BOC Research Institute

China's Economic and Financial Outlook

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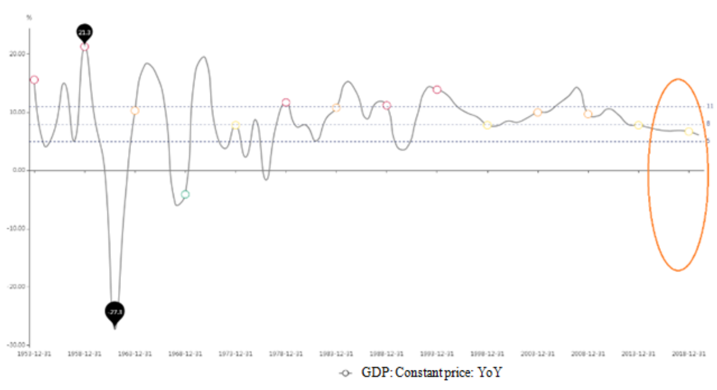
Highlights

- 2020Q1 witnessed an earth-shaking reversal of the economic environment at home and abroad. The unexpected spread of COVID-19 pandemic around the world, coupled by commodity price slumps and global financial market upheaval, has dealt the heaviest blow to the Chinese economy since its start of reform and opening-up. China's GDP growth is likely to enter a rarely seen negative territory and hit a 45-year low.

- Looking forward to Q2, China will find the economic impact of local COVID-19 epidemic abating gradually, but still remain under pressure from various aspects as the virus is expected to further spread worldwide and send its ripples back to the country. China's economy is estimated to regain positive growth in Q2 as the government is stepping up the implementation of policies on resumption of work and production, and launching increasingly strong policies to stabilize growth.

- Now China's economy faces huge challenges and risks posed by unprecedented structural factors (shifting from old to new growth drivers and restructuring of global industry and value chains) and cyclical factors (global COVID-19 pandemic, commodity price slumps and financial market upheaval). To tackle the economic downturn and the threatening employment and social problems, we suggest special responses at special times. The macro-policy maker should take strong actions resolutely to make adjustments and give top priority to stabilizing employment, supporting SMEs and ensuring basic living standards.

China's Economic Growth Curve in the Past 70 Years (%)



Source: BOC Research Institute

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Major Policy Overhaul Needed to Cushion COVID-19 Shock

-- China's Economic and Financial Outlook (2020Q2)

2020Q1 witnessed an earth-shaking reversal of the economic environment at home and abroad. The unexpected spread of COVID-19 pandemic around the world, coupled by the commodity price slumps and financial market upheaval, has seriously affected the economy. The Chinese economy is suffering the heaviest shock since its launch of reform and opening-up. China's GDP growth is likely to enter a rarely seen negative territory and hit a 45-year low. Looking forward to Q2, China will find the economic impact of local COVID-19 epidemic abating gradually, but still remain under pressure from various sides as the virus is expected to further spread worldwide and send its ripples back to the country. China's GDP is estimated to regain positive growth (at around 3%) in Q2 as the government is stepping up the implementation of policies on resumption of work and production, and launching increasingly strong policies to stabilize growth. Now China's economy faces huge challenges posed by unprecedented structural factors (shifting from old to new growth drivers and restructuring of global industry and value chains) and cyclical factors (global COVID-19 pandemic, commodity price slumps and financial market upheaval). To meet the challenge of economic downturn and the threatening employment and social problems, we suggest special responses at special times. The macro-policy maker should take strong actions resolutely to make adjustments and give top priority to stabilizing employment, supporting SMEs and ensuring basic living standards.

I. 2020Q1 Economic Review and Q2 Outlook

I.1 The COVID-19 outbreak may turn China's economic growth negative in Q1 for the first time since its reform and opening-up began

The **global economic slowdown** and **Sino-US trade frictions** added to the downside pressure on Chinese economy in 2019. Its GDP growth slowed down to 6.1%, yet still within a reasonable range in general. However, 2020 began with an earth-shaking reversal of domestic and overseas situations.

First, the COVID-19 outbreak has exploded into a global pandemic. The sudden outbreak of COVID-19 in early 2020 quickly evolved into a "major public health emergency[1] with "the fastest spread, the broadest infections and the greatest degree of difficulty in containment since the founding of the People's Republic of China". The epidemic led to the extended Chinese New Year holiday, traffic control and restrictions on the movement of people, having a severe impact on the national economic activity. Since March, China has made notable progress in COVID-19 containment, but the global spread of the virus has escalated increasingly. Many countries have declared a state of emergency, even lockdown of cities or countries. The World Health Organization has raised the global risk level of COVID-19 to "very high", labeling it as a "pandemic".

Second, global oil prices underwent an epic slump. The COVID-19 outbreak has worsened global economic expectations and subdued energy demand, which drove down crude oil prices markedly. Against this background, the "collapse" of OPEC+ production cut deal on March 6 has dealt a fatal

[1] As of March 23, 2020, there were 291,900 confirmed cases worldwide, including 81,747 confirmed cases in Chinese mainland and directly affecting more than 100 countries and regions.

blow to global oil prices. The price of Brent crude plunged by more than 30% at the opening on March 9. Brent crude futures settled at USD27.03 per barrel on March 23, down 59.2% from USD66.25 per barrel at the beginning of the year. In addition, commodity prices have also dropped significantly. LME copper closed at USD4,601 per ton on March 23, down 25.87% from the beginning of the year.

