

MIZUHO CHINA MONTHLY

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June 2019 Edition

Mizuho Bank, Ltd.
Mizuho Bank (China), Ltd.

China Business Promotion Department
Advisory Department

- Executive Summary -

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| China's Economy | The Impact of US-China Tensions on China's Exports as Seen in US Statistical Data |
| <p>Based on US tariffs thus far China's exports of targeted products to the US have fallen 30% y-o-y. Comparing the changed rates of "China" and "non-China" exports to the US before and after tariffs for all items subject to tariffs, 30% of subject items from China appear to be undergoing substitution. The possibility exists that export substitution leading to installations of new equipment may already be happening. Even if the US and China reach a trade agreement in the future, the return of production to China could be difficult, and restraints on new investment would seriously affect China's economy.</p> | |
| News from the China Advisory Department | Observations about current monetary policy and the markets |
| <p>China is attracting attention as it tussles with the US over trade. State policies have a major impact on Chinese interest rates and exchange rates, so an understanding of the policy direction is vital for gauging the direction of the markets. This report will examine the movements of Chinese monetary policy, interest rates and exchange rates these past few years. It will also look at some points to consider when gauging the direction from here on.</p> | |

The Impact of US-China Tensions on China's Exports as Seen in US Statistical Data

- Substitution of China's exports has expanded to over 30% of tariff items -

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1. The US and China both invoke retaliatory tariffs once again

The United States and China have again fallen into another round of mutual trade recriminations after US President Donald Trump announced on May 5 that the US would move to raise retaliatory tariffs on \$200 billion worth of Chinese products from May 10. The 11th round of US-China trade talks scheduled for May 10 were held in Washington, but these did not stop Washington from acting. In addition, on May 13 the US announced a policy of 25% additional tariffs on \$300 billion worth of Chinese goods as a fourth set of hikes against China. Implementation is expected to begin at the end of June at the earliest, and if realized, an additional 25% tariff will be imposed on almost all imports from China, along with the previous tariff measures. Also, ahead of the US announcement of the fourth round of tariff rate hikes, on May 13 China announced that it would raise retaliatory tariffs on \$60 billion worth of US products as of June 1.

Since the US-China Summit on December 1, 2018, which has held for the first time in approximately 12 months, the two countries have conducted a total of six rounds of high-level trade talks to seek an agreement (not including round 11). During this period, in response to US demands for the expansion of imports of agricultural and other products in December and the US request for China's structural reforms (in the areas of forced transfer of technology, intellectual property protections, non-tariff barriers, cyber attacks, services & agriculture), China has taken measures that include the early establishment of the Foreign Investment Law, and there has been positive coverage by Chinese media such as "new progress has been made" subsequent to each round of talks.

Nevertheless, the resurgence of US-China tensions showed the world that the gap between the two countries is not easy to overcome. If the fourth round of tariffs against China is implemented, China may not only see a fall in exports, but also face a substantial deterioration of economic conditions accompanying the slump of investment and consumption, due to the deterioration of business confidence and reluctance to invest in China.

This report analyzes trade trends based on all available tariff item data and examines the impact of past and future US tariffs on China's exports and the overall Chinese economy. Our conclusion upfront is that substitution of exports from China, including trends involving installation of new equipment, is expanding, and that even if the US and China reach an agreement, there are concerns that it would continue to have a serious impact upon the Chinese economy.

2 Analysis of the impact of US tariffs on China's exports

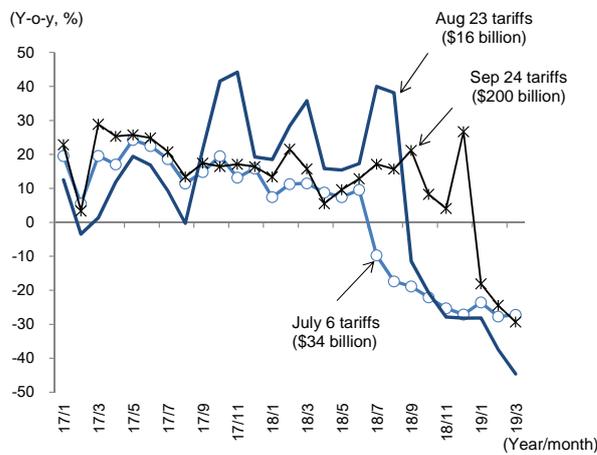
(1) Overview of export items to the US subject to tariffs; down 30% y-o-y through March 2019

First, we confirm all US tariffs against China on China's exports to the US. We can take the value of trade items subject to US tariffs compiled using data from the US Department of Commerce to confirm that

China's exports to the US suffer a major impact immediately after tariffs are imposed (**Chart 1**). Subsequent to the first round of additional tariffs which were imposed on July 6th (25% tariff rate), there was a substantial deterioration of China's exports to the US from July onward. In the case of the second round (imposed on August 23rd, 25% tariff rate) and third round (imposed on September 24th, 10% tariff rate) of additional tariffs, US-bound exports either fell or slowed down sharply from each of the following months in September and October respectively.

