BOC Research Institute

China's Economic and Financial Outlook

Q2 Report 2022 (Issue 50) **March 30, 2022**

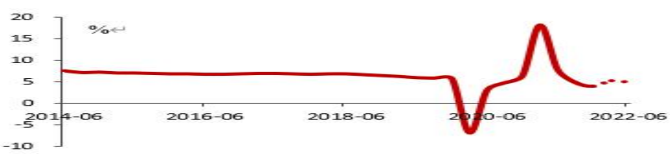
Highlights

● China's economy was off to an auspicious start in the first two months of 2022, with major economic indicators better than expected, which is a manifestation of policies of ensuring steady growth. However, the economy has begun to face increasing problems and challenges since March, when western countries rolled out a stream of sanctions measures against Russia amid the escalating Russia-Ukraine conflict, the global commodity prices surged again, and COVID-19 spread fast across various cities in China. Therefore, the economic boom is likely to edge down. The Q1 GDP growth is expected to be around 5.2%.

● Looking into 2022Q2, it remains to be seen whether the momentum of economic recovery will continue, and three key factors including external shocks, epidemic evolvement and policies of ensuring steady growth should be the focuses. Based on the preliminary judgment, the epidemic and the weak income growth will hinder the consumption recovery, along with slowing real estate investment and export growth. However, given more policies are expected to implement to ensure steady growth, the market expectation will be stabilized, the infrastructure and manufacturing investments are expected to grow at a faster pace, and the high-tech industries will maintain a high growth rate, which is conducive to the overall stability of economic growth. The Q2 GDP growth is expected to be around 5.1%, 0.1 percentage points slower than that of Q1.

●More attention should be paid to the changes of domestic and international conditions. Risk contingency planning and risk prevention should be prepared. Efforts should be made to implement various policies and arrangements and strive to stabilize macroeconomic performance. We suggest: 1) fiscal policy should be more effectual to expand effective investment; 2) monetary policy should continue to play its role thus to promote the realization of "reasonable aggregate, optimized structure and reduced prices"; 3) targeted efforts should be made to stabilize market entities to ensure a stable employment market; 4) continuous efforts should be made to consolidate the consumption base and to foster a beneficial environment for stable consumption recovery; 5) effective measures for risk resolution in real estate should be rolled out timely to advance the transformation of the real estate market; 6) local governments should play more active roles in stabilizing growth and promoting transformation.

GDP Better Than Expected



Source: BOC Research Institute

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Continuous Economic Recovery Remains to Be Seen After a Good Start Boosted By Policy Support

-- China's Economic and Financial Outlook (2022 Q2)

China's economy was off to an auspicious start in the first two months of 2022, with a better-than-expected recovery. Major economic indicators in terms of consumption, investment and industrial production grew faster, thus laying a solid foundation for achieving the projected economic target for this year, i.e. GDP growth of around 5.5%. This is a manifestation of policies of ensuring stable growth. However, the economy has begun to face increasing problems and challenges since March, when western countries rolled out a stream of sanctions measures against Russia amid the escalating Russia-Ukraine conflict, the global commodity prices surged again, and COVID-19 spread fast across various cities in China. The security of industrial and supply chains became a highlighting issue again, the pressure of imported inflation was mounting, and micro, small and medium enterprises (MSMEs) were faced with greater difficulties in operation. The financial markets were increasingly volatile, and the market expectations were unstable. Therefore, the economic boom is likely to edge down. The Q1 GDP growth is expected to be around 5.2%. Looking into 2022Q2, it remains to be seen whether the momentum of economic recovery will continue, and three key factors including external shocks, epidemic evolvement and policies of ensuring steady growth should be the focuses. Based on the preliminary judgment, the epidemic and the weak income growth will hinder the consumption recovery, along with slowing real estate investment and export growth. However, given more policies are expected to implement to ensure steady growth, the market expectation will be stabilized, the infrastructure and manufacturing investments are expected to grow at a faster pace, and the high-tech industries will maintain a high growth rate, which is conducive to the overall stability of economic growth. The Q2 GDP growth is expected to be around 5.1%. More attention should be paid to the changes of domestic and international conditions . Risk contingency planning and risk prevention should be prepared. Efforts should be made to implement various policies and arrangements and strive to stabilize macroeconomic performance.

I. 2022Q1 Economic Review and 2022Q2 Outlook

I.1 Economic Review of 2022Q1

1. Consumption growth rebounded faster than expected, but the foundation for recovery needs to be consolidated.

From January to February, the total retail sales of consumer goods up by 6.7% YoY, 2.8 percentage points (pps) faster than the average growth of 2020 and 2021, and higher than the market expectation(4.6%). **First, the off-line contact consumption recovered.** Driven by the generally controllable epidemic and a stream of policies rolled out by localities to promote consumption, contact consumption including catering, off-line retails and so on recovered in January and February. Specifically, catering revenue increased by 8.9% YoY, close to the level (9.7%) in the same period of 2019. Retails sales of convenience stores, specialty stores, franchised stores and department stores above designated amount increased by 12.8%, 10.3%, 5.3% and 2.1% respectively YoY, all faster than the average growth of 2020 and 2021. **Second, consumption demands for upgrading products continued to release.** In January and February, retail sales of household appliances and AV equipments, cultural and office supplies were much better than the same period prior to the epidemic outbreak, increased by 12.7% and 11.1%, respectively. These two categories accounted for 3% of the total consumption, and contributed 5.2% to the consumption growth during January and February. **Third, boosted by the price surge of commodities and increasing demand for investment preservation, consumption of oil products, gold, silver and jewelry grew rapidly,** with a YoY increase of 25.6% and 19.5%, respectively during January and February. These two categories accounted for about 6% of the total consumption, and contributed 17.7% to the consumption growth during January and February. **Fourth, as chip shortage eased, automotive consumption recovered to a certain degree.** Automotive consumption recorded a YoY increase of 3.9%, representing a 9.8% contribution to the consumption growth during January and February. Although the momentum of consumption recovery exceeds expectations in January and February, the foundation of recovery still needs to be consolidated. In February, the surveyed unemployment rate in urban areas rose for the fourth consecutive month to a high level of 5.5%. A weak income foundation will drag on the sustainability of consumption recovery. The CPI and core CPI maintained around 1% in February on a YoY basis. A weak price performance reflects weak consumer demands. Moreover, the domestic epidemic outbreaks have greatly affected off-line activities and cross-regional movements since March, which will delay the consumption recovery. Therefore, the consumption growth of Q1 is generally estimated to be around 5.8%.