Third, the global stock markets triggered "circuit breakers" and chain reactions[2]. Panic surged across global financial markets amid global COVID-19 pandemic and oil price plunge. The VIX index soared to 82.69 on March 16, an all-time high that refreshed the record hit during the 2008 international financial crisis. As US stocks have triggered "circuit breakers" four times since March, the three major US stock indexes have sank into a "technical bear market" (i.e. down more than 20% from the recent peak). As of market close on March 23, the stock markets of more than 10 countries including the United States, Brazil, Canada, Thailand, Philippines, Pakistan, South Korea, Indonesia, Mexico, Colombia and Sri Lanka had triggered the "circuit breaker", and the stock indexes of more than 30 stock markets worldwide had dropped into a "technical bear market".

Old challenges (global economic slowdown and Sino-US trade war) and **new shocks** (global COVID-19 pandemic, oil price slumps and stock market woes) together are dealing the heaviest blow to China's economy since its start of reform and opening-up, with its GDP growth likely to reach a 45-year low. According to the January and February data, either investment, consumption, imports and exports on the demand side or the industrial and service production on the supply side showed a sharp contraction. In February, the official PMI fell to 35.7, the lowest on record. As production and work have been resumed in a well-organized manner across the country, China is expected to see its economic activity improving in March as compared with February, yet still below the normal level. GDP growth in Q1 is estimated to be around -10% using the production approach (Table 1).

Table 1: Production-based Estimate of GDP Growth in Q1 (%)

	Jan.-Feb. cumulative	Jan.-Mar. cumulative[3]	% of GDP[4]	Contribution to GDP growth	GDP growth
Agriculture	-6.0 (estimated)	-5.0 (estimated)	7.11	-0.35	-9.6
Industry[5]	-13.5 (real)	-10.0 (estimated)	38.97	-3.90	
Service[6]	-13.0 (real)	-10.0 (estimated)	53.92	-5.39	

Source: BOC Research Institute

[2] "Circuit breaker" refers to a regulatory measure to suspend trading to control risks when the stock index movement reaches the specified threshold. Different countries set different circuit breaker levels. In the United States, a market-wide drop of 7% will trigger the "circuit breaker".

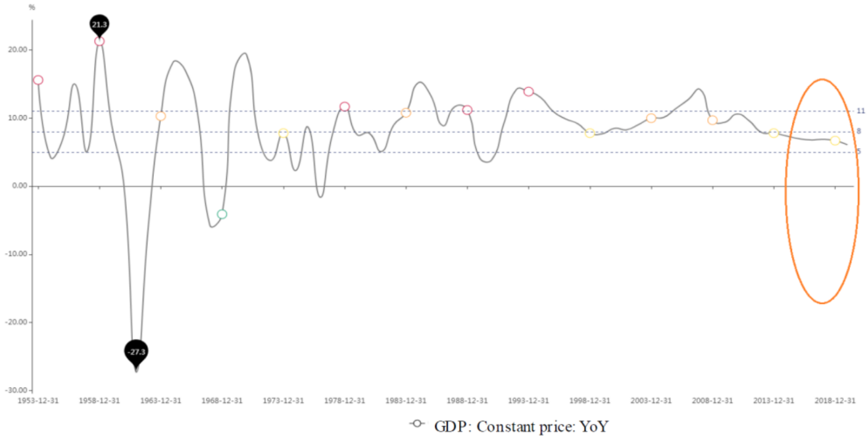
[3] Q1 data are estimates, with the assumption that economic activity gradually recovers in March to a level generally better than February.

[4] By reference to the three sectors' weights in GDP in 2019.

[5] The secondary sector consists of industry and construction. It is assumed here that industry and construction have the same growth rate. In reality, however, construction activity should be hit harder than manufacturing during the epidemic but recover faster after it.

[6] The services production index released by the National Bureau of Statistics is cited here. As shown by historical data, it is 1 to 2 percentage points away from the growth rate of service added value. During the epidemic, the service sector has been hit harder than manufacturing and will recover at a slower pace after it.

Figure 1: China's Economic Growth Curve in the Past 70 Years (%)



Source: Wind, BOC Research Institute

1. The three major demands have been hit hard by the pandemic and sent into the negative growth territory

Investment activity contracted significantly, showing negative growth in all the three segments. From January through February, national fixed asset investment (excluding rural households) fell by 24.5% year-on-year (YoY). **First,** manufacturing investment deteriorated significantly, shrinking by 31.5% YoY from January through February. **Second,** the delay in post-holiday restart of work had a marked negative impact on infrastructure projects in the short term, with infrastructure investment falling by 30.3% YoY from January through February. **Third,** real estate investment shrank markedly from January through February due to the shock on both supply and demand sides. Real estate investment tumbled by 16.3% YoY during the two months, with sold and newly started floor spaces down 39.9% and 44.9% YoY respectively.