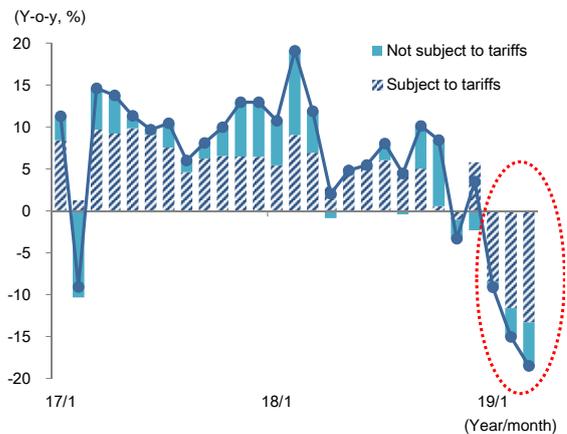
Since the tariff rate of the third round of additional tariffs was initially set lower than the first and second rounds of tariff hikes at 10% (while it was initially scheduled to be raised to 25% in January 2019, the actual rate hike was implemented on May 10, 2019 as noted earlier), US-bound exports subject to tariffs slowed down but still remained in positive territory even after the application of tariffs. However, as in the case of the first and second round of tariff hikes, they have fallen deep into negative territory after the turn of the year in 2019. Given that China's US-bound exports not subject to tariffs have also continued to fall below previous-year levels from November 2018 onward, it appears that the impact of the global manufacturing slowdown was not so small. March US-bound exports of all tariff items dropped sharply by 30.2% y-o-y and China's overall exports to the US dropped by 18.5% y-o-y. If the fourth round of tariffs is put into effect, retaliatory tariffs will be imposed on all of China's exports to the US. If overall exports to the US shrink by 30%, a simple calculation shows that this reduction would be equivalent to about 1% of China's GDP.

Chart 1: China's exports to the US (tariff items)



Note: Aggregate of items subject to US tariffs at the HS8 digit level.
Source: Made by MHRI based on US Department of Commerce data

Chart 2: China's exports to the US (overall)



Source: Made by MHRI based on US Department of Commerce data

and factors other than tariffs are also included. Therefore, it is necessary to make continuous observations beyond the present analysis.

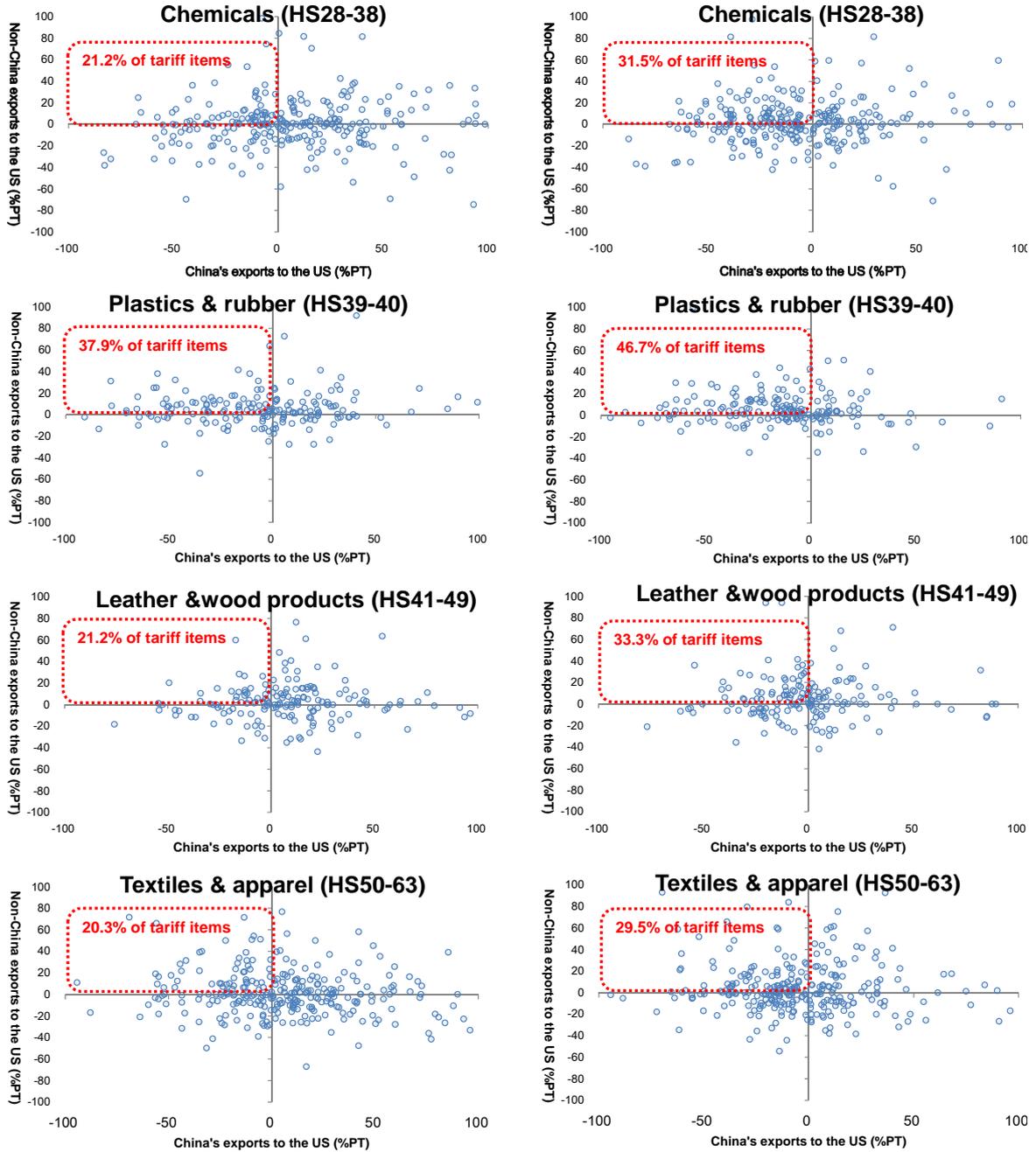
According to **Chart 3** based on the above method, the substitution incidence rate for all items subject to tariffs was 24.1% immediately after the punitive tariffs were triggered in (A) but 32.4% in the latest six months as seen in (B), so it can be surmised that substitution of China's exports is growing¹. However, in both (A) and (B) the export substitution incidence rate is spreading in other quadrants. Even though the ratio of items (in the first and fourth quadrants) in which China's exports increased even after imposition of punitive tariffs fell from 53.4% in (A) to 39.1% in (B), is still maintaining a certain level, revealing that export substitution is not so easy.

Looking at the substitution incidence rate for different item categories, in (A) "Plastics & rubber" and "Mechanical & electrical equipment" have relatively higher substitution immediately after the invocation of tariffs, but in (B) many items in the recent period have seen an increase in the substitution incidence rate (**Charts 4-1, 4-2** and **Chart 5**). In particular, in (A) "Animal & animal products," "Vegetable products," "Food & beverages etc.," "Leather & wood products" and "Footwear, feathers, magnetic products & precious metals" are more than 10% PT higher, suggesting that the substitution incidence rate has risen for categories of items having a relatively low degree of processing. On the other hand, the rate of substitution for "Machinery & electrical equipment" is only 4% PT higher from (A) to (B), indicating that this category is polarized into items that are easy to substitute and items that are difficult to substitute.

¹ When calculating the substitution incidence rate for tariff items based on calendar year year-to-year ratios for the period prior to the increase in US-China tensions, the average for the 2015 to 2017 period was 21.0% (2015: 21.2%, 2016: 19.6%, 2017: 22.3 %).

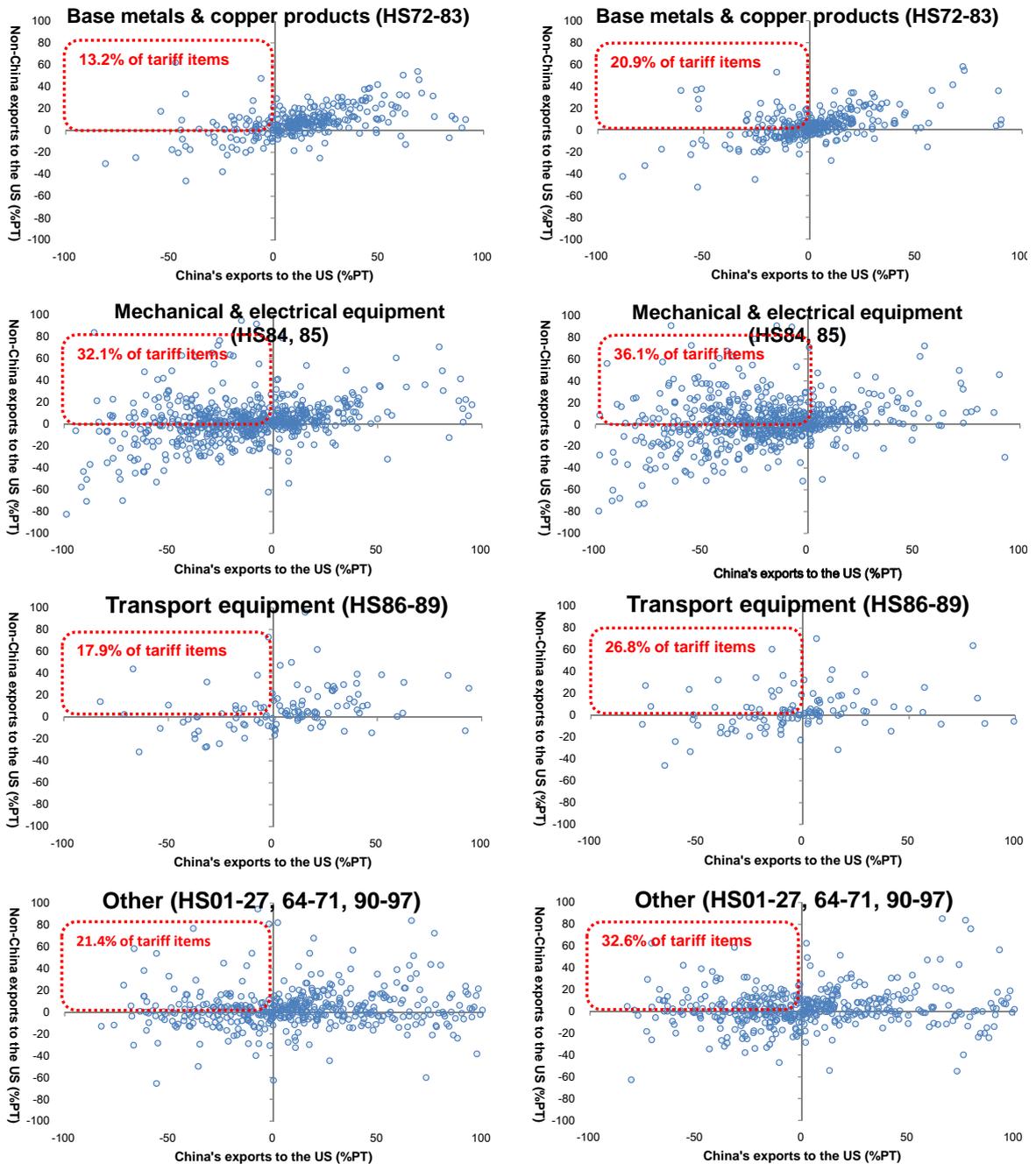
**Chart 4-1: Changes before & after tariffs for export items subject to US tariffs
(by item classification)**

(A) Immediately after tariffs (3-month avg) (B) Recently (Oct 2018-March 2019 average)
Source: Made by MHRI



**Chart 4-2: Changes before & after tariffs for items subject to US tariffs
(by item classification)**

(A) Immediately after tariffs (3-month avg) (B) Recently (Oct 2018-March 2019 average)
Source: Made by MHRI



(3) Export substitution brought on by production transfers is also occurring

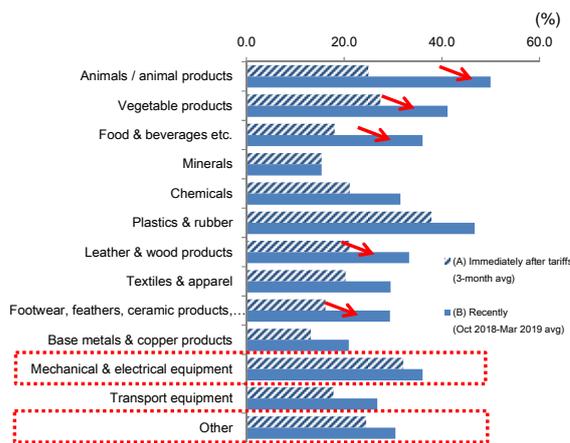
Lastly, using specific items as an example, we consider which countries are experiencing substitution

effects as China's exports decline, and whether it is due to production transfers accompanied by the installation of new facilities. It is thought that export substitution immediately after tariff invocation is mostly accomplished by raising the operating rates of existing equipment. It is not easy to immediately judge new investments that involve a review of the supply chain while the future of US-China tensions is uncertain, and in any event, it takes a certain amount of time to set up production facilities. However, there are many cases of production transfers reported in the media. If production transfers are happening, that seems to suggest that exporting companies are starting to revamp the supply chain by responding with a temporary increase in capacity utilization rates in other countries, so the impact on China's economy is becoming more serious.

Looking at the top 10 items (all included in the third round of tariffs) of China's exports to the US subject to US tariffs by value, it can be seen that the growth of three products -- "printed circuit assemblies (HTS84733011)," "PC peripheral equipment (HTS84715001)" and "PC components (HTS 84733051)" -- turned negative immediately after tariffs were imposed (October), and significant negative growth has continued up to recently (**Chart 6**). These three items alone account for 9% of the tariff targets, and have a large influence. They explain 30% of the decline since the beginning of 2019 of China's exports to the US that are items hit with tariffs. Therefore, below we look at the details of export substitution for these three items.

According to exports of the three products to the US by country/region (**Charts 7-9**), since the imposition of tariffs in October exports of "printed circuit assemblies" from such Asian countries as Korea, Taiwan and the Philippines have expanded, and exports of "PC components" from Korea and Taiwan in addition to Mexico have grown. However, these countries did not make up for the decrease in exports from China, and their exports to the US as a whole turned to decline after tariffs were applied. On the other hand,

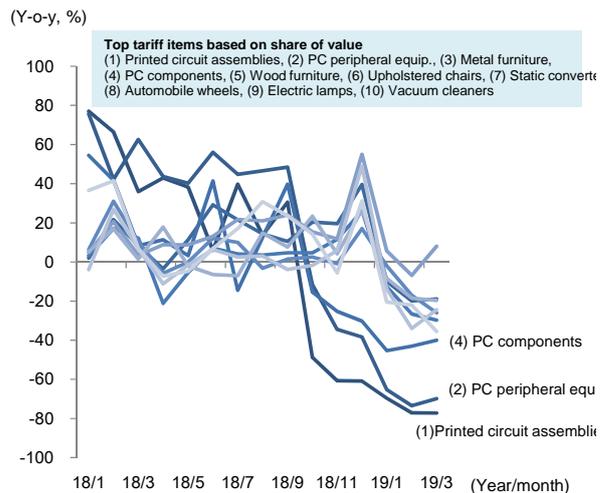
Chart 5: Substitution incidence rate by item classification



