China Monetary Policy Report
Quarter One, 2008

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In Q1 2008, given the changing international economic situation and the serious sleet and snow disaster in southern China, effective measures were taken to overcome their adverse impacts, resulting in a steady and rapid momentum of development and better-than-expected economic performance. Agriculture developed steadily. Industry grew rapidly. Retail sales maintained stable and fast growth. Problems such as the rapid investment growth, excessive money supply, and large foreign trade surplus were somewhat eased. But the consumer price index (CPI) rose relatively rapidly due to the influence of the disaster. In Q1, GDP posted 6.1 trillion yuan, up 10.6 percent year on year, and the CPI registered year-on-year growth of 8 percent.

In accordance with the overall arrangements of the Central Committee of the Communist Party of China (CPC) and the State Council, the People's Bank of China (PBC) implemented a tight monetary policy, adopted comprehensive measures, and properly handled the pace, priorities, and intensity of financial macro-adjustment policies to maintain a balance at the aggregate level. Efforts were made to strengthen liquidity management in the banking system. Since the beginning of 2008, the PBC raised the reserve requirement ratio by a total of 2 percentage points on four occasions, and guided the money and credit supply to grow at a reasonable pace to optimize the credit structure while flexibly conducting open market operations. The PBC continued to promote the reform of financial enterprises, to strengthen the flexibility of the RMB exchange rate, to improve foreign exchange administration, and to promote balanced economic and financial development.

As an initial result of the tight monetary policy, the financial sector performed in a sound manner, and money and credit growth moderated. At end-March 2008, broad money M2 was growing 16.3 percent year on year, a deceleration of 1 percentage point. Growth of RMB loans slowed down, with outstanding loans registering a year-on-year increase of 14.8 percent at end-March, a deceleration of 1.5 percentage points from the same period of 2007 and a deceleration of 1.3 percentage points from the end of 2007. In Q1, RMB loans increased by 1.3 trillion yuan, representing a deceleration of 89.1 billion yuan year on year. At end-March, the central parity of the RMB against the US dollar stood at 7.0190 yuan per dollar, representing an appreciation of 4.07 percent from the end of 2007; the central parity of the RMB against the euro and the Japanese yen was 11.0809 yuan per euro and 7.0204 yuan per 100 yen, depreciations of 3.74 percent and 8.75 percent respectively from the end of last year; the nominal effective exchange rate of the RMB as calculated by the Bank for International Settlements was up by only 0.09 percent from the end of the last year.

At present, the global economic environment faces a grave and complicated situation with great uncertainties, as reflected in the economic slowdown, the turbulence in financial markets, and the persistent price hikes of grain, oil, and other primary commodities. In the Chinese economy, general price levels remain high, numerous factors constrain agricultural production and an income increase for farmers, the risk of a fixed-asset investment rebound persists, and energy-saving and pollution-reduction endeavors remain arduous tasks. There is a large surplus in the balance of payments, liquidity is excessive, and the decline of money and credit growth is still not solidly based. In general, promoted by the combined forces of industrialization, urbanization, internationalization, and the structural upgrading of industrial production and consumption, the Chinese economy remains strong and resilient. In the first half of 2008, with the changing external economic situation and the unfolding effects of the domestic macro-adjustment policies, the Chinese economy is likely to slow down modestly, CPI will remain high, and price trends should be closely watched.

During the next stage, the PBC will follow the overall arrangements of the State Council, giving higher priority on its agenda to contain price rises and to curb inflation, implementing a tight monetary policy, increasing the predictability and effectiveness of the adjustment policies, using a mix of monetary policy instruments, restraining the rapid growth of money and credit, guiding expectations, and properly handling the pace, priorities, and intensity of the adjustment in a scientific manner based on the changing domestic and external environments and taking fine-tuning measures when appropriate in order to create a sound monetary and financial environment for economic growth and structural adjustments. The PBC will continue to strengthen liquidity management using policy tools such as open market operations and the reserve requirement ratio. Efforts will also be made to appropriately apply price instruments and interest rate tools to promote the market-based interest rate reform. Exchange rate flexibility will be strengthened to put into play its role in optimizing resources allocation and containing price increases. Endeavors will be made to guide financial institutions to issue loans in an appropriate and balanced manner to prevent drastic fluctuations and to optimize the credit structure. Policies will be adopted to encourage growth in some sectors while discouraging growth in other sectors, and to render greater credit support to the structural adjustment and to such fields as agriculture, the rural areas, and the farmers, the services sector, small and medium-sized enterprises, independent innovation, and the saving of energy and environmental protection. The PBC will take comprehensive measures to deepen the reform of foreign exchange administration and to promote a balance of payments equilibrium. Direct financing will be promoted, and the reform of financial enterprises and financial innovation will be carried forward to promote the balanced development of the financial market. At the same time, restructuring will be accelerated with a view to expanding domestic demand.

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Part 1 Monetary and Credit Performance

In the first quarter of 2008, the Chinese economy maintained steady and rapid growