.

IV.3 The focus of supply-side structural reform should shift from "breaking" to "making".

First, shifting from overcapacity cuts to pursuing transformation and upgrading. The task of cutting excessive coal and steel capacities has been accomplished. Greater importance should be attached to improving industry chains in 2020. Robotics, high-tech and new materials, 5G and artificial technology should be advanced to promote integration of industrialization and information technology, and to boost technological upgrading of traditional industries and development of emerging industries.

Second, shifting from de-leveraging to leverage improvements. Under the deleveraging policy effects, macro leverage ratio has been stable while tilted to the downside in recent years, with micro leverage ratio coming down continuously. As a result, financing channels are tightened too fast to some degree. In the future, the deleveraging policy should switch to improving leverage, thereby helping stabilize market expectations and increase leverage efficiency.

IV.4 Shifting from de-stocking to ensuring stable supply to keep the property market stable

First, the government should adhere to the demand management policy of keeping loan and purchase restrictions not relaxed, while distinguishing between speculative demand and real demand. In the future, the real estate regulation policy should remain city-specific to curb investment or speculative demand while supporting real housing demand.

Second, keeping in line with the prevailing trends in economic development such as urban renewal, population aging and clustering of cities, **efforts should be strengthened to increase housing supply, including renovation of old residential areas, elderly care services and rental housing construction, so as to cushion the abrupt downturn in shantytown redevelopment** that adversely affects real estate investment.

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