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China’s Economic and Financial Outlook

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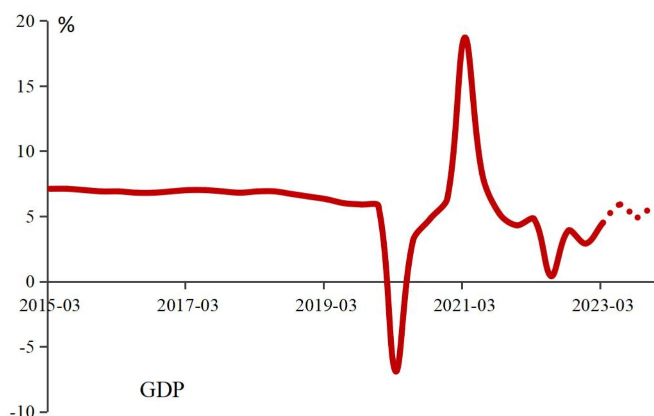
Highlights

- In 2023H1, the impact of the Covid-19 pandemic in China has decreased significantly, the pressures of supply shock, demand contraction and weakening expectations have eased. The contribution of domestic demand to economic growth increased. China’s GDP grew by 4.5% in Q1, stronger than the market expectation. Entering the second quarter, the momentum of economic recovery has slowed down due to weak internal impetus and insufficient demand. GDP in Q2 is estimated to be around 6%.
- Looking ahead to H2, China’s economic growth will still mainly depend on how well the domestic demand recovers. Driven by policies to promote consumption and accelerated release of service consumption, consumption is expected to maintain a moderate recovery, infrastructure investment will continue to grow rapidly, and investment in high-tech industries will be a strong support for the growth of manufacturing investment, the real estate market will gradually bottom out. GDP is expected to grow by about 4.9% in Q3, and by around 5.4% for the year.
- The uncertainty of the external environment is still relatively large and the growth momentum of the domestic economy is not strong. It is suggested that multiple measures should be taken to stabilize market expectations. The fiscal policy should further be enhanced to stabilize economic growth. The monetary policy should focus on “aggregate, structural and regulatory” to support economic recovery. Try to form a joint force to expand domestic demand. Pay attention to the impact of sluggish international demand on foreign trade enterprises. The real estate policy should focus on persistently stabilizing expectations and mitigating risks.

China's Growth Momentum Needs to be Enhanced



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China's Growth Momentum Needs to be Enhanced, Policy Focus Needs to be Expectations Stabilization

-- China's Economic and Financial Outlook (2023Q3)

In the first half of 2023, the impact of the Covid-19 pandemic in China has decreased significantly, the pressures of supply shock, demand contraction and weakening expectations have eased. The contribution of domestic demand to economic growth increased. China's GDP grew by 4.5% in Q1, stronger than the market expectation. Entering the second quarter, the momentum of economic recovery has slowed down due to weak internal impetus and insufficient demand. GDP in Q2 is estimated to be around 6%. Looking ahead to the second half of the year, global economic growth will continue to slow down and China's export growth will face pressure. China's economic growth will still mainly depend on how well the domestic demand recovers. Driven by policies to promote consumption and accelerated release of service consumption, consumption is expected to maintain a moderate recovery, infrastructure investment will continue to grow rapidly, and high-tech industry investment will be a strong support for the growth of manufacturing industry investment. With the real estate market gradually bottoming out, the decline in real estate development investment will slow down. GDP is expected to grow by about 4.9% in Q3, and the annual growth will be around 5.4%. Multiple measures should be taken to stabilize market expectations. The fiscal policy should further be enhanced to stabilize economic growth. The monetary policy should focus on "aggregate, structural and regulatory" to assist in sustained economic recovery. Try to form a joint force to expand domestic demand. Pay attention to the impact of sluggish international demand on foreign trade enterprises. The real estate policy should focus on persistently stabilizing expectations and mitigating risks.

I. 2023H1 Economic Review and H2 Outlook

I.1 Economic review in 2023H1

In the first half of the year, there was significant downward pressure on the global economy, and China's overall external market demand slowed down. The impact of the Covid-19 pandemic in China has decreased significantly, and the pressures of demand contraction, Supply shock and weakening expectations have eased. Consumption, especially contact consumption, has significantly rebounded, and investment in infrastructure and manufacturing has grown rapidly. China's GDP growth reached 4.5% in Q1. Entering the second quarter, the momentum of economic recovery has slowed down due to weak internal impetus and insufficient demand. This not only reflects the impact of the "scar effect" of the pandemic, but also due to the challenges brought by economic transformation and upgrading. GDP is estimated to grow by around 6% in Q2. Looking back at the macroeconomic situation in 2023H1, three major driving forces and three major challenges are worth noting.

1. Three drivers

Driver 1: Consumption and services were the main driving forces for the ongoing recovery. China's consumption showed a good recovery in 2023H1, thanks to the fading impact of COVID-19, recovery of offline consumption, the rising tide of post-pandemic demand, and a low base for comparison. Total retail sales of consumer goods grew by 9.3% from January through May.

The average two-year growth for 2022-2023 was 4.5% in Q1, then slowing down to 3.8% in April and May, manifesting a gradually moderating pace of recovery. Consumption showed structural disparities. First, service consumption recovered better than commodity consumption. In-person consumption such as tourism and catering grew robustly. Second, upgraded consumer demand continued to be released. The consumer spending on gold, silver and jewelry surged from January through May due to the rising gold prices pushing up consumers' investment demand and the post-pandemic release of wedding-related demand. Third, automobile consumption growth decreased at first, and then increased.

Driver 2: Infrastructure and manufacturing investment continued to play a key role in stabilizing growth. From January to May, the fixed asset investment increased by 4%. More specifically, the infrastructure and manufacturing investment increased by 7.5% and 6%, driving the growth of fixed asset investment by about 1.6 and 1.8 percentage points, respectively. First, Infrastructure investment increased rapidly due to expanding fiscal expenditure and construction. Project construction advanced fast, coupled with the construction PMI remaining in a high boom range. Second, new industry momentum drove manufacturing investment growth. In first half of year, the bumpy decline in prices of crude oil, coal, steel and other industrial products discouraged enterprises from investing. The strong performance in exports of technology-intensive products such as electric vehicles, lithium batteries and computer-integrated manufacturing (CIM) drove the structural shift and upgrading of the manufacturing investment.

Driver 3: Structural changes in export products and markets. In the first five months of 2023, the export value increased by 0.3% (in US dollars, the same below), and the growth rate in March and April reached 14.8% and 8.5%, respectively.Three reasons could explain why the performance of China' s exports exceed expectations: First, exports to emerging economies grew fast. Second, new energy export products became increasingly competitive, and the three "rising stars" (manned electric vehicles, lithium batteries and solar cells) delivered a stellar performance in exports. Third, the delivery of backlog orders led to a high increase in exports.

2. Three challenges

Challenge 1: The real estate market is still in the bottoming stage with high uncertainty. The real estate market showed signs of bottoming out for a pickup in Q1. Since April, however, key indicators such as sales and investment have fallen significantly. From January through May, China's total completed investment in real estate development declined by 7.2%, 3.2 percentage points more than the drop rate in 2022. On the one hand, real estate sales recovery was transitory. Slow income growth throttled consumer spending. There was great uncertainty about the housing price developments and risk expectations going forward, dampening the consumer confidence. On the other hand, property developers lacked of confidence. The completed floor space has kept improving since 2023 began, yet with accelerating divergence between housing starts and completions.

Challenge 2: As insufficient demand remained a constraint, the production recovery and price level were depressed. Household consumption remained low in H1, the property market was still at the bottom and exports were weaker than the last year. First, domestic-demand-related industries showed lackluster performance. Due to the modest property market recovery, the production in upstream industries, such as steel and building materials, slowed down. The downstream manufacture of consumer goods suffered because of the weak commodity consumption. Second, price levels remained low. CPI and PPI gained 0.9% and shed 2.6% from January to May, respectively. The CPI growth decreased as pork and energy price kept going down. The PPI decreased more sharply due to the oversupplied industrial product markets.

Challenge 3: Employment remains under pressure in both volume and structure terms.

China's surveyed urban unemployment rate has been declining since March, reaching a new low of 5.2% in May. In the future,there will be some pressure on both the total employment volume and structure. The *Report on the Work of the Government* for 2023 set the goal of "creating about 12 million new urban jobs". However, the business sector does not have many job openings due to the weak recovery momentum. Also, structural problems on both labor supply and demand sides have become prominent, prolonging the frictional unemployment. On the supply side, job seekers increasingly prefer job security and stability. The mismatch between demand and supply cannot be addressed in the near term. On the demand side, the consumer service sector, which is less knowledge-intensive, shows a brighter outlook, but the major industries represented by manufacturing cannot create enough jobs.

I.2 Economic outlook for 2023H2

Looking ahead to the second half of the year, global economic growth will face slowing pressure, putting China's exports growth under pressure. The domestic economic recovery will rely more on domestic demand. Driven by policies to promote consumption and accelerated release of service consumption, consumption is expected to maintain a moderate recovery, infrastructure investment will continue to grow rapidly, and high-tech industry investment will be a strong support for the growth of manufacturing industry investment. With the real estate market gradually bottoming out, the decline in real estate development investment will slowly narrow. GDP is expected to grow by about 4.9% in Q3, and the annual growth will be around 5.4%.