Note: The substitution incidence rate is the second quadrant ratios for the item classification in Charts 4-1 & 4-2. ("Other" refers to ""Other" in Chart 4-2, excluding animal & animal products, vegetable products, food & beverages, minerals, footwear/feathers/magnetic products and precious metals

Source: Made by MHRI based on US Department of Commerce data

Chart 6: Exports of key items subject to tariffs to the US



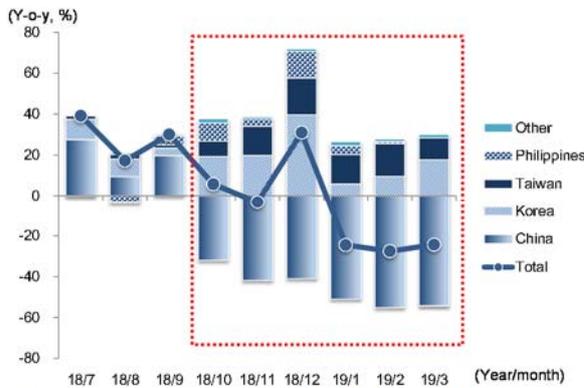
Note: The top 10 items by export value exported to the US subject to US tariffs.

Source: Made by MHRI based on US Department of Commerce data

while Mexico's positive contribution to "PC peripheral equipment" began to shrink almost at the same time exports from China fell after tariffs were invoked, the contribution from Taiwan has greatly increased, and Taiwan's overall exports to the US showed positive y-o-y growth up to January 2019.

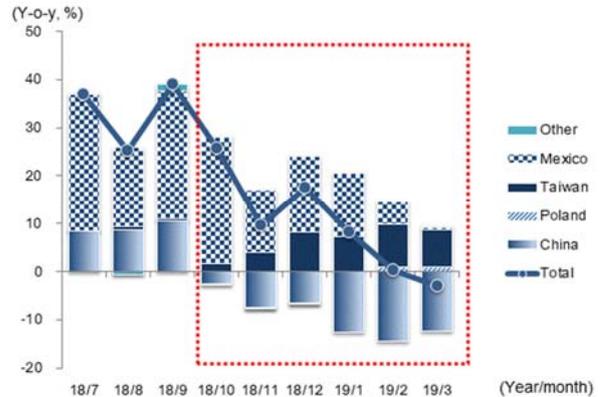
Although it is necessary to use data on operating rates by item ,country, and region in order to confirm whether such export substitution is due to increased production rates or production transfers that lead to new facilities, acquisition is difficult (it seems that there are many countries/regions for which data were never initially developed). Therefore, based on operating rates calculated using various assumptions², we have identified countries that are believed to have had production transfers that involve new facilities after tariffs on exports to the US were imposed on the three items. "Printed circuit assemblies" is one region (Taiwan), "PC peripheral equipment" is two countries/regions (Taiwan, Poland) and "PC components" is two countries (Philippines, Ireland). In addition to Taiwan and the Philippines, which

Chart 7: Exports of printed circuit assemblies to the US



Note: Total of HTS8473301140 and HTS8473301180
Source: Made by MHRI based on US Department of Commerce data

Chart 8: Exports of PC peripheral equipment to the US



Note: Only HTS8471500150, a subitem of HTS84715001, is considered. Similarly, subitem HTS8471500110 is excluded due to many periods of defects.
Source: Made by MHRI based on US Department of Commerce data

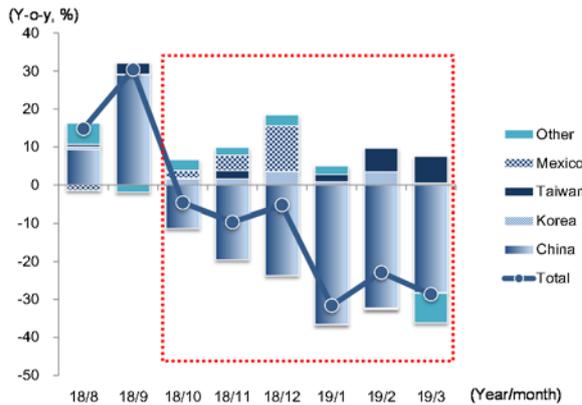
have been exporting to the US since before tariffs, we note that production transfers may have occurred in Poland, Ireland that have only had a minimal track record of exporting to the US. For example, in Poland, where exports of PC peripheral equipment to the US only averaged about \$1 million per month before tariffs were imposed, exports of the same product to the US in February-March 2019 jumped to over \$20 million a month on average (see **Chart 10**). The list of \$200 billion worth of Chinese products, including PC peripheral equipment, subject to tariffs was published in July 2018. While it appears that substitution

² If data on operating rates cannot be obtained, one method (known as the Warton School method) for calculating the operating rate is to consider the past production peak as an operating rate of 100%. Using this method as a reference, we take the ratio of the peak of each country/region's exports to the US prior to tariffs to the latest level of exports after tariffs (period (B) above) as a measure of the operation rate. If the calculated operating rate exceeds 100%, it indicates the installation of new equipment. However, since this report uses substitution data covering the substitution of exports from China to the US by other country/region, there are also such responses as switching exports from other countries/regions to the US or switching domestic-use products to exports. Therefore, countries/regions where the calculated utilization rate exceeds 150% are considered as production transfer destinations accompanied by new equipment installation. In addition, in order to exclude cases of accidental small volumes of exports, we limit ourselves to countries/regions having a value share of exports to the US in the most recent period (March 2019) of more than 1%.

by production transfer occurring over roughly six months is somewhat too fast³, it is necessary to continue to keep an eye on whether substitution trends are spreading to other countries.