Consumption has been severely affected by COVID-19, which forced up the proportion of online retail sales. Consumption dropped by 20.5% YoY from January through February, down 28.7 percentage points from the same period last year and becomes the lowest on record. **First,** discretionary consumption plummeted while non-discretionary consumption maintained positive growth. From January through February, the consumption of cereals, oils and foodstuffs and beverages increased by 9.7% and 3.1% respectively. However, discretionary consumption such as household appliances plunged by over 30% due to income decline, impeded logistics and delayed resumption of work. **Second,** online shopping rose notably as a substitute for shopping at brick-and-mortar stores. From January through February, online retail sales of physical goods grew by 3% YoY, accounting for 21.5% of total retail sales of consumer goods, up 5 percentage points over the same period of the previous year. Online retail, unmanned retail and other new consumption modes are becoming new bright spots in consumption.

Exports dropped significantly and the trade balance turned from surplus to deficit. First, growth of either exports or imports dived. USD-denominated exports and imports grew by -17.2% and -4% YoY accumulatively, respectively, a decrease of 12.7 and 1.6 percentage points from the same period of last year. After offsetting imports against exports, the trade balance of China turned from surplus to deficit (from USD41.45 billion a year ago to USD-7.1 billion). **Second,** exports to major trade partners plunged. From January through February, China's exports to the United States, EU, Japan and ASEAN grew by -27.7%, -18.4%, -24.5% and -5.1% respectively, down 13.6, 20.8, 23.4 and 7.1 percentage points respectively from the same period last year. **Third,** exports of labor-intensive products recorded an even bigger drop. From January through February, exports of electromechanical products, clothing, textiles, plastic products and furniture declined by 16.2%, 20%, 19.9%, 16% and 22.8% respectively.

2. Both industrial and service sectors declined markedly amid the COVID-19 outbreak

Industrial and service activities fell notably in the first two months due to the negative impact of the outbreak, the delayed resumption of work and production and the impeded transportation and logistics. In the first two months, value added of the industrial enterprises above designated size and the Service Production Index dropped by 13.5% and 13% YoY respectively. Manufacturing PMI and non-manufacturing PMI were 35.7% and 29.6% in February respectively, both representing the lowest on record.

The output of most industrial sectors and products declined. By sector, 39 of the 41 industrial sectors showed a downward trend in value added[7]. Specifically, general motors manufacturing, general-purpose equipment manufacturing and special-purpose equipment manufacturing recorded bigger declines (by 31.8%, 28.2% and 24.4% YoY respectively from January through February). In terms of products, 533 of the 612 products showed a YoY decline. Especifically automobiles, cloths and mobile phones recorded sharper drops (by 45.8%, 36% and 32.5% YoY respectively from January through February), while healthcare and COVID-19 containment products such as face masks and alcohol surged. By ownership type of economic entity, foreign and private enterprises were hit harder by the pandemic, with the industrial added value falling sharply (by 21.4% and 20.2% YoY from January through February respectively). State-owned enterprises showed stronger resilience to risks with a less decline (by 7.9% YoY in the first two months) in industrial value added.

COVID-19 has had a notable impact on the service sectors and spurred their digital reform. On the one hand, both consumer and producer services showed a significant decline. Transportation, hotels and restaurants, wholesale and retail and real estate were among the hardest hit due to the sharp slowdown in social activities. Except for financial services (up 4.5% YoY) and information transmission, software and information technology services (up 3.8% YoY), all service sectors declined to varying degrees from January through February. On the other hand, the digitalization of service sectors has accelerated. During the coronavirus outbreak, new forms and modes of business such as online retail, online education and working-from-home have thrived. In February, the business activity index of telecoms and internet software industry (41.4%) was significantly higher than services business activity index (30.1%).

A large number of enterprises have pressed the "pause button" on their production and operation activities. The outbreak of COVID-19 delayed the post-holiday restart of work and production in most parts of the country, leaving business activity significantly below the normal level. In February, the average daily coal consumption of the six major power generation groups fell by 19.77% YoY to 394,900 tons. In mid-March, the intra-city traffic intensity in Beijing and Shanghai only recovered to 50% and 63% of the level recorded last year. Business activity has been restored faster since March, yet still plagued with shortage in virus containment supplies, impeded transportation and logistics, industrial chain disruptions and rising operating costs. Overall, the industrial value added and the service value added are estimated to fall by 9.9% and 10% respectively in Q1.

3. CPI growth remained above 5% while PPI was subdued

Prices continued to diverge in Q1. **First,** CPI and PPI demonstrated different trend, showing a widening gap in between. CPI inflation lingered around all-time highs, standing at 5.4% and 5.2% respectively in the first two months, mainly due to the impact of COVID-19, sustained pork price

[7] Only petroleum and natural gas extraction and tobacco industries maintained a positive growth trend, up 2.1% and 6.9% YoY respectively.

hikes and seasonal disturbance. By contrast, PPI growth was softened to 0.1% and -0.4% YoY respectively in the first two months amid the weak demand and global oil price slump resulting from the pandemic. **Second,** the core CPI (excluding food and energy) showed a divergent trend from overall CPI. In the first two months, the core CPI rose by 1.5% and 1% YoY respectively, hovering near historical lows in a downtrend. The widening CPI-PPI inflation gap and the low core CPI mirrored, more or less, the sluggish demand of the real economy.