First, consumption maintains a moderate recovery, with consumer confidence and spending power expected to be further improved. Amid the ongoing economic recovery, macro policies will further work to keep consumption recover better. Given the lingering "scarring effect", however, it still takes time for consumers to restore their capacity and willingness to spend. Consumption recovery is expected to be moderate and gradual. The potential for service consumption will be further unleashed, automobile consumption is expected to stabilize, and the consumption of housing-related goods will remain under pressure. The consumption is expected to grow by about 5.7% in Q3, and by around 8% for the year.

Second, investment growth will remain stable, with infrastructure and manufacturing investment leading the overall growth rate. First, the growth of infrastructure investment will remain fast. Infrastructure investment will still be the major momentum of economic recovery and domestic demand expansion. Second, manufacturing investment will still have its structural support. Chinese government considers the development of a modern industrial system as its priority, and has been providing strong support for such industries as new energy vehicles and artificial intelligence. In the context of building advanced manufacturing clusters, credit policies will continue to support the forward-looking investments in high-tech and equipment manufacturing industries. Third, the decline in real estate investment will gradually narrow down. Overall, fixed asset investment is expected to grow by about 5% in Q3 and 5.5% for the year.

Third, demand in the international market may further slow down, putting pressure on export growth. First, end-user demand is sluggish in Europe and the United States. Interest rate hike in Europe and the United States have not yet ended, and excess savings in the United States may be exhausted by the end of Q3, implying a likely slowdown in consumer spending. Second, ASEAN countries may become weaker contributors to China's exports. ASEAN exports growth remains in the negative territory due to sluggish international demand, having an adverse effect on the "China-ASEAN" trade chain. Since the international demand has shown no signs of improvements, the "China-ASEAN" trade will likely continue to soften. China's exports in Q3 are expected to fall by about 2.1% year-on-year, pick up from a low base in Q4 and end the year with an annual growth of about 0.2%.

Fourth, industrial production will accelerate and services recovery continue to maintain promising. First, as shown by the average inventory period (about 40 months), the industrial sector is expected to enter the phase of active restocking in 2023H2. The continued recovery of market demand will gradually translate into an acceleration in industrial production. Second, the new drivers of industrial production are expected to further unleash their leading role. Efforts have been made in 2023 to foster the development of high-end and green manufacturing industries . Third, the service sector is expected to further recover. With the consumption requiring close contact further recovering, the improved income will continuously add to consumers' spending power. Given the low base of last year, the services recovery is still expected to bolster economic growth. The industrial value added and service value added are estimated to grow by 4.5% and 4.8% respectively in Q3, and by 4.4% and 5.8% for the year.

Fifth, CPI will rise moderately, and the decline in PPI will gradually narrow. First, the consumption recovery will drive a moderate increase in CPI. Second, PPI decline will gradually narrow due to the domestic economic recovery and fading effect of a high comparison base. CPI and PPI are expected to rise by around 0.7% and fall by 2.1% in Q3, and increase by about 0.9% and drop by 2.2% for the year, respectively.

II. 2023H1 Financial Review and H2 Outlook

II.1 Financial review in 2023H1

In 2023H1, China launched a number of major financial reform measures, established the Central Financial Commission and the Central Financial Work Commission and created the National Financial Regulatory Administration (NFRA). China's financial sector has entered a new phase of "institutional + functional" supervision. The registration-based IPO mechanism was fully implemented, and the fundamental institutions of capital market were further improved. At the same time, ensuring steady growth of the real economy is still the primary objective of China's current financial and monetary policies. Driven by policy guidance and demand recovery, credit supply and aggregate financing to the real economy showed expansion in size and decline in price. China's financial markets (e.g. foreign exchange and stocks), however, became more volatile under combined effects of internal and external factors, including the economic recovery was weaker than expectations and more bank failed in Europe and the United States.

1. Money and credit supply expanded notably in the context of economic recovery and policy tailwinds

From January through May 2023, new aggregate financing to the real economy totaled RMB17.31 trillion, up RMB1.48 trillion year-on-year. New RMB loans hit a record high of RMB12.36 trillion, up RMB1.84 trillion year-on-year, mainly due to continued effects of monetary policy and increased corporate desire for financing.Considering the under motivated corporate financing amid weak secondary market, the domestic equities financing of non-financial enterprises totaled RMB389.5 billion, down RMB54.5 billion year-on-year. The growth of government bonds and enterprises bonds recorded a year-on-year decline of RMB190.4 billion and RMB798.9 billion, respectively. The moderated growth in government bonds is related to the front-loaded issuance of special government bonds in H1. The weaker growth in enterprise bonds was due to a rise of costs of debt financing in a more volatile bond market and expanding credit supplies as an alternative to bonds.