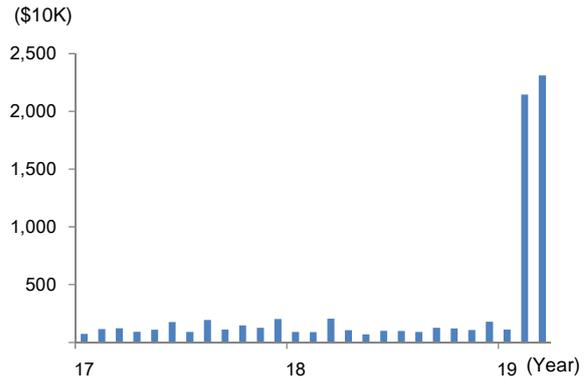
When matching the countries where this transfer of production seems to have occurred and, as shown in **Charts 7 to 9**, the countries/regions where exports to the US expanded after tariffs were imposed, "printed circuit assemblies" are Korea and the Philippines, "PC components" are Korea, and we can surmise that Mexico responded by raising the capacity utilization rate.

Chart 9: Exports of PC components to the US



Note: HTS8473305100 is the only subitem for HTS84733051.
Source: Made by MHRI based on US Department of Commerce data

Chart 10: Poland's exports to the US (PC peripheral equipment)



Source: Made by MHRI based on US Department of Commerce data

3. Conclusion

To summarize the impact of US tariffs on China's exports as discussed above, among all exports covered by tariffs 30% have seen a sharp y-o-y decline up to the recent period (March 2019). Among the tariff items for which data are available, cases of apparent export substitution from China to another country have expanded from immediately after tariffs (23.5%) to more recently (31.6%). In addition, export substitution has not been limited to raising the operating rate, and possibly includes cases of production transfers (new equipment) that may be leading to an alteration of the supply chain.

The production transfer trend still appears to be limited, but once production transfers that lead to the installation of new equipment are executed, production operations are expected to continue at the transfer destination for a certain period of time in order to recover investment and other costs. Thus, it may be difficult for this production to return to China. In addition, downward pressure on new investments in China could lead to a slumping Chinese economy over the medium to long term. Even if it is possible to avoid a fourth round of tariffs, if the current third round is protracted, the negative impact on the Chinese economy may gradually increase. Whether it will be possible in future US-China talks to reach an agreement on eliminating the conventional retaliatory tariffs can be said to be an important point in determining the

³ Since the period of the rapid increase in Poland's exports of PC peripheral equipment to the US is a short time of only two months (Feb-March 2019), it is possible that this trend is only temporary. In addition, if the recent export growth pace continues, that translates into annual increased production of \$250 million. As a period of only six months to go from deciding this kind of plan for a large-scale increase in production to export shipping is seen as too short, the increase in Polish production may have been planned before the tariffs were announced. Poland is a participating country in China's Belt and Road Initiative, and in that context, it may be considered as a new destination for Chinese companies.



outlook for China's economy.

China's Economy

Observations about current monetary policy and the markets

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1. Introduction

We are about to enter the second half of 2019. Though the first half of the year saw no particular Japanese factors capable of shaping the market, the deep-rooted trade dispute between China and the US continued to attract attention. At the time of writing (mid-May 2019), there remain deep divisions between the two sides when it comes to intellectual property rights and technology transfers, with the Chinese government facing some tough policy choices.

Events in China (related to the authorities or markets, etc.) are drawing more focus, but with Chinese interest rates and foreign exchange rates strongly influenced by government measures, an understanding of policy trends is vital when it comes to gauging the direction of the markets. This report will examine the movements of Chinese monetary policy, interest rates and exchange rates these past few years. It will also look at some points to consider when gauging the direction from here on.

2. Monetary policy measures

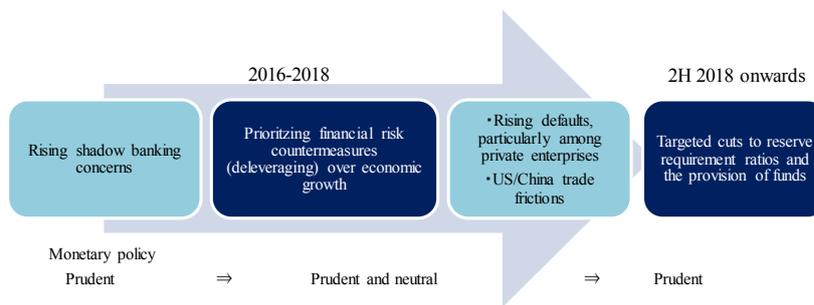
The word ‘prudent’ is used to describe the accommodative direction of Chinese monetary policy at present. Amid growing concerns about the expanding shadow banking sector, the authorities used a meeting of the Communist Party Politburo Standing Committee in October 2016 to signal a shift from a ‘prudent’ policy to a tighter ‘prudent and neutral’ policy, with the government announcing its intention to control asset bubbles and prevent economic and financial risk. However, deleveraging has led to several negative side effects, with the economy slowing and private-sector cash flow conditions deteriorating at a faster pace than expected, for example. With concerns also growing about the unexpected decline in US/China trade relations, the government used a meeting of the Politburo Standing Committee in July 2018 to announced a shift back to a more accommodative ‘prudent’ policy.