I.2 Economic Forecast for 2020Q2: The economy is gradually recovering under multi-faceted pressure

1. Infrastructure investment will become a greater stabilizer of growth, compared with the gloomy prospects of real estate and manufacturing investment

First, infrastructure investment will be given top priority in the macro-policy toolkit for counter-cyclical regulation in 2020. The issue size of special-purpose government bonds is expected to further increase. **Second,** the real estate regulation policy will focus on relief. The already-tight liquidity of property developers has been hit by a sales freeze. The resumption of activity is slow and investment will remain low in the short term. **Third,** manufacturing investment will remain under a big pressure. On the one hand, the COVID-19 pandemic remains a drag on domestic demand and will lead to further shrinkage in foreign demand. On the other hand, manufacturing operation is deteriorating, which restricts the growth of manufacturing investment. Overall, investment growth is expected to be around 4.5% in Q2.

2. Consumption growth will gradually recover on strong policies launched to ensure employment and boost consumption

The escalating overseas spread of the virus have further underscored the importance of domestic demand. Future contributors to consumption growth include the following: **First,** as the domestic COVID-19 situation increasingly improves, industries such as retail trade, culture, entertainment and catering will accelerate their recovery. Household consumption growth is expected to recover in Q2. **Second,** more policies will be launched in a faster pace to boost consumption. For example, the vehicle purchase restrictions will shift to vehicle use encouragement, and consumer electronics users will be encouraged to upgrade their devices. However, the current high unemployment rate will directly translate into lower personal income and lack of consumer confidence, curbing the recovery of consumption growth to some degree. To sum up, consumption growth will be around 4% in Q2.

3. Foreign trade is frustrated by a second shock wave from worsening overseas pandemic situation, worsening the already fragile exports

On the one hand, the foreign demand will further shrink as the pandemic has remarkably impacted global economic and trade activities. Recently, IMF and OECD have both sharply lowered their forecasts for global economic growth in 2020. China’s PMI New Export Orders Index fell by 20 percentage points to 28.7% in February, with foreign demand showing signs of continued weakness. China’s foreign trade will take a much longer time to recover as its exports already frustrated by Sino-US trade frictions are further hit by COVID-19 outbreak at home and abroad. **On the other hand,** the escalating overseas pandemic has substantially pushed up the risk of shortened or partially disrupted global supply chains. China’s manufacturers will also face many problems such as halted parts supply, interrupted production and liquidity pressure. Overall, exports are expected to grow by around -10.5% in Q2.

4. Industrial and service activities will regain positive growth as enterprises get back to production in a faster pace

With the gradual improvement of the epidemic situation in China, it is expected that industrial and service activities are likely to recover in Q2. The main reasons are as follows: **First,** the impact of COVID-19 on industrial and service activities will increasingly abate as enterprises are speeding up their restoration of production. In mid-March, over 95% of industrial enterprises above the designated size resumed production nationwide (excluding Hubei Province), with about 80% of employees back to work on average. **Second,** consumption will gradually return to normal after COVID-19 fades away, with the suppressed consumer demand expected to be partially released. This will not only boost services such as hotels and catering, wholesale and retail, transportation and sports and entertainment, but also conducive to restore industrial activities in terms of food and beverage manufacturing, automobile manufacturing and manufacturing of sports and entertainment products. **Third,** as the government frequently issued policies to stabilize growth, the growth of infrastructure investment will pick up rapidly in the future, especially in the field of "new infrastructure". To sum up, the industrial value added and service value added are estimated to grow by about 2.9% and 3.3% respectively in Q2.

5. CPI inflation will pull back from a high level, with PPI still likely to go down further

Production and supply will be gradually restored as the COVID-19 outbreak eases. The food prices will cease to surge. CPI inflation is expected to gradually abate in the future to show a pattern of "ramp-down from a high beginning" through the year. Since March, the Ministry of Agriculture and Rural Affairs' agricultural product wholesale price index has declined month-on-month, closing at 126.23 on March 23, down 5.54% from the beginning of March (133.64). However, considering the high carryover effects and the fact that the pig production industry chain has not yet fully recovered, the CPI inflation is unlikely to show a quick decline. Instead, it will ramp down gradually within the higher range. Besides, PPI will remain under a great downside pressure in Q2, probably still in the negative territory, taking into account the recent oil price slumps that will lead to a sharp decline in PPI and the negative impact of worsening overseas pandemic situation on commodity prices. As the economic recovery gains pace in H2, however, PPI growth is expected to stabilize and finish the year with a U-shaped curve. Overall, CPI and PPI are expected to rise by around 4.5% and -0.5% respectively in Q2.