2. Investment growth rebounded markedly, with manufacturing and infrastructure investments the main support.

During January and February, the national fixed asset investment (excluding rural households) grew by 12.2% YoY, 8.3 pps faster than the two-year average growth of 2020 and 2021. Investments in the three major sectors, namely, manufacturing, infrastructure, and real estate outperformed the market expectations, with a YoY increase of 20.9%, 8.1% and 3.7%, respectively (see Figure 1). **First, manufacturing investment performed strong due to a fast growth of exports, improvement of corporate profits, increased support of bank credit, and a low base of last year, among other factors.** In 2021, the growth rate of industrial companies' profits reached 34.3% on a cumulative basis, and that of the medium and long-term loans balance to manufacturing granted by financial institutions stood at 31.8%. **Second, infrastructure investment recovered under the early-on effects of policies of ensuring stable growth.** The Ministry of Finance has granted a quota of newly-added special bonds of RMB1.46 trillion in advance for 2022 since the beginning of the year. As at the end of February, the issuance of local government bonds reached RMB1.2 trillion, including RMB877.5 billion newly-added special bonds, 60.1% of the granted quota. **Third, real estate investment was backed by the accelerated construction of real estate enterprises.** As the increasing fund pressure and the policies of "ensuring delivery", real estate enterprises demonstrated much stronger demand to reclaim funds through accelerated construction, which was evidenced by a 1.8% increase of construction area in January and February, and was conducive to the increase of construction and installation costs (accounting for about 60% of real estate investment). Besides, real estate enterprises paid part of the project funds before the Spring Festival, which also played a certain role in supporting real estate investment. Overall, investment is estimated to grow by about 10% in Q1.

Figure 1 Growth Rate of Three Major Investments

	Completion Rate of Fixed Asset Investment	Completion Rate of Investment in Real Estate Development	Manufacturing Investment	Infrastructure Investment
Jan.-Feb. 2021	0.96%	7.59%	-0.65%	-3.02%
Mar. 2021	2.65%	7.67%	2.97%	-1.47%
Apr. 2021	3.71%	8.44%	3.27%	0.26%
May 2021	3.99%	8.60%	3.30%	1.28%
Jun. 2021	4.46%	8.25%	3.48%	2.59%
Jul. 2021	4.18%	7.95%	2.68%	2.63%
Aug. 2021	4.20%	7.70%	2.30%	3.12%
Sep. 2021	4.00%	7.19%	1.97%	3.60%
Oct. 2021	3.93%	6.75%	2.00%	3.99%
Nov. 2021	4.00%	6.40%	1.90%	4.75%
Dec. 2021	3.93%	5.69%	1.89%	5.36%
Jan.-Feb. 2022	12.20%	3.70%	8.10%	20.90%

Note: Data for 2021 is the two-year average growth.

Source: Wind, BOC Research Institute

3. Export growth declined but remained high.

In January and February, Chinese exports (denominated in USD) increased by 16.3% YoY, lower than the reading of 20.9% in December 2021, but still beyond the market expectation of a 14% growth, also 1.2 pps higher than the two-year average of 2020 and 2021. Driven by continuous recovery of domestic consumption, increasing materials imports, high commodity prices and other factors, imports increased by 15.5% YoY in January and February, which was lower than the reading of 19.5% in December 2021 but still at a high level. The trade surplus widened YoY to USD115.96 billion in January and February, a YoY increase of 19.5%. Overall, exports remained at a high level in Q1, with an estimated growth of about 15%. **First, industrial production and global supply chain were disrupted by overseas pandemic, aggravating geopolitical conflicts and so on, which to some extent prolonged the substitution effect of Chinese exports.** In January and February, more than 15,000 and 30,000 new cases per day were recorded in Vietnam and Indonesia, respectively, and exports of Vietnam and Indonesia slipped, with growth rates of exports lower than the same period and the fourth quarter of 2021. **Second, countries have begun to ease their pandemic control policies and opened up the economy again since January 2022, which boosts the demand for terminal consumption and the faster growth of exports of China's labor-intensive products.** In January and February, manufacturing PMIs in the United States and euro area were 58.6% and 58.2%, respectively, both in the boom range. **Third, prices turned out certain support.** Influenced by higher commodity prices and supply constraints such as chip shortages, the prices of some exports surged, underpinned the accelerating export growth.