The credit structure continued to improve to increase support for key fields and weaker links of the national economy. By credit structure, the growth rate of outstanding credit to manufacturing, inclusive small and micro businesses, green and agriculture-related sectors was 41.2%, 26%, 38.3% and 16.2%, respectively, significantly higher than the growth (11.8%) of total

outstanding loans. **By term structure,** medium- and long-term corporate loans accounted for a larger share, but the demand for medium- and long-term household loans remained subdued. From January through May 2023, new medium- and long-term corporate loans amounted to RMB8.11 trillion, accounting for 64% of total new loans, a surge of 20.2 percentage points year-on-year. New medium- and long-term household loans stood at RMB997 billion, accounting for 7.9% of total new loans, down 2.7 percentage points year-on-year. Notably, while the medium- and long-term credit grew remarkably faster, the rise in corporate investments did not sustain. Their divergence implies that credit funds may have not been effectively converted into corporate investment.

2. Liquidity remained reasonably sufficient, with market interest rates declining in general

First, main policy rates decreased again after 10 months. In June, PBOC unexpectedly lowered the 7-day reverse repo rate and the 1-year MLF rate by 10 bps each to 1.9% and 2.65%, respectively. **Second, short-term money market interest rates showed an inverted-V shaped pattern of movements.** The weighted monthly average rate of pledge-style repos and the weighted monthly average rate of inter-bank lending increased markedly at the beginning of 2023 in the context of robust recovery of the Chinese economy, reaching a near-term high of 2.07% and 1.92% in February, respectively. But since then, because of the lower-than-expected economic recovery, both rates kept dropping and fell to 1.55% and 1.50% in May, respectively. **Third, deposit rates continued to fall.** Following their deposit rate cuts in September 2022, China's state-owned major banks further lowered their deposit rates in June 2023. For example, the three-year time deposit rate declined to 2.45% from 2.6%. However, the household sector preferred saving to borrowing due to weak confidence in spending and unwillingness to borrow. Deposits did not scale back for lower interest rates. From January through May 2023, RMB deposits increased by RMB2.4 trillion year-on-year, with the growth led by time deposits.

3. The China Government Bond (CGB) yield showed a choppy decline, with bond issuance expanding steadily

The bond market has shown the following characteristics in H1: **First, total bond issuance grew steadily.** As of June 20, total bond issuance reached RMB32.5 trillion, up 11.4% year-on-year. Specifically, the CGB issuance reached RMB4.32 trillion, up 33.8% year-on-year. The local government bond issuance was RMB4.1 trillion, down 7% year-on-year. The commercial bank bonds issued were RMB647.1 billion, an increase of 6.8%. Specifically, funds kept funneling into the key areas that policy hope to target on. The issuance of commercial bank bonds earmarked for "small and micro businesses", "agriculture, rural areas and farmers" and "green development" stood at RMB385.1 billion, a year-on-year increase of 19.9%. The issuance of corporate bonds reached RMB1.8 trillion, an increase of 25% year-on-year, due to the recovering demand for corporate financing. **Second, Term spreads widened slightly and credit spread volatility narrowed.** As of June 20, the CGB term spread (between 10-year and 1-year CGB yields) stood at 0.78%, up 4 bps from the beginning of the year. The credit spread (between the yield on 3-year AA+ commercial papers and mid-term notes and the yield on 3-year CDB bonds) was 0.61%, down 37 bps from the beginning of the year. **Third, overseas institutions cut their exposure to RMB-denominated bonds.** Foreign investors' exposure to RMB-denominated bonds shrank in terms of both size and percent share due to diverging monetary policies at home and abroad, alongside the widening spread between Chinese and US interest rates. At the end of April, the RMB-denominated bonds held by foreign institutions totaled RMB3.17 trillion, representing a share of 2.17%, down RMB221 billion and 0.23 percentage points from the beginning of the year, respectively. **Fourth, the credit risk continued to converge.** As of June 20, the defaults on credit bonds amounted to RMB8.7 billion, representing a year-on-year decrease of 70.3%. By industry,

default risks of credit bonds were concentrated in the real estate industry, with a total of 9 property developers in default on RMB6.4 billion of debts in aggregate.

4. The RMB exchange rate showed wider two-way swings in a W-shaped pattern

In 2023H1, the RMB exchange rate surged to around 6.7 before remaining range-bound between 6.8 and 7, followed by a decline to around 7.1 in mid-June, showing a general pattern of two-way fluctuations. As of June 20, 2023, the spot exchange rate of USD against RMB was quoted at 7.17.