The authorities have taken steps to improve the cash flow situation and lower financing costs for private enterprises and small and micro businesses (who find it particularly hard to raise funds at present). As laid out in Fig. 1, the government has cut required reserve ratios in a targeted manner while also supplying funds intermittently. It has also set a target of increasing lending to small and micro businesses by at least 30% for major state-owned banks, for instance.

[Fig. 1] Monetary easing measures introduced from 2018 onwards

| Date | Policy Area | Details |
|--------------|-------------------------|---|
| January 2018 | Required reserve ratios | The ratio was lowered by 0.5–1.5% for banks that meet certain conditions, with the funds released lent to small and medium-sized businesses and the rural sector. |
| April | Required reserve ratios | The ratio was lowered by 1.0%. |
| June | Required reserve ratios | The ratio was lowered by 0.5%. |
| October | Required reserve ratios | The ratio was lowered by 1.0%. |
| December | TMLF | The government announced the introduction of a targeted Medium-term Lending Facility (TMLF) to promote lending to small and medium-sized businesses. |
| January 2019 | Required reserve ratios | The ratio was lowered by 0.5% twice (a total cut of 1.0%). |
| January | TMLF | The TMLF provided RMB 257.5 billion to some commercial banks. |
| April | TMLF | The TMLF provided RMB 267.4 billion to some commercial banks. |
| May | Required reserve ratios | Approximately RMB 280 billion was released to some regional banks with assets of less than RMB 10 billion by cutting the ratio from 10.0-11.5% to 8.0%. |

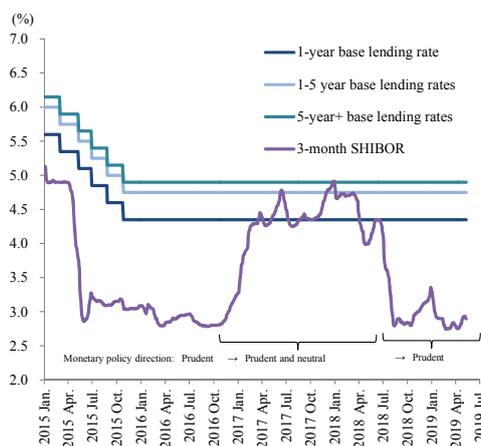
Source: Prepared from various reports and material from the People's Bank of China



3. The reaction of interest rates and foreign exchange

Fig. 2 and Fig. 3 set out interest rate and foreign exchange movements during this period.

[Fig. 2] Base lending rates and SHIBOR



Source: Bloomberg

[Fig. 3] The USD/RMB exchange rate



Source: Bloomberg

Base lending rates are fixed by the People's Bank of China (PBOC) and they have not shifted since 2016, but the 3-month SHIBOR (a money-market reference rate) has broadly shifted from 3% to 5% and back to 3% in tandem with monetary policy changes. Though market interest rates fell when the government introduced accommodative policies, the financing costs of private enterprises and small and micro businesses remain high on the back of high risk premiums. Yi Gang, governor of the PBOC, has spoken about the need to develop competitive lending markets by strengthening the market's role in setting interest rates.

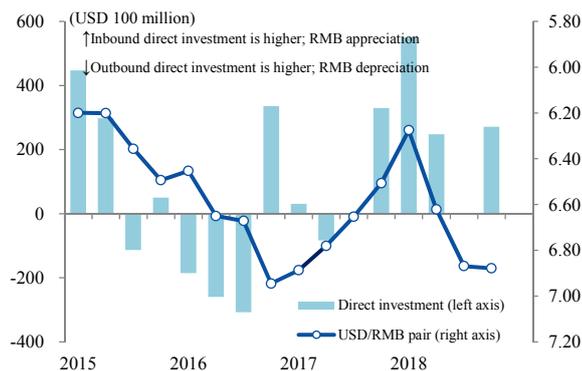
Furthermore, the National People's Congress (a body equivalent to Japan's parliament; hereinafter 'NPC') discussed utilizing 'interest rates' when it met in March, with the PBOC's Monetary Policy Report for 4Q 2018 (released February) also talking about the need to control interest rates so the economy moves in line with the rate of potential growth.