II. 2020Q1 Financial Review and Q2 Outlook

II.1 Q1 financial market characteristics: the financial market remained stable and resilient

Since the beginning of COVID-19 outbreak, the Chinese government has put supporting the real economy higher on the priority list. The government has effectively supported the virus containment and the resumption of business activity by increasing credit supply, reducing financing costs and launching relief policies for SMEs and self-employed individuals. Meanwhile, China continued with the market-oriented and law-based reform of its financial service sector. The new policy on government bond futures has been launched, the new securities law has become effective and the outstanding floating-rate loans have begun to switch their interest rate benchmark to loan prime rate (LPR). These policies and measures have paid off well. China's financial market remained relatively stable, outperforming most economies.

1. The growth of major financial supply indicators fell and then picked up, with aggregate financing to the real economy (AFRE) stable in scale

Q1 began with a decline, followed by a pickup, in major financial supply indicators. M1 growth fluctuated widely while M2 and AFRE remained stable. As of February 2020, M1 grew by 4.8% YoY, up 4.8 percentage points from zero growth in January. M1 growth was 0.4 percentage point faster than at the end of 2019 and 2.8 percentage points faster than last year. This not only shows that M1 rebounded naturally with the disappearance of the Spring Festival effects, but also reflects PBOC's timely response to the COVID-19 outbreak that has prevented further liquidity deterioration in the business sector. After the market reopened on February 3, the central bank released RMB1.7 trillion of liquidity through reverse repurchase and MLF for two consecutive days. The massive reserve money injection also led to a rebound in M2 growth. Broad money M2 grew by 8.8% YoY at the end of February, showing pickup after a slight decline in January, 0.1 percentage point faster than at the end of 2019 and 0.8 percentage point faster than last year.

Although the COVID-19 outbreak has hurt the demand, the accelerated issuance of local government bonds and the faster growth in corporate bonds from January through February have helped keep aggregate financing stable. The stock of aggregate financing to the real economy grew by 10.7% in February, up 0.05 percentage point YoY. Specifically, new corporate bond issues reached RMB386 billion, with an increase of RMB298.5 billion YoY, mainly due to lower interest rates on credit bonds and ample liquidity in the inter-bank market. Newly issued local government bonds stood at RMB182.4 billion, with a decline of RMB252.3 billion YoY. This is mainly due to the exclusion of nearly RMB300 billion of bonds issued during the last week of February from the CDC data. The actual new issues exceeded RMB400 millions.

RMB loans grew faster than expected and corporate loans continued to rise. RMB4.24 trillion of new loans were granted in the first two months, up RMB0.13 trillion YoY. Especially in January, new loans grew faster than expected, mainly due to financial regulators' counter-cyclical regulation that enhanced support for non-financial enterprises. More specifically, loans to non-financial companies increased significantly. In the first two months, new loans to non-financial companies stood at RMB3.99 trillion, up RMB0.58 trillion YoY, suggesting increasingly improved financing environment for the real economy.

2. Liquidity remained ample in the financial system with falling average interest rates

To maintain reasonably sufficient liquidity in the banking system during the virus containment in Q1, the prudent monetary policy was fine-tuned to be more flexible and appropriate to keep the money market stable and drive down average interest rates. **First,** the monetary policy strengthened counter-cyclical operations, In Q1, PBOC cut reserve requirement ratios twice to release a total of about RMB1.35 trillion, and also lowered the bid-winning rates for reverse repurchase and MLF operations by 10 bps each. **Second,** the average money-market interest rate continued to decline. On March 23, the overnight Shibor, 7-day Shibor and 7-day interbank pledged repo rate (DR007) were 1.73%, 2.33% and 2.21% respectively, down 89, 33 and 35 bps YoY, respectively (Figure 2). **Third,** LPR reform has driven down the financing costs of enterprises continuously. As of February 2020, the 1-year and 5-year LPR were 4.05% and 4.75% respectively, down 20 and 10 bps from those at the beginning of the LPR reform. As of December 2019, the weighted interest rate for RMB loans was 5.44%, down 18 bps from 2019Q3 (Figure 3).

Figure 2: Shibor vs. DR007 Curves

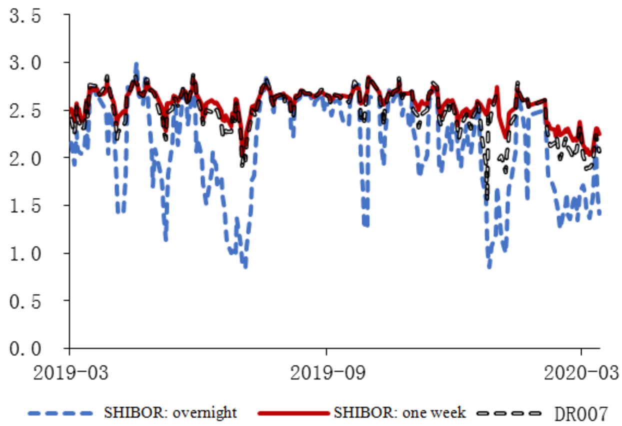
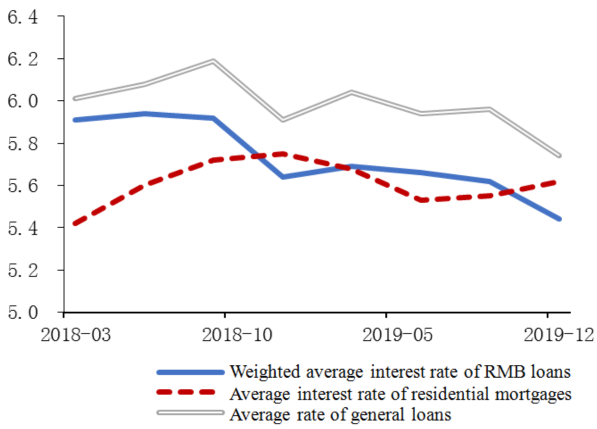