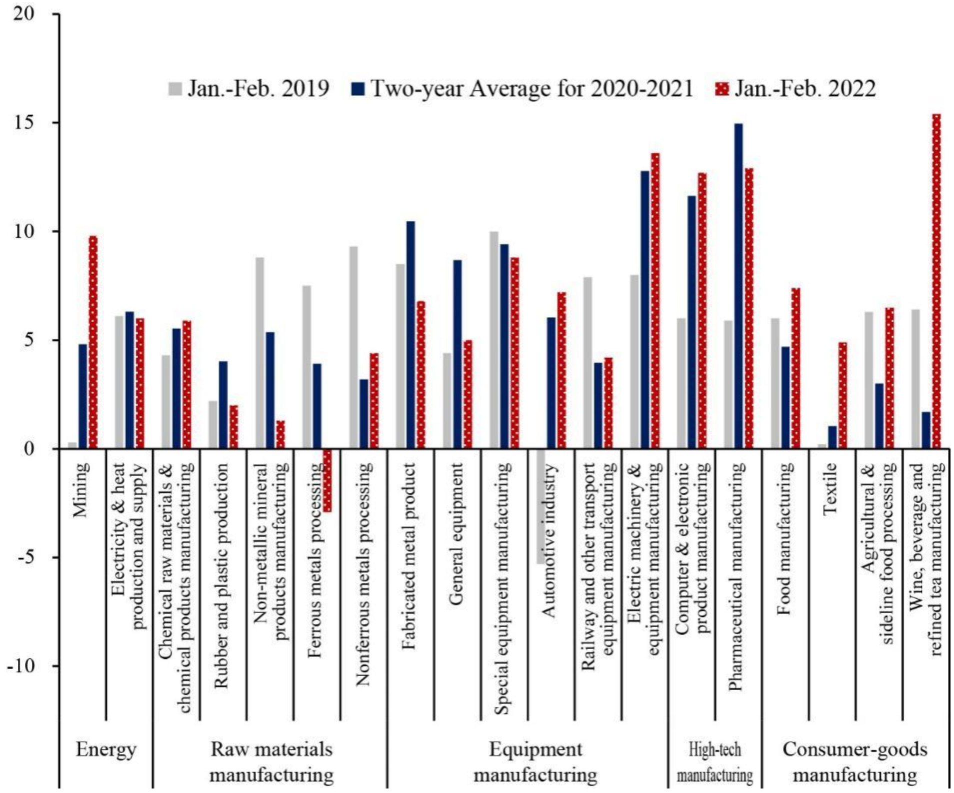
4. Industrial growth was better than expected while the service sector was less prosperous.

In January and February, industrial value added increased by 7.5% YoY, 3.2 pps faster than that of

December 2021, and 1.4 pps faster than the two-year average growth of 2020 and 2021. The industry is estimated to grow by about 6% in Q1. However, the service sector recorded a low sentiment index reading. The Service Production Index increased 4.2% YoY in January and February, up 1.2 pps from December 2021, but down 2.1 pps from the two-year average growth for 2020-2021. The value added of services is estimated to grow by around 5% in Q1.

First, eased supply constraint drove the production of upstream energy industry, and demand improvement promoted restorative growth of downstream sectors**.** In 2022, the production of upstream energy industry accelerated significantly, influenced by rising commodity prices, rectifying policies of controlling both the quantity and intensity of energy and resources consumption, and a series of policies to ensure steady growth. In January and February, the value added of mining industry increased by 9.8% YoY, 6.9 pps faster than the two-year average growth for 2020-2021. Boosted by rising consumer demand during the Spring Festival, higher growth was achieved in the manufacturing value added of downstream consumer goods, such as food, agricultural and sideline foods, tobacco and alcohol, textile apparel, etc. Midstream sectors showed differentiation performance. Affected by the rising cost of raw materials and the cooling of the real estate market, raw material manufacturing industries bear obviously increased production and operation pressures, for instance, intermediate rubber, nonferrous metal processing, ferrous metal processing, non-metallic mineral products and metal products. In contrast, some midstream equipment manufacturing industries steadily recovered. As chip shortages eased, the value added of automobile manufacturing increased by 7.2% YoY, in January and February, while that of electrical machinery and equipment manufacturing increased by 13.6% YoY,, driven by faster growth in exports and investment (see Figure 2).

Figure 2 Industrial Value Added Growth by Segment (%)



Source: Wind, BOC Research Institute

Second, high-tech manufacturing performed strong, leading the high-quality development of manufacturing. In January and February, the value added of high-tech manufacturing and equipment manufacturing increased by 14.4% and 9.6% YoY,, respectively. Specifically, the value added of computer communications and other electronic equipment manufacturing, pharmaceutical manufacturing, and instrumentation manufacturing recorded double-digit growth.

Third, the relapse of Covid-19 and high costs made it more difficult for small and medium enterprises (SMEs) to produce and operate. SMEs were faced with increased production and operation pressures due to the **relapse** of domestic epidemic, high costs of energy and some raw materials, insufficient security of industrial and supply chains. Small business PMIs have been in the lower boom range for several months. Meanwhile, high costs and insufficient demand put SME profits under pressures.

Fourth, recurrent outbreaks and depressed property sales constrained the recovery of the service sector. The service sector PMI was 50.3% in January and 50.5% in February, down from the same period a year earlier, indicating a weak sentiment in services. Specifically, retails, ecological protection and environmental governance, residential services and other industries were greatly affected by the epidemic, with the business activity index in the low region below 45%. Meanwhile, the real estate sales cooled down. In the first two months, sales area and amount of commercial housing decreased by 9.6% and 19.3% year on year, respectively. The decrease of sales amount enlarged compared to that of December 2021 (-17.8%). And the property sales by volume in 30 large and medium-sized cities decreased by about 30% YoY,.

5. Inflation was overall moderate and controllable as the CPI maintained at lows, and the PPI declined from highs.

In Q1, China's inflation was overall moderate and controllable. In January and February, the CPI and PPI rose by 0.9% and 8.9%, respectively, on a cumulative basis. **First, the constant low price of pork led to low CPI growth.** As pork production maintained at a high level, and the outbreak affected the food and beverage sector, the combination of supply and demand sides caused pork prices to fall again. In February, the national average wholesale price of pork was RMB20.1 per kilogram, a YoY decrease of 53.5%. **Second, the PPI growth declined from the high because of the effects of domestic policies of ensuring supply and stabilizing price plus the high base effect, but the pace of the decline of PPI slowed down due to the surging global oil prices.** Under the influence of the escalating Russia-Ukraine conflict, the prices of crude oil, nonferrous metals and other international commodities rose further, driving the price of domestic oil-related industry high. In February, the CRB Composite Index and the average price of Brent Crude Oil Futures rose 26.37% and 51.09% year on year, respectively. The CPI and PPI are estimated to rise by 0.9% and about 8.6% respectively in Q1.