Three main factors explain the recent depreciation in RMB. First, the US Dollar Index (DXY) was higher in a short term. DXY rose to about 104 in early June as the US core inflation remained high and the market expectation of US tightening was further elevated. **Second, the China-US interest rate spread became more inverted.** Since mid-May, the inverted spread between the China 10-year Government Bond yield and the US Treasury 10-year yield widened due to a rising of US Treasury 10-year yield and a falling of China 10-year Government Bond yield. As of June 20, the spread between the China 10-year Government Bond yield and the US Treasury 10-year yield further expanded from -61 bps in early May to -109 bps . **Third, the domestic economic recovery remained fragile and the sluggish foreign demand undermined exports, affecting the current account surplus and exchange balance.** According to the General Administration of Customs of China (GACC), China's trade surplus in May was USD65.8 billion, down 16% from the same period of 2022. According to the State Administration of Foreign Exchange (SAFE) data, the banks' surplus in forex settlement and sale in May was USD3.3 billion, down 39% from the previous month. The banks' surplus in forex settlement and sale on behalf of customers under the current account fell by USD3.8 billion to USD12.9 billion.

5. A-shares showed pronounced sector rotation

Against the backdrop of domestic economic recovery and complex global geopolitical environment, China stock market has turned from the trough in 2022 to growth in the first half of 2023, though accompanied by range-bound movements. In the first quarter of 2023, A-shares demonstrated a rough but upward movement and Shanghai Stock Exchange Composite Index (SSEC) increased by 5.9%, spurred by the adjustement of COVID-19 policy and the recovery of market confidence. Since the second quarter, however, A-shares entered into a phase of adjustment characterized by larger fluctuations. On June 20, SSEC closed at 3,240.36, marking a 4.9% rise from the end of 2022.

Different factors accounted for the trajectory of A-shares. On the bullish side, listed companies resumed their operations, recording a year-on-year increase in earnings. Amid the decline in raw material prices and the expanding international shipping supply, companies experienced decline in their production and shipping costs, and effectively cleared backlog orders. According to the Q1 earning report of listed companies, 79.2% reported profit and 53.5% saw a year-on-year growth. On the bearish side, China's economic recovery fell short of expectations. The weakening economic data in Q2 has sparked concerns about its future recovery prospects. Moreover, the divergence in US and Chinese monetary policies created turbulence in the A-share markets. The Fed's hawkish rate hikes have led to the inverted China-US interest rate spread, triggering capital outflow and downward pressure for China stock market.

Performance across A-share sectors varied. First, companies within "the valuation system with Chinese characteristics" sector, primarily represented by state-owned enterprises in finance, telecommunications, and energy industries, experienced an upward revaluation. They benefited from state policies for constructing modern capital market with Chinese characteristics as well as growing confidence in state-owned enterprise reforms. Over the last three months, the Wind Index for "the valuation system with Chinese characteristics" has increased by 3.9%, outperforming the

broad stock market index by 3.8%. Second, the information technology sector sustained its upward trend. ChatGPT, a high-profile chatbot, made a significant impact in 2023, paving the way for novel applications of Artificial Intelligence (AI) technology. The investment enthusiasm for ChatGPT also boosted the AI sector. In early April, the Wind AI Index reached its second-highest level on record, surpassed only by its peak in 2015. The index's highest daily gain was 2.4 times that of the broad market over the same period. Finally, the real estate sector remained weak. Despite of a temporary growth early this year, the real estate sector declined, concluding the first half of 2023 with an average monthly decrease of 2.4% in this sector's index.

6. Green loans grew rapidly, and the carbon market made steady headway

First, total green loans continued to grow rapidly since 2022. As of 2023Q1, China's outstanding green loans grew by 38.3% year-on-year, significantly higher than that (11.8%) of all loans over the same period, taking up a larger share of 11% in all loans. Specifically, as green production and consumption have increasingly become an important topic in the society recently, the demand for financing across the energy conservation and environmental protection industries increased, indicated by 53% year-on-year growth rate of loans, . **Second, the issuance of green bonds remained at a high level.** According to Wind data, about RMB590 billion of green bonds were newly issued in 2023H1, slightly higher than a year earlier (about RMB580 billion). Among them, the green financial bonds issued by commercial banks exceeded RMB200 billion, doubling year-on-year. **Third, the carbon market advanced steadily, with the restart of CCER gaining pace.** In H1, the price of China Emission Allowances (CEAs) in the national carbon market remained at about RMB57/ton, with a monthly turnover of about 1.3 million tons, a modest year-on-year decline. The carbon market is divided between mandatory carbon reduction and China Certified Emission Reduction (CCER). China suspended CCER trading in 2017, but there have been persistent calls for its resumption in recent years. In March 2023, the General Office of the Ministry of Ecology and Environment issued a document publicly soliciting inputs on the CCER methodology. In addition, relevant authorities have said on many recent occasions that they are preparing for restarting the CCER trading.

II.2 Financial outlook for 2023H2

China's financial market will likely remain steady in H2. From the perspective of economic fundamentals, the continued economic recovery and market confidence restoration will be tailwinds for the market. From the policy point of view, given the fragile footing of recovery, PBOC is expected to use open market operations and various lending facilities to ensure reasonably sufficient and stable liquidity.