Figure 3: RMB Lending Rate Curve



Source: Wind, BOC Research Institute

3. The bond market has moved from "consolidation" to "upswing", with the Sino-US interest rate spread widening further

In Q1, the bond market finished its consolidation at highs in 2019 and staged another upswing. It is mainly attributable to the rising risk aversion fueled by COVID-19 outbreak, abundant liquidity and a sharp weakening of economic fundamentals. The ChinaBond New Composite Net Price Index rose to 104 on March 23, which is a new high in recent years up 1.7 from the end of last year. The bond market has shown the following characteristics: **First**, the subdued inflation expectations have driven down the interest rates on government bonds and credit bonds. Although CPI remained high driven by food price hikes, PPI deflation was serious in the upstream. Subdued inflation expectations have pushed the risk-free rate of return and the return on risky assets downward. On March 23, the 10-year China government bond yield fell to around 2.63%, while the yield of one-year AAA short-term commercial papers fell to 2.5%. **Second**, the Sino-US interest rate spread continued to expand, and foreign investors continued to increase their allocations to the Chinese bond market. The 10-year Sino-US treasury yield spread increased to about 170 bps from 122 bps at the end of 2019, even peaking at 195 bps. As at the end of February 2020, foreign institutions held a total of RMB2.28 trillion of bonds, an increase of RMB90.2 billion from the end of 2019. **Third**, bond issues expanded steadily and the issuance of local government bonds accelerated. Bond issues totaled RMB10.7 trillion in 2020Q1 of 2020 (up to March 23). Among them, the proportion of local government bond issues rose to 13.4%. As for credit bond issues, commercial papers and mid-term notes accounted for 15.9% of total, basically flat with last year. **Fourth**, the risk of default increased. Despite the bullish bond market, a rising number of bond default risk events have occurred under the downside economic pressure. 40 domestic credit bonds had been defaulted in 2020Q1 (up to March 23), totaling RMB54.73 billion, accounting for 37.6% of the annual total defaults in 2019.

4. A-shares have been shaken down amid the epidemic, showing relatively strong resilience and independence

A-shares showed an overall downward trend in Q1, with the Shanghai Composite Index falling 13.77% from 3,085 points at the beginning of the year to 2,660 points on March 23. The A-share market shows the following main characteristics: **First,** the epidemic developments have become a key factor affecting the short-term movements of A-shares. The market tumbled twice in late January and late February respectively, mainly due to the continuous spread of the virus at home and abroad and the surge in risk aversion over the short term. **Second,** the cross-border capital flows has fluctuated in a much wider range, and northbound capital flows under the Shanghai/Shenzhen-Hong Kong Stock Connect have turned from net inflow to net outflow. Since March (up to March 23), northbound capital flows have turned out to be a net outflow of RMB82.1 billion. **Third,** A-shares have shown stronger resilience amid a general slump in the world's major stock markets. Due to China's effective virus containment, stronger counter-cyclical regulation and overall undervaluation of A-shares, the A-share market has shown less downturn, ranking among the best-performing stock markets.

5. RMB remained stable with a depreciation tendency, better than the currencies of most economies

RMB rose and then fell in value against USD in Q1, stable with a depreciation tendency in overall. During the global currency rout, RMB exchange rate remained basically stable. From January 2 to January 17, RMB exchange rate against USD rose from 6.9631 to 6.8585, with an appreciation of 1.50%. Then RMB exchange value turned down amid global financial market meltdown. On March 23, the spot exchange rate of RMB against USD was 7.1187, down 2.14% from the end of last year and representing less depreciation than GBP (12.1%), CAD (9.5%), INR (5.2%) and ZAR (20.2%)

against USD. Main reasons are as follows: **First,** Market expectations stabilized again on the Sino-US phase 1 trade deal concluded. China and the United States reached a consensus on the text of the phase 1 trade deal in December 2019, reducing the tariff rate from 15% to 7.5% for USD120 billion worth of Chinese exports to the United States. **Second,** as shown by the balance of banks' foreign exchange (FX) settlements and sales on behalf of customers, either spot or forward, there was a bigger net inflow of short-term capital. Banks' spot FX settlements and sales on behalf of customers rose from USD3.639 billion in December 2019 to USD8.284 billion in January 2020. Banks' forward FX settlements and sales on behalf of customers fell from USD15.36 billion in December to USD8.995 billion in January, indicating subdued expectations of RMB depreciation in January. **Third,** the COVID-19 outbreak put a downside pressure on RMB value. The virus outbreak and spread have weighed heavily on China's economic growth. The RMB depreciation reflects the changes in fundamentals to some extent.