I.2 Economic Outlook for 2022Q2

Looking ahead to Q2, it remains to be seen whether the momentum of economic recovery will continue, with three key factors to focus on. **First, external shocks.** The situation in Russia and Ukraine is still evolving, and sanctions are still being put in place, whose impact is brewing. The industrial and supply chains face new challenges, the Federal Reserve (Fed) is accelerating its pace of tightening monetary policy, the global interest rates are on the rise, leading to changes in the direction of capital flows, and the financial markets will continue to be volatile. These all will have significant impacts on the Chinese economy. **Second, epidemic evolvement.** Effective control of epidemic is a prerequisite for continuous economic recovery. At present, targeted measures in epidemic prevention and control become more difficult to take, and a new round of COVID-19 resurgence is still spreading. The resurgence has a continuous and negative impact on demand recovery and stable production. **Third, policies of ensuring steady growth.** In Q2, the steady economic operation will still face many challenges, including mounting cost pressures burdened on enterprises by commodity prices fluctuating at highs, greater difficulties in operation of MSMEs, tightened liquidity of real estate industry, and increasing risks of local government debts, etc. Macro-policy implementation will be further intensified in line with the arrangement of the *2022 Report on the Work of the Government*. Meanwhile, new supporting policies are likely to roll out to defuse the risks of real estate enterprises. Based on the preliminary judgment, in Q2, the epidemic and the weak income growth will hinder the consumption recovery, along with slowing real estate investment and export growth. However, given more policies are expected to implement to ensure steady growth, the market expectation will be stabilized, the infrastructure and manufacturing investments are expected to grow at a faster pace, and the high-tech industries will maintain a high growth rate, which is conducive to the overall stability of economic growth. In addition, GDP growth over the same period in 2020-2021 averaged 5.5%, a high base. Therefore, with all taken into consideration, GDP growth is predicted to be around 5.1% in Q2, down about 0.1 pps from Q1.

1. The epidemic and the weak income growth **will weaken the momentum of consumption recovery.**

Looking ahead to Q2, the COVID-19 resurgence will continue restricting consumption, but under the precision control policy, the impact of the epidemic outbreak on consumption recovery will be overall controllable. In the future, consumption is expected to remain on upward trend, but there is uncertainty about the intensity and sustainability of the momentum. On the one hand, given the current mounting downward pressures on the economy, SMEs were struggling to operate, the per capita disposable income growth of urban and rural residents declined for three consecutive quarters, and the surveyed unemployment rate rose for four consecutive quarters. Against this backdrop, consumption lacks the foundation for a strong rebound. On the other hand, the ongoing decline of property sales, which may be difficult to bottom out in Q2, continues to drag down housing-related consumption. Taken together, consumption is expected to grow by about 5% in Q2, down about 0.8 pps from Q1.

2. Investment will remain stable, but the continuity of real estate investment growth remains to be seen.

Looking ahead to Q2, investment will recover steadily, but at a slower pace. First, the continued growth of real estate investment will be faced with the insufficient improvement of financing side, disappointing sales and other constraints. On the one hand, considering the high credit risk of real estate enterprises, bank credit granting still tends to be cautious, and external financing channels such as credit debt and offshore debt continue to be blocked. On the other hand, the downturn in the sales side makes it more difficult for real estate enterprises to finance their internal operations. In January and February, property sales and funds available to real estate development enterprises fell 19.3% and 17.7%, respectively. Second, infrastructure investment is expected to maintain the fast growth momentum, benefiting from the strengthening of fiscal expenditure. Third, manufacturing investment will continue to grow faster. Overall, fixed asset investment is expected to grow by about 8% in Q2, down about 2 pps from Q1.

3. Export growth will gradually decline due to slowing foreign demand and rising costs.

Looking ahead to Q2, China's export growth rate will continue to decline overall. First, external demand slows down. On the one hand, the Russia-Ukraine conflict and Russian-concerned sanctions have pushed up global risk aversion, which may hinder global economic activities and demand. On the other hand, the United States and Europe have stepped up monetary policy tightening in response to inflation, which may affect the financing environment and investment confidence of the real economy, add downward economic pressures and lead to weaker demand. Second, the prices surge of energy, raw materials, labor force, sea freight and other factors put more cost pressures on foreign trade enterprises and affect their willingness to take orders. Third, the increasing external uncertainty factors make financial markets including foreign exchange rate more volatile, which affects the business expectations of foreign trade enterprises. In terms of imports, faster growth in investment will lead to an increase in the scale of raw materials imports, and high commodity prices. The scale and price effects will support a fast growth of imports. In general, exports are expected to grow by about 10% in Q2, down about 5 pps from Q1, and imports are expected to grow by about 11.4%, down about 1.2 pps from Q1.

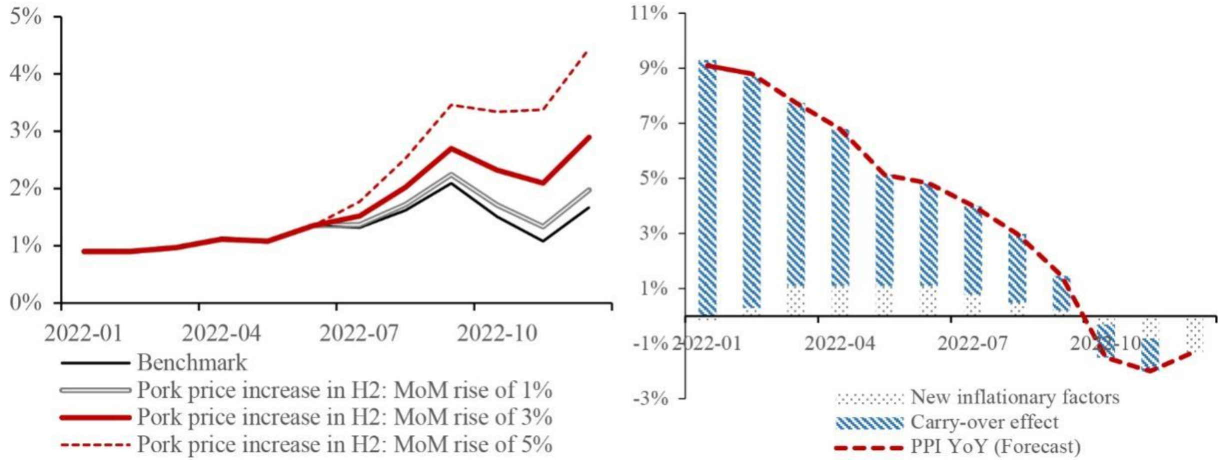
4. The production side will remain under pressures due to continuous impact from internal and external uncertainties.