1. The money supply and aggregate financing will steadily strengthen to ensure unabated funding support for enterprises.

Looking forward to H2, money supply will remain stable and sufficient, and the financing environment is expected to remain stable and be slightly relaxed. **First, money supply and aggregate financing will maintain a medium to high rate of growth.** In June, in order to encourage financial institutions to increase credit supply for economic stability, PBOC made several cuts on interest rates of major monetary policy instruments, which will drive M2 and social finance to maintain medium-to-high growth. **Second, increased support will be provided for key fields and weaker links of the economy.** Driven by the continued implementation of structural monetary policy instruments, financial institutions will likely maintain their robust credit support for relevant fields. In particular, the credit growth in green sectors and high-tech manufacturing stands to remain above 30%, and the credit growth in inclusive finance is expected to stay above 20%. **Third, the credit growth in real estate is still struggling to stabilize.** The property market

remains an uncertainty as home buyers are under motivated. The growth of real estate loans will still be struggling to increase in the near future.

2. Market rates will stay low to keep corporate financing costs low

The financing cost of the real economy is expected to remain low in H2. **First, policy rates remained low.** Even if the economy recovers somewhat, the policy rates still need to remain low to bolster the recovery. It is expected that the 7-day reverse repo, MLF and other policy rates will remain low. Further small cuts in policy rates are still possible. **Second, money market rates will stabilize at the bottom.** Economic recovery will restore corporate demand for financing and thus stabilize interest rates in the short-term money market. However, an easy monetary policy will keep market rates low. **Third, lending rates will stay low.** The recovering demand for corporate financing will push lending rates higher, albeit at a moderate pace. Lending rates will stay low in H2. **Fourth, deposit rate cuts may spread wider.** State-owned major banks' further cuts on deposit rates in June 2023 will probably be followed by smaller banks' deposit rate reduction in H2.

3. Bond yields may remain low, and enterprise bond financing will maintain steady growth

First, total bond issuance will increase steadily. The supply of interest rate bonds is expected to further expand as the fiscal policy is working to stabilize the economy. Driven by a solid recovery of the real economy, the issuance of enterprise bonds and corporate bonds stands to increase steadily. **Second, bond yields may remain low.** In terms of policy, liquidity will remain reasonably sufficient amid persistent policy tailwinds as the real economic recovery was weaker than expectations, which will keep bond yields low. From the perspective of demand of bond assets, wealth management products will maintain an exposure to bond assets in the context of deposit rate cuts, supporting bond prices. **Third, bond market risks still deserve due attention.** At present, the real estate industry is still at a high liabilities-to-assets level amid the ongoing market clearing. With the profitability remaining strained, the real estate industry is still exposed to potential credit risks. Close attention should be paid to operating conditions of property developers in the future.

4. The RMB exchange rate will gradually stabilize, poised for steady strengthening

First, relevant spillover effects are expected to abate. Although the two-way swings of RMB value have widened recently, DXY can hardly remain strong after the Fed released a clear signal at its June FOMC meeting, then the China-US interest rate spread will become less inverted. **Second, the domestic economic growth will pick up steadily.** With the concerted macro-policy efforts in place, China's economic will keep recovering. The internal growth momentum will continue to improve, the consumer confidence will be further restored and the economic fundamentals will play an increasing role in supporting the foreign exchange market. **Third, cross-border capital flows will be generally stable.** China's foreign exchange market shows rational and well-ordered trading on both supply and demand sides, and the market resilience has been significantly improved. Exchange rate expectations remain stable, foreign exchange reserves are reasonably abundant and the balance of payments is basically in equilibrium. **Fourth, China has a variety of macro policy tools about exchange rate.** In May 2023, the China Foreign Exchange Market Steering Committee (CFXC) announced at a meeting that PBOC and SAFE would correct pro-cyclical and one-sided behaviors where necessary to curb speculation. PBOC has a rich policy toolbox for stabilizing the exchange rate, such as "counter-cyclical factors", forex risk reserves and forex reserve requirements, which provides a guarantee for the correction of RMB exchange rate overshoots in the future.