The USD/RMB pair's rate has also remained broadly consistent with the direction of monetary policy. However, the Dollar Index has also fluctuated up and down during this time, with the RMB also falling sharply in 2018 on concerns about US/China trade, so the impact on these should also be considered. Monetary easing usually leads to falling interest rates and currency depreciation. A cheaper currency then boosts trade competitiveness and this often invites criticism from other countries. While China probably wants to avoid a situation where its trading competitiveness falls due to a strong RMB, it also seems concerned that excessive RMB depreciation might lead to capital outflows. In fact, capital outflows have tracked RMB depreciation since the authorities began guiding the currency lower from August 2018 (Fig. 4). The RMB swung lower again in the latter half of 2018 on US/China trade frictions, but the government has strengthened measures to restrict capital outflows (by restricting large overseas remittances and money exchanges), so this has ensured inbound direct investment remains higher than outbound direct investment. Like when the RMB weakened up until the end of 2016, investors were calmed when the USD/RMB pair switched course just before the key RMB 7.0 level. The pair has approached this level again on worsening US/China trade relations and growing concerns about an economic slowdown, and there is ample reason for thinking the pair will temporarily hit this level on RMB bearishness. However, if the authorities signal they are prepared to let the RMB undergo a sharp, one-sided fall after the pair tops RMB 7.0, this could lead again to a higher risk of evasive RMB-selling and fund outflows, so unless the situation changes drastically, the authorities will probably act to prevent the RMB from weakening. The NPC indicated that it would improve the exchange rate formation mechanism and keep the RMB's exchange rate at a reasonable balanced level. As such, it might strengthen measures aimed at stabilizing exchange rates (such as the introduction of foreign exchange risk reserve requirements to prevent excessive RMB depreciation⁴ or the introduction of counter-cyclical factors⁵), so caution will be needed.

⁴ Source article: <https://www.mizuhobank.co.jp/corporate/world/info/cndb/report/branches/express/pdf/R419-0409-XF-0105.pdf>

⁵ Source article: <https://www.bloomberg.co.jp/news/articles/2017-05-26/OQJM3U6KLV601>

[Fig. 4] Direct investment



Source: State Administration of Foreign Exchange, Bloomberg

4. Policy goals

We will now take a look at the policy targets that help determine the direction of monetary policy. As outlined in Fig. 5, the PBOC pursues four policy goals as it controls the balance between easing and tightening. These are (1) maintaining stable prices, (2) promoting economic growth, (3) promoting employment, and (4) maintaining the international balance of payments. The government’s main targets related to these goals are the CPI figure, GDP, and the employment data. Though the authorities have not outlined a target related to the international balance of payments, they probably reference the trade balance and direct investment. When there are concerns these targets might not be achieved, the authorities move to stimulate the economy through monetary easing.

[Fig 5] PBOC policy goals and government targets

| PBOC policy goals | Government targets (NPC) | | | | Major concerns |
|---|------------------------------------|---------------------|---------------------|---------------|---|
| | Main headings | 2019 target | 2018 target | 2018 result | |
| Maintaining price stability | CPI | Around +3.0% | Around +3.0% | +2.1% | An economic downturn; sharp fluctuations in crude oil and food prices |
| Promoting economic growth | GDP | +6.0-6.5% | Around +6.5% | +6.6% | US/China trade frictions |
| Promoting employment | New urban jobs | At least 11 million | At least 11 million | 13.61 million | |
| | Registered urban unemployment rate | 4.5% or below | 4.5% or below | 3.8% | Defaults by private enterprises and small and micro businesses, etc. |
| Maintaining the international balance of payments | — | — | — | — | US/China trade frictions; capital outflows when the RMB depreciates |

Source: Prepared from various reports

As outlined above, the authorities have introduced targeted easing measures in the wake of trade frictions and corporate defaults, with the PBOC and the government coordinating targets and policies. The authorities will probably continue to pursue easing until the situation improves and they are confident of hitting government targets. They may also ease further if the situation deteriorates. As for prices (CPI), past trends suggest the authorities are more concerned about inflation swinging above target than below target, so they are probably prepared to tolerate a certain drop in prices.

The markets pay particular attention to the GDP figure. The trade balance makes a significant contribution to this figure, with the lion’s share of China’s surplus dependent on the US (Fig. 6). If exports to the US fall by just 10%, it is estimated this will shave around 0.4% off GDP. This will have a major impact on the achievement of the government targets. Though not a pressing matter at the moment, if the US trade deficit with China (China’s surplus with the US) is eliminated in future as the US is calling for, this will push GDP down by over 2%. Unless other things change, the Chinese government will have to accept lower growth or boost the economy through economic stimulus.

[Fig. 6] China's trade balance in 2018

(Unit: RMB 1 billion)

| | Exports | | Imports | | Trade balance | |
|----------------------------|---------|-------------|---------|-------------|---------------|-------------|
| | Amount | Against GDP | Amount | Against GDP | Amount | Against GDP |
| Total | 16,418 | 19.7% | 14,087 | 16.9% | 2,330 | 2.8% |
| With the US | 3,169 | 3.8% | 1,021 | 1.2% | 2,148 | 2.6% |
| Share accounted for the US | 19.3% | — | 7.2% | — | 92.2% | — |

Source: Bloomberg

5. Conclusion

The trade dispute with the US is a major factor of instability for China. Under these circumstances, it is hard to be optimistic about the environment surrounding China, with the authorities likely to continue pursuing easing in line with targets and policies. However, the authorities will also want to keep a lid on leveraging while preventing excessive RMB depreciation, so they will continue to face tough policy choices. As the world's second largest economy, events in China have a major impact on other countries and markets, so market participants will continue to watch the situation from here on. It is advisable to keep monitoring the movements of the Chinese authorities based on the monetary policy points covered in this article.

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