Looking ahead to Q2, industrial production is expected to face some downward pressures, despite undiminished policies of ensuring steady growth. **First, the demand side lacks of driving forces.** Epidemic shocks, together with the downturn in the property sales market, provide insufficient driving forces to the recovery of domestic demand. At the same time, factors such as epidemic and geopolitical conflicts will increase the uncertainty of global economic recovery and add to the risk of stagflation. **Second, shortages of core components, such as chips, remain.** Although the shortage of automobile chip supply has eased somewhat, short-term capacity is limited and can hardly meet the demands of vehicle, parts and production scheduling, and the gap in chip supply and demand is likely to widen further. **Third, cost pressures mounts.** As geopolitical conflicts further disrupt the recovery of global supply chains, the landscape of global energy supply and demand is likely to change, which drives commodity prices upwards and continues to compress corporate profit margins. Under the circumstance of a controllable epidemic on the whole, the service sector will keep the overall momentum of recovery. Industrial value added is projected to grow by around 5.6% in Q2, about 0.4 pps lower than that of Q1, and the value added of the service sector is projected to grow by about 5.1%, about 0.1 pps higher than that of Q1.

5. The PPI-CPI gap will narrow as the CPI rises from lows and PPI growth declines.

In Q2, the supply and demand fundamentals of Chinese economy will be generally stable, and inflation would remain moderate. **First, the CPI is likely to rise slightly in low levels.** The surging prices of global grains and crude oil and enhanced carry-over effect (the carry-over effect of CPI was 0.23 pps in Q1, and 0.87 pps in Q2) will be the major driving forces for the CPI recovery. However, pork will remain in a state of greater supply than demand, and drag down the CPI growth to a large extent. **Second, PPI growth will continue to decline, and the surging global oil prices are likely to slow the pace of PPI decline.** In the future, domestic policiy effects of ensuring supply and stabilizing price will further appear, the prices of coal and steel etc. are expected to remain within reasonable region, and the carry-over effect will fade (the carry-over effect of PPI was 8.12 pps in Q1, and 4.48 pps in Q2). Therefore, the PPI growth is projected to continue to decline in Q2. However, note that the decline might be slowed down by the supply-demand landscape of global crude oil under the influence of escalating geopolitical games and the potential rise of oil prices. All taken together, the CPI and PPI are expected to increase by around 1.2% and 5.6%, respectively in Q2, and their spread will be further narrowed (see Figure 3).

Figure 3 Forecast of YoY Growth of CPI (LHS) and PPI (RHS) in 2022



Source: BOC Research Institute

II. 2022Q1 Financial Review and 2022Q2 Outlook

II.1 Financial Review of 2022Q1: Financial Market Became More Volatile amid Geographical Conflicts

In 2022, the situation facing China's financial operation was complicated by the recurrence of outbreaks, the start of the Fed rate-hiking cycle and the continuing contraction of global demand. In particular, the full-scale escalation of the Russia-Ukraine conflict became a major disruptive factor. Its significant impact on China's financial market was evident in the sharp rise in the prices of safe-haven assets represented by gold and commodities, and the sharp drop in the prices of risky assets such as stocks and bonds. Since the beginning of this year, regulators have focused on increasing support to the real economy, especially SMEs. Under the influence of lower required reserve ratio and interest rates and the continuous support of structural monetary policy instruments, money supply and aggregate financing maintained a fast growth, the credit structure was continuously optimized, and money market rates declined steadily. However, it should also be noted that SMEs still faced great difficulties in their operations; weak expectations of economic recovery led to inadequate demand for medium and long-term credit; and financial institutions ran into certain constraints in serving the real economy.

1. Countercyclical regulatory policies continue to play their role, but financial data failed market expectations.

In January and February, the new aggregate financing was RMB7.36 trillion, a record high. **The significant increase in bond financing was an important factor driving aggregate financing growth.** The issuance of government bonds and enterprise bonds increased by RMB919.7 billion over a year earlier. **New RMB loans declined slightly,** down RMB52.3 billion compared to the previous year, which was the first time in recent years. **Equity financing continued to increase year on year.** Domestic equity financing for non-financial enterprises recorded RMB202.4 billion, up RMB34 billion year on year, as the registration-based IPO system brought out more benefits of stock market reform. **Off-balance sheet financing continued to decline.** Off-balance sheet financing, including trust loan, entrusted loan and undiscounted bank acceptance bills, decreased by RMB57.4 billion, RMB432.8 billion more than the decrease of the same period of the previous year, continuing the decline of recent years. The decrease of undiscounted bank acceptance bills increased significantly by RMB503.8 billion.

The credit structure was constantly optimized and support for priority areas and weak links

continued to increase. First, credit growth remained high in industrial, inclusive and green sectors. **Second, the growth of real estate loans continued to decline.** Affected by recurring COVID-19 outbreaks and an overall low expectation of the property market, the real estate market continued to cool during January and February in 2022. The household medium and long-term loans increased by RMB696.5 billion, a significant decrease of RMB659.6 billion year on year.

It is noteworthy that weak business expectations for the economy led to a decrease in new medium and long-term loans. During January and February in 2022, new medium and long-term corporate loans stood at RMB2.6 trillion, a significant decrease of RMB534.8 billion year on year. This was mainly attributed to the impact of the epidemic, high commodity prices and other factors, which have sustained impact on the production plan and normal operations of enterprises. Entering 2022, as the epidemic situation became severe, enterprises had insufficient motivation for medium and long-term credits. Bill financing increased by RMB484 billion in January and February, a YoY decrease of RMB326 billion. The phenomena of supplementing credit with bills was notable, indicating that enterprises' credits demands were mainly for short-term bail-outs and they still held weak expectations on future economy.