5. A-shares remain volatile with sporadic opportunities

First, the aftermath of the COVID-19 pandemic, often referred to as the "scarring effect", is gradually alleviating. A series of pro-growth initiatives continue to boost the economy, and consumer confidence is on an upward trajectory. As a result, aggregate demand is poised for further recovery. Second, listed companies within the "the valuation system with Chinese characteristics" sector are likely to sustain their upward revaluation momentum. In 2022, these companies reported an aggregate net profit of RMB2.7 trillion, as per data from Wind. Despite of an 16.3% growth in their operating revenue, their stocks traded at a P/E ratio of 7.6x, significantly below the market average of 20x to 25x P/E. Moreover, ongoing reforms in the capital market and the state-owned enterprise are expected to improve investor confidence. Third, the A-shares market stands to benefit further from the AI tailwinds. ChatGPT recently has released its API, which could enable companies across industries to leverage the computational power of ChatGPT and optimize their business models. This development will usher in more investment opportunities for A-shares. Fourth, external factors may create disturbances for A-shares. On June 14, the Fed decided to pause its rate hikes. However, against the backdrop of resilient inflation, the market anticipates that the Fed is likely to raise 25 basis points again towards the end of 2023. This indicates that the interest rate difference between China and the U.S. will continue to be inverted. Compounded by the depreciation of Renminbi, capital may outflow from China stock market for superior returns from U.S. dollars.

6. Green finance is likely to keep expanding fast, with the CCER restart much-anticipated

First, green loans are on track for rapid growth. The state-supported energy conservation and environmental protection industry is expected to maintain a rapid growth of 50%, and the growth momentum remains strong for the financing of green infrastructure upgrading and clean energy. Thus, H2 likely continues to grow rapidly. **Second, the issuance of green bonds will probably remain at a high level.** The recent reduction in bond market rates has created a more favorable price environment for green bond issuance in H2. The issuance of green bonds in H2 is expected to reach RMB700 billion, surpassing the 2022H2 level, and bring the annual issuance to a level beyond RMB1.2 trillion. **Third, CCER is expected to restart.** Preparations for the CCER restart are underway. The restart is very likely in 2023H2. Then China's carbon market will be driven by both compulsory emission reduction and voluntary emission reduction, laying a solid foundation for the funding of green industries. **Fourth, the timing of carbon market expansion remains to be seen.** In recent years, when the carbon market will expand to incorporate which industries additionally have been a concern of those outside the market. At present, more than 2,000 thermal power generation companies are included in the carbon market. In the future, carbon-intensive emitters in the petrochemical, steel, non-ferrous metals, paper and chemical industries are expected to join the carbon market one after another.

Table 1: China's Main Economic & Financial Indicators and Forecasts in 2023H2 (%)

Indicator	2020 (R)	2021 (R)	2022 (R)	2023 (F)				
				Q1 (R)	Q2(E)	Q3(F)	Q4(F)	Full year (F)
GDP	2.2	8.1	3.0	4.5	6.0	4.9	5.6	5.4
Industrial value added of enterprises above designated size	2.8	9.6	3.6	3.0	4.1	4.5	6.0	4.4

Service industry added value	1.9	8.5	2.3	5.4	**7.5**	**4.8**	**5.5**	**5.8**
Fixed asset investments (cumulative)	2.9	4.9	5.1	5.1	**4.0**	**5.0**	**5.5**	**5.5**
Investment in real estate development (cumulative)	7.0	4.4	-10	-5.8	**-7.6**	**-5.0**	**-3.5**	**-3.5**
Total retail sales of consumer goods	-3.9	12.5	-0.2	5.8	**11.5**	**5.7**	**9.5**	**8.0**
Exports (in USD)	3.6	29.6	7.0	0.5	**-3.9**	**-2.1**	**5.8**	**0.2**
Imports (in USD)	-0.6	30.1	1.1	-7.0	**-4.9**	**2.7**	**3.0**	**-1.5**
Consumer price index (CPI)	2.5	0.9	2.0	1.3	**0.2**	**0.7**	**1.3**	**0.9**
Producer price index (PPI)	-1.8	8.1	4.1	-1.6	**-4.3**	**-2.1**	**-0.9**	**-2.2**
Broad money supply (M2, ending balance)	10.1	9.0	11.8	12.6	**12.0**	**11.8**	**11.5**	**11.5**
Aggregate financing to the real economy (stock, ending balance)	13.3	10.3	9.6	10.0	**9.8**	**9.6**	**10.0**	**10.0**
1-year MLF (end-of-period)	2.95	2.95	2.75	2.75	**2.65**	**2.65**	**2.65**	**2.65**
1-year LPR (end-of-period)	3.85	3.80	3.65	3.65	**3.55**	**3.55**	**3.55**	**3.55**
RMB/USD spot exchange rate (end-of-period)	6.54	6.37	6.95	6.87	**7.1**	**6.8**	**6.6**	**6.6**

Source: BOC Research Institute

III. Macroeconomic Policy Orientations

III.1 A raft of measures to stabilize market expectations

The recent economic recovery has been weaker than expected, which should be taken seriously. The policy certainty and predictability should be properly managed, with a policy communication mechanism created to avoid shocks on market expectations due to policy actions. The macroeconomy monitoring and early warning should be enhanced to make responses more agile, professional and targeted. The "Two No Irresolutions" policy ("unswervingly consolidating and developing the public sector and unswervingly encouraging, supporting and guiding the development of the non-public sector") should be upheld consistently to boost the confidence of private enterprises, and the policy support for key and weaker sectors such as small, medium and micro enterprises should be extended as appropriate to allow more space for their recovery.