II.2 Financial Forecast for 2020Q2: less volatility and stronger independence as a whole

1. Money and credit supply will grow steadily with mixed credit demand

As the epidemic increasingly eases in China and the policy to ensure steady growth further works, **major financial supply indicators are expected to grow steadily with mixed credit demand. First,** the service sector and SMEs, among the hardest hit, will have less demand for credit. **Second,** credit supply to infrastructure construction will ramp up to an annual aggregate bigger than the previous year's total. **Third,** health care and virus containment-related industries will have growing credit demand as against the overall trend. **Fourth,** capital-intensive and technology-intensive enterprises, less affected by the outbreak, will maintain stable credit demand. **Fifth,** traditional consumer credit will slow down, but new consumer credit demand will expand.

2. Liquidity will remain reasonably sufficient with still-low market interest

The monetary policy will remain flexible and moderate in Q2, likely to keep market interest rates low. **First,** as the COVID-19 outbreak has added to the downside pressure on the economy, the monetary policy will remain counter-cyclical. **Second,** the price of funds tends to fall on non-financial enterprises' shrinking demand for financing. **Third,** the financing cost of the real economy will continue to decline as the efficiency of monetary policy transmission will be further boosted. As the interest rate benchmark for outstanding floating-rate loans is further shifting to LPR, LPR will become a stronger yardstick for pricing of loans and drive down the financing costs of enterprises.

3. The "bond bull" run will continue, but the risk of bond defaults must be guarded against

Economic growth and monetary policy expectations will mount to significant influences over bond yields. Given local governments' existing debt burden and budget deficits that may restrict the fiscal policy, the monetary policy is expected to further ease to fuel a bond bull run. **In terms of economic fundamentals,** the global oil price slump will be more reflected in PPI and CPI for Q2. Non-food prices are estimated to continue with negative quarter-on-quarter growth in Q2 following the epidemic. Food price inflation, from a high level in 2019, is expected to gradually soften as from 2020Q2. Subdued inflation expectations will become the fundamental support for a bull run of the bond market. **As for foreign investors' allocations,** by the end of February 2020, the holding scale of foreign institutional investment in the inter-bank bond market further increased by RMB75.6 billion compared with the end of January. Given the further expansion of Sino-US treasury yield spread and the stable RMB exchange rate, foreign investors are likely to increase their allocations to the Chinese bond market in Q2. However, the recovery of some domestic industries may be weaker than expected as overseas COVID-19 outbreak may spread to China. Therefore some industries that are already debt-ridden are likely to face higher risk of default.

4. A-shares will continue to fluctuate on still-high market uncertainty in the short term

A-shares are likely to remain in a fluctuation range in Q2. **First,** the escalating overseas outbreak of the virus will put the world economy under bigger downside pressure. Weak foreign demand will add to the difficulty in China's economic recovery and development. **Second,** the financial market uncertainty and risk aversion remain high and will hurt the Chinese stock market. **Third,** given the high leverage ratio and popular passive trading and program trading in the US stock market, the self-reinforcing downbeat expectations will increase the probability of global liquidity risks. China's economy being expected to shake off the COVID-19 impact first, A-shares are expected to recover mildly with fluctuations.

5. With more stabilizing factors emerging, RMB exchange rate will continue to swing widely

More stabilizing factors for RMB exchange rate will emerge in Q2 as China makes remarkable achievements in virus containment. **First,** in terms of macro-economy, China's economy will be on track to rebound in Q2 on abating pandemic and China's counter-cyclical policy moves. **Second,** in terms of the global monetary environment, the Sino-US interest rate spread is expected to remain wide or even further widen. As of March 18, the 10-year Sino-US treasury yield spread reached 169 bps, an increase of 43 bps over the beginning of the year. The likelihood of US Federal Reserve's further easing in the future will back up the RMB exchange rate to some degree. **Third,** the US Dollar Index is unlikely to rise further. The COVID-19 outbreak will increase the downside pressure on the US economy and push up the risk of a weakening US Dollar Index, which will ease the depreciation pressure on RMB. **Fourth,** China's financial opening-up is conducive to balancing the supply and demand of the foreign exchange market. A higher level of financial opening-up in the future will help expand cross-border investment and financing channels and probably attract international capital inflows.

Table 3: Forecasts on China's Main Economic and Financial Indicators in 2020Q2 (%)

Indicator	2016 (R)	2017 (R)	2018 (R)	2019 (R)	2020		
					Q1 (E)	**Q2 (F)**	**Full year (F)**
GDP	6.7	6.8	6.6	6.1	**-9.6**	**3.0**	**2.5**
Industrial value added of enterprises above designated size	6.0	6.6	6.2	5.7	**-10.0**	**2.9**	**2.3**
Value added of the service sector	7.8	8.0	7.6	6.9	**-9.9**	**3.1**	**3.0**
Fixed asset investments (cumulative)	8.1	7.2	5.9	5.4	**-17.0**	**4.5**	**3.5**
Total retail sales of consumer goods	10.4	10.2	9.0	8.0	**-13.0**	**4.0**	**3.0**
Exports	-7.7	7.9	9.9	0.5	**-12.0**	**-10.0**	**-5.5**
Imports	-5.5	16.1	15.8	-2.7	**-2.5**	**-1.0**	**-1.0**
Consumer Price Index (CPI)	2.0	1.6	2.1	2.9	**5.1**	**4.5**	**3.8**
Producer Price Index (PPI)	-1.4	6.3	3.5	-0.3	**-1.4**	**-1.5**	**-0.1**
Broad money supply (M2, closing balance)	11.3	8.1	8.1	8.7	**8.7**	**8.8**	**9.0**
Aggregate financing to the real economy (Stock)	12.8	14.1	10.3	10.7	**10.7**	**10.8**	**10.9**