2. Policy interest rates were cut, and the overall level of interest rates declined steadily.

Since the beginning of the year, with the reduction of policy interest rates and LPR, the overall level of interest rates has declined steadily, and the financing cost of the real economy has decreased. **First, policy interest rates were cut.** On January 17, the central bank reduced its 1-year medium-term lending facility (MLF) and 7-day reverse repo rates to 2.85% and 2.1%, both by 10 basis points. **Second, money market rates showed an upward trend after a decline.** DR007 and R007 dropped to about 2% in mid-February as the central bank cut interest rates in January and carried out a large number of reverse repo operations before the Spring Festival. But interest rates have started to fluctuate upward since mid-February due to reverse repo maturities and centralized taxation, etc. **Third, corporate lending rates hit record lows.** At the end of 2021, the weighted average interest rate of RMB loans of financial institutions and the benchmark interest rate were 4.76% and 5.19% respectively, the lowest on record. In particular, the interest rate on corporate loans was 4.61% for the year 2021, the lowest level since the reform and opening-up.

3. CGB yields fluctuated at recent lows, with attention paid to the widening credit spread.

In Q1, the yield on 10-year CGB continued the fluctuation at the end of the previous year, at a three-year low on the whole. **First, the issuance of local government special bonds, subordinated bank debts and medium-term notes increased remarkably, while interbank deposit certificates decreased significantly.** As the fiscal policy produced effects early on, the issuance of local government bonds accelerated significantly, with the special bonds increased by RMB877.5 billion year on year in January and February, the issuance of subordinated debts of commercial banks increased by 137.9% year on year, and that of medium-term notes increased by 22.5% year on year, while that of interbank deposit certificates decreased by 3.7% year on year. **Second, the term spread climbed slightly and the credit spread continued to widen.** As at March 25, the term spread of CGB (10Y-1Y CGB yields) averaged 72 bps, up 8 bps year on year, and lower money market rates contributed to a rapid downturn in short-term CGB yields. The credit spread rose from 50 bps at the end of last year to about 80 bps, raising concerns of corporate defaults. **Third, bond defaults fell sharply, but the risk of offshore bond defaults in the real estate industry cannot be underestimated.** As at March 25, 15 bonds defaulted. The overdue principal and interest on defaults totaled about RMB12.353 billion, down 83.57% year on year. And the default amount of offshore bonds concerned with the real estate reached about RMB4.868 billion in January and February.

4. A-shares dropped remarkably due to the influence of COVID-19 resurgence and geopolitical conflicts.

In Q1, A-shares as a whole were on the downward trend, especially in late February, when market panic spread and the share prices plunged driven by the escalating Russia-Ukraine conflict. **First,** recurring COVID-19 **outbreaks put the real economy under pressure and weakened market confidence.** Since mid-February, increased pressure on epidemic prevention and control has affected economic operations, and weaker expectations of the economy have increased market selling pressure. **Second, geopolitical conflicts caused panic in the market, resulting in A-shares being oversold.** The Russia-Ukraine conflict brought dramatic volatility to global financial markets, including A-shares market, which saw a sharp decline. **Third, the Financial Stability and Development Committee (FSDC) pledged to stabilize expectations, restoring market confidence.** On March 16, the Financial Stability and Development Committee of the State Council held a special meeting, and made clear statements on market concerns such as macroeconomic performance, real estate enterprises, China concept stocks, platform economy and the stability of Hong Kong's financial market. The meeting proposed that monetary policy should be proactive, policies that are beneficial to the market should be actively introduced, and investors should be guided to correctly understand related issues. Subsequently, the irrational and disorderly decline of the stock market was contained, along with a rebound.

5. The RMB exchange rate rose steadily, reaching a four-year high.

In Q1, the RMB exchange rate showed a steady upward trend. This was mainly attributed to: **first, a continuous export surplus.** Since 2022, China's foreign trade exports have maintained the good momentum, and continued trade surpluses drove a buoyant demand for RMB to settle foreign exchange, pushing up the RMB exchange rate. The surplus of foreign exchange settlement and sales under current account recorded USD31.06 billion in January, including USD38.44 billion in trade in goods. **Second, accelerating foreign capital inflows.** On the one hand, the net inflows of foreign direct investment in China increased significantly. USD37.86 billion foreign capital flowed in during January and February in 2022, up 45.2% year on year. On the other hand, there was a significant increase in net cross-border capital inflows in China's stock and bond markets. The surplus of foreign exchange settlement and sales under securities investment notched USD1.95 billion in January, 2022. **Third, rising safe-haven demand for RMB.** As the Russia-Ukraine conflict escalated in February, hedging motives drove the demand for allocation of partial RMB assets and pushed the RMB exchange rate high.

6. The first implementation cycle of the China Carbon Emission Trade Exchange ended smoothly, with strict regulations on data quality.

In terms of quota trading volume and trade prices in the first quarter of 2022, carbon prices in the national carbon market rose steadily, but trading volume still had room for increase. The price-discovery mechanism of the national carbon market gradually came into effect, the awareness, capacity and proficiency of emissions reduction of enterprises got improved, and the operation of the national carbon market played a greater role in reducing corporate greenhouse gas emissions and accelerating green and low-carbon transition. According to the circular released by the Ministry of Ecology and Environment (MEE), the first implementation rate for the national carbon market was 99.5% (in terms of performance) and the first implementation cycle ended smoothly.

Carbon emission trading is an important policy tool to achieve the goals of carbon peaking and carbon neutrality. And accurate and reliable data is the lifeline for the standardized operation of the carbon emission trading market. In order to crack down on the fraud of carbon emission data in emission-controlling enterprises, the MEE organized 31 working groups to supervise the quality of carbon emissions reporting while providing with assistance. In mid-March, the MEE published cases of typical problems such as fraud of carbon emission reporting data of four institutions, and proposed to improve the mechanism of quality management of carbon emission data, and to crack down on violations such as misrepresentation, deception and falsification of data.