III.2 The proactive fiscal policy will be more proactive to further stabilize growth

First, to address the contradiction between public revenue and expenditure, the funding gap should be filled with funds from various sources. The policy-based development financial instruments should be used. Second, local governments should be encouraged to diversify their funding avenues by issuing refinancing bonds and exploring perpetual bond issuance. For the debts incurred by local governments in providing pure public products, local debts can be replaced with special treasury bonds to reduce the cost of debts. Third, the principal redemption and interest payments on local government bonds should be assured. The market-oriented transformation of local government financing vehicles (LGFVs) should be accelerated to mitigate relevant risks through debt-for-equity swaps, debt replacements and asset divestiture and restructuring.

III.3 The monetary policies should continue to produce effects in "aggregate + structural + regulatory" to support the economic recovery

Financial institutions should be guided to step up support for the real economy. The monetary policy should continue to unleash its role in guiding financial institutions towards optimal credit arrangements, thus ensuring adequate credit support for industrial, infrastructure, manufacturing and other major sectors of the economy and further bolstering the confidence of enterprises, especially private enterprises' confidence in investment and production. Interest rates need be cut on structural monetary policy instruments to enhance financial institutions' ability to extend credit. Moderates cuts on the interest rates of such instruments can be considered to further motivate financial institutions. The monitoring and guidance of fund flows will be enhanced. Financial institutions will be encouraged to strengthen the scrutiny of fund flows and uses. It is suggested to strengthen the dynamic and coordinated supervision of the financial market, establish a day-to-day information monitoring, collection and analysis mechanism throughout the market process, closely track the flows of foreign capital and related transactions and strengthen the management and forecast of cross-border investment activities and capital flows in the capital market. Macro-prudential instruments such as the foreign exchange risk reserve will be used in response to exchange rate movements, so as to keep the exchange rate moving in both ways.

III.4 Promoting a virtuous cycle of stronger internal growth drivers and improved public expectations, thereby generating synergies to expand domestic demand

First, a stronger impetus should give to the recovery and expansion of consumption. A good environment should be created for improving both household income and economic growth. The tax burden on residents need to be further eased, with the thresholds for individual income tax raised by varying degrees according to local economic conditions. New drivers of consumption growth need to be created through supply upgrading, and the consumer scenarios should be improved and innovated to unleash the potential for consumer spending. Second, new scenarios will be developed to drive industry and investment growth and encourage the entry of private-sector capital. It is necessary to further unleash the leading role of government investment, improve the reforms in key areas of business environment, promote fair competition and property protection, set a benchmark for private investments, stabilize public expectations and boost the vitality of the private-sector capital market.

III.5 Paying attention to the impact of sluggish international demand on foreign traders, and providing them with comprehensive services and support

First, the impact of changes in the external situation should be closely tracked and assessed to ensure timely relief for distressed export enterprises. Proper monitoring and early warning should be in place while assisting enterprises secure market orders through tax support and financial facilitation, and providing enterprises with multi-channel access to the domestic market. Second, the support for enterprises exploring diversified markets should be enhanced. Comprehensive information services should be provided for exporters, such as information on local laws and regulations on land, environment and labor. Such platforms as the China International Import Expo (CIIE) will be leveraged to help better tap overseas markets. Financial institutions will be encouraged to make trails on cross-border services and investment and financing facilitation. Third, due attention should be paid to the impact of changes in international trade rules and political and economic landscapes on relevant industrial chains. Keep embracing of changes in the latest developments in policies, laws and regulations on vital overseas markets and advantageous industries, so as to give timely risk alerts to relevant enterprises when necessary.

III.6 There is still policy space for bolstering the property market as an ongoing effort to stabilize expectations and mitigate risks

For homebuyers, the first-tier cities can loosen their purchase restrictions as appropriate by, for example, recalibrating the definition of "second homes" and flexibly implementing the rule that "mortgages on second homes are treated in the same way as a first mortgage, as long as the buyer has paid off the first loan", so as to encourage homeowners to become home sellers-and-upgraders. Information sharing, risk control and integration of registration systems need to be promoted for real estate collateral across the banking systems. It is necessary to maintain housing credit support for residents, give loan discounts to first-time homebuyers and home upgraders and consider lowering the interest rates on housing provident fund loans at an appropriate time. For property developers, efforts should be stepped up to implement structural monetary policy instruments, including the loan support plan for ensuring housing delivery, the special relending facility for distressed developers and the loan support plan for rental housing.

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