Source: BOC Research Institute

III. Macro-economic Policy Orientations

III.1 The fiscal policy should be more proactive, and counter-cyclical regulation should be strengthened

Deficit ratio should be raised to about 4% and special-purpose local government bond issues be expanded to about RMB4 trillion. It is suggested to increase the budget deficit ratio to about 4% from 2.8% in 2019. The government is advised to consider expanding special-purpose local government bond issues to about RMB4 trillion from RMB2.15 trillion in 2019. Major projects and infrastructure construction in the state plan should be sped up, and the development of new infrastructure such as 5G networks should be accelerated.

Tax cuts and fee reductions for SMEs will be strengthened. The government should expand the scope of SMEs eligible for deferral of social security contributions, expand the makeshift VAT exemption for small taxpayers and additionally increase subsidies for regions and industries hit hardest by the virus outbreak. Besides, financial institutions should be encouraged to increase credit support to micro and small businesses through tax incentives, such as exemption of VAT on interest income from loans to micro and small businesses and on income from guarantees for financing to micro and small businesses.

The COVID-19 impact on employment and household income deserves intensive attention, more jobs should be created for urban and rural residents and a safe net should be in place for low-income populations. The fiscal policy should grant subsidies, incentives and tax reliefs to SMEs to prevent massive layoffs spurred by overburdens. Meanwhile, subsidies for low-income groups should be emphasized to ensure their basic living standards. To boost the recovery of catering, tourism, shopping, transportation activities, local governments are encouraged to issue coupons to local residents.

III.2 The monetary policy should remain flexible and moderate to ensure stable economic growth

Counter-cyclical regulation should be increasingly strong. Considering the COVID-19 impact and the downside economic pressure, the monetary policy maker is still likely to further reduce the reserve requirement ratio in the near future.

More attention should be paid to pushing down the financing costs of enterprises. MLF rate cuts should be stronger to drive down LPR, which need be further leveraged to cut financing costs of non-financial enterprises. In addition, PBOC should consider lower the benchmark deposit rate as appropriate to create more room for banks to lower their lending rates.

Strong efforts should be made to mitigate the risk of liquidity disruptions among SMEs. SMEs with fragile cash flows are prone to liquidity problems due to their rigid costs such as wages, equipment use and loan interest. The monetary policy should grant special supports to SMEs, such as loan extension and rollover without principal repayment.

Stronger support should be provided for "new infrastructure" and other new areas of economic growth. As China's new industries and new economy continue to release their growth potential, the credit demand in these fields will expand continuously in the future. Structural monetary policy should also match the needs of economic development, for example, introducing such policy tools as special-purpose lending facilities that allow financial institutions to support related fields.

III.3 Precision reliefs should be provided for industries hit hard by virus outbreak

Broader tax cuts and fee reductions and stronger government subsidies are recommended for industries hit hard by the virus outbreak in the short term, such as transportation, cultural tourism, hotels, catering, cinema and exhibitions. In addition, vehicle purchase restrictions should be relaxed by, for example, reducing the vehicle purchase tax for cars below a certain displacement threshold. Modern public services, notably health care, should be developed with vigor. Efforts should be made to foster new industries and forms of business emerging from the COVID-19 pandemic, including online education, online retail and working-from-home.

III.4 The real estate regulation policy should be more flexible and locality-specific while upholding the guiding principle that "houses are for living in, not for speculation"

To uphold the guiding principle that "houses for living in, not for speculation", focus should be on relief rather than stimulus. Restrictions on property purchases and loans should not be relaxed to prevent money from being noncompliantly channeled into the property market. The monitoring of all real estate-related financial products should be strengthened. No pass should be granted for the time being to the channeling products that have been greatly tightened by the new asset management regulations. In adhering to the guiding pimple that "houses are for living in, not for speculation", two erroneous tendencies should be prevented. We should neither regard the policy of reasonably supporting the steady development of the real estate industry as a relaxation of real estate regulation, nor turn the relief policy for property developers into a new round of real estate stimulus. The core is that the supporting policy should focus on relief rather than stimulus.

Various measures should be taken to mitigate the property developers' risk of liquidity disruptions. Property developers should be allowed to postpone or pay land premiums in installments, with lower pre-sale criteria, expedited sales approval and lessened taxes in place to help property developers generate cash inflows. Adjustments to real estate credit-related assessment indicators in MPA should be considered. Some property developers hit harder by the virus outbreak should be given opportunity to have their solvency pressure relieved with loan extension and rescheduling.

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