II.2 Financial Outlook for 2022Q2: With Targeted Policies, Financial Markets are Expected to Stabilize at Weak Level

Looking ahead to Q2, China's financial markets are expected to stabilize at a weak level, driven by stable economic fundamentals and adequate liquidity. From the perspective of economic fundamentals, the continuous implementation of macro-control policies will support the future economic development, while supply constraints in coal and other fields are also tending to ease. These are conducive to stabilizing the economy and benefiting the financial markets. From the perspective of liquidity, the liquidity of the financial system will remain adequate , driven by the sustained support of sound monetary policy and the constant surplus in the balance of payments. From the perspective of policies, the FSDC recently proposed to "take full advantage of the long-term investment of insurance funds and guide insurance institutions to allocate more funds to equity assets", to "encourage M&A of real estate enterprises and grant M&A loans", and to "complete rectifications of major platform companies, with restrictions and conveniences all set up", etc. The stance will greatly stabilize market expectations, alleviate the problems such as long-term capital shortages in the capital market, the fast downturn of real estate financing, the increasing volatility of Chinese concepts stocks and the weak investment confidence of entrepreneurs, and consolidate micro foundations for sound economic development. However, given the uncertainty of the Russia-Ukraine conflict, global major countries hike interest rates and market liquidity continued tightening, and intensified epidemic control, the financial performance is still faced with lots of uncertainties.

1. Key financial indicators will grow steadily amid increasing financial support to enterprises.

Looking ahead to Q2, the financing environment as a whole will be robust and tend to be accommodative. **First,** money supply and aggregate financing are expected to grow steadily. On the one hand, the central bank offered increasing MLF loans in succession from January to March, helping to boost the incentive of financial institutions to put in medium- and long-term loans. On the other hand, the growth of M2 and aggregate financing has started to slow since March 2021, a lower base. The growth of M2 and aggregate financing in Q2 is expected to be higher than that of Q1. **Second,** the credit structure continues to be optimized. Financial institutions will continue to maintain a high level of support in areas such as inclusive micro and small businesses, green development, high-end manufacturing, and science, technology and innovation. **Third,** the real estate financing environment tends to stabilize. On March 16, the FSDC proposed to "timely study and put forward effective solutions to prevent and defuse risks centering on real estate enterprises, and supporting measures for transition to the new development pattern". It is expected that the financing environment in the real estate market will improve.

2. Market interest rates will go down in a steady manner, further reducing the financing cost of the real economy.

Looking ahead to Q2, stabilizing growth is an arduous task, along with the resurgence of outbreaks, and the policies will maintain stable and tend to be accommodative. Market interest rates are expected to continue their downward trend. **First, money market interest rates may be reduced.** Although the Fed has kicked off the rate hikes, the actual Sino-US interest rate spread will maintain at a high level against the backdrop of high inflation in the United States. As RMB exchange rate becomes more resilient, China's monetary policy remains relatively independent.

Therefore, the possibility of reducing required reserve ratio or interest rates cannot be excluded. **Second, the LPR interest rate may be lowered.** If the central bank cuts interest rates in Q2, it will drive the LPR down appropriately to further guide corporate lending rates downwards. **Third, there is a possibility of eased mortgage rates.** In Q1, banks in Guangzhou, Shenzhen Suzhou and other cities lowered mortgage rates. The FSDC meeting on March 16 sent out positive catalysts to the real estate market. Therefore, the housing credit policies are expected to ease in Q2, and mortgage rates are expected to decline.

3. Bond markets are unlikely to get stronger, and may fluctuate within a wide range.

Looking ahead to Q2, bond markets will continue to be volatile under the influence of multiple factors. **Externally,** the global monetary policies are being tightened, in particular, the Fed has raised interest rates by 25 basis points, which will cause some disturbance to the yield trend of China's bond markets. The bond market interest rate is likely to be pushed high. **In terms of economic fundamentals,** although current macro indicators are better than expected, the economy has not stabilized significantly. Especially under the influence of recurrent epidemic, the economy still faces significant downward pressure, which may drive bond market interest rates downwards. **In terms of confidence,** the market is concerned about the risk of corporate defaults despite the fact that the default amount in the bond market has fallen sharply since 2022. In particular, real estate enterprise are still under great pressure in terms of solvency in 2022, therefore, their credit risks should be under close watch.

4. Policies of ensuring stable growth will create synergy for return of confidence in the capital market.

As investors rebuild their confidence, A-shares are expected to recover steadily in Q2. **First, policies have sent out a clear signal to ensure stability, and the market sentiment is turning positive.** The FSDC emphasized on "active adoption of market-friendly policies and prudent adoption of contractionary policies". Given the policy signal of "preventing rapid contraction of monetary policy", market concerns over liquidity tightening will be tempered for some time to come. **Second, investment opportunities under the goals of carbon peaking and carbon neutrality will boost emerging sectors.** With policies implemented, investments related to carbon peaking and carbon neutrality will further expand. Green industries such as PV, new energy vehicles, new energy power generation, environmental protection, etc. will enter a growth phase driven by both policies and economic development. **Third, the Fed has entered a rate-hike cycle, which causes disturbance to A-shares.** The Fed expects to raise interest rates several times during the year and also hints that it is about to start shrinking its balance sheet. With full communication, there may not be excessive panic in the market, but it will still put pressure on A-shares. **Fourth, the impact of other uncertainties on A-shares should be watched out.** Domestic resurgence of outbreaks put economic recovery under pressure, and adversely affected the A-shares market. The Russia-Ukraine conflict pushed commodity prices high as a trend that could remain relatively high in the medium term, and drove up global inflation expectations, which will impact overvalued sectors in global capital markets.

5. The spillover effect of the Fed's rate hikes appears, and the RMB exchange rate will continue the bi-directional volatility.

Looking ahead to Q2, under the influence of the Fed's rate hikes and falling demand for exchange settlement, the RMB exchange rate can hardly rise obviously, and is expected to continue its volatility. In terms of devaluation, **the trade surplus advantage is unsustainable.** The momentum of the global economic recovery is weakened in 2022, so is the external demand, in contrast to rising production costs. All these factors make the trade surplus advantage unsustainable. Besides, the seasonal RMB settlement peaked after the Spring Festival, and the driving force for appreciation diminished. **The Fed's rate hikes will have spillover effects.** The Fed has started a rate-hike cycle, and monetary policies between China and the United State have diverged, leading to narrowing of the Sino-US interest rate spread and mounting pressure of cross-border capital outflows. However, the RMB exchange rate still has a basis for appreciation. **RMB assets are still attractive to foreign investment.** Currently, the global economy is under increasing downward risks, the United State is experiencing severe inflation, while China demonstrates stable economic performance and overall moderate inflation. So RMB assets remain a good investment option for overseas funds. **The demand for RMB payment and settlement is increasing.** At present, both the international payment shares of RMB and demand for RMB settlement are increasing, which is conducive to appreciation of the RMB exchange rate. In January 2022, the international payment shares of RMB rose to 3.2%, ranking fourth around the globe.

6. Efforts will be made to expand the carbon market and accelerate the building of CCER market.

It is expected that the national carbon market will be built centering around five aspects. **First, standardizing the system of carbon market factors.** Supporting rules will be improved to further refine the supporting system of the carbon market including transaction entities, time scale, target total amount, subjects of transaction (allowances or other voluntary emission reduction credit products), trading, accounting and performance etc. **Second, expanding the coverage of carbon market.** The industry coverage and transaction subjects will be expanded in order to increase market activity. In line with the overall arrangement of the competent authorities, the industry coverage of the national carbon market will be expanded to include more high-emission industries after the stable operation of the carbon market in the power generation industry. **Third, improving the allocation mechanism of allowances.** The establishment of a scientific and long-term allocation mechanism of allowances is beneficial for emission-controlling enterprises to have a clear expectation of the allowance tightening scale and the time scale of allowance updating. **Fourth, enhancing the quality of carbon trading-related data.** Carbon dioxide emissions accounting will be regulated through technical means. Industry self-regulation will play an active role, and the carbon market data quality will be improved through supervision, training, etc. **Fifth, accelerating the restart of project approval of China Certified Emission Reduction (CCER).** In the first implementation cycle, some emission-controlling enterprises used CCER to offset carbon emissions. Now the CCER supply in the market is well below demand, which requires speeding up the restart of CCER project approval.

Table 1 China's Main Economic & Financial Indicators and Forecasts in 2022Q2 (%)

Indicator	2019 (R)	2020 (R)	2021 (R)	2022 (F)		
				Q1 (E)	Q2 (F)	Full year (F)
GDP	6.0	2.2	8.1	**5.2**	**5.1**	**5.3**
Industrial value added of enterprises above designated size	5.7	2.8	9.6	**6.0**	**5.6**	**6.1**
Value added of the service sector	7.2	1.9	8.2	**5.0**	**5.1**	**5.2**
Fixed asset investment (cumulative)	5.4	2.9	4.9	**10.0**	**8.0**	**5.5**
Investment in real estate development (cumulative)	9.9	7.0	4.4	**3.5**	**1.0**	**4.0**
Total retail sales of consumer goods	8.0	-3.9	12.5	**5.8**	**5.0**	**5.2**
Exports	0.5	3.6	29.9	**15.0**	**10.0**	**8.0**
Imports	-2.7	-0.6	30.1	**12.6**	**11.4**	**6.5**
Consumer Price Index (CPI)	2.9	2.5	0.9	**0.9**	**1.2**	**2.1**
Producer Price Index (PPI)	-0.3	-1.8	8.1	**8.6**	**5.6**	**3.8**
Broad money supply (M2, ending balance)	8.7	10.1	9.0	**9.3**	**9.2**	**9.5**
Aggregate financing to the real economy (stock, ending balance)	10.7	13.3	10.3	**10.5**	**10.3**	**10.5**
1-year MLF	3.25	2.95	2.95	**2.85**	**2.80**	**2.80**
1-year LPR	4.15	3.85	3.80	**3.70**	**3.65**	**3.65**
USD/RMB spot exchange rate	6.97	6.54	6.37	**6.35**	**6.40**	**6.45**

Source: BOC Research Institute

III. Macro Policy Suggestions

First, fiscal policy should be more effectual to expand effective investment. Fiscal policy should increase support for clean energy, national computing network to synergize east and west, and government-subsidized housing, while further strengthening funds are in step with projects.

Second, monetary policy should continue to play its role thus to promote the realization of "reasonable aggregate, optimized structure and reduced prices". Open-market operations, lending facilities and other tools should be made full use of to maintain reasonably abundant liquidity. The LPR quotation mechanism should be refined to release the potential of loan pricing mechanism.

Third, targeted efforts should be made to stabilize market entities to ensure a stable employment market. Structural tax and fee reduction policies should be implemented, and the availability and stability of key products such as grains and coal should be strengthened. Policies of stabilizing employment proposed in the *2022 Report on the Work of the Government* should be implemented.

Fourth, continuous efforts should be made to consolidate the consumption base and to foster a beneficial environment for stable consumption recovery. Green smart appliances can be promoted to the countryside through issuing consumer vouchers and trade-in subsidies, among other forms. Restrictions on vehicle purchases can be eased at a faster pace if conditions permit. The application of digital and intelligent technologies in life services should be encouraged.

Fifth, effective measures for risk resolution in real estate should be rolled out timely to advance the transformation of the real estate market. Against a backdrop of downward pressure on the economy, the principle of city-specific measures should be adhered to, and relevant policies can slightly loosen to release a positive signal and stabilize market expectations in areas where the real estate market is falling too fast.

Sixth, local governments should play more active roles in stabilizing growth and promoting transformation. The impact of new changes in foreign trade and finance on stable growth should be watched out for. Regions with better scientific research and industrial bases should play a leading role in innovation. The mechanisms of integrated market development, regional cooperation and solidarity, and interregional benefit compensation should be further refined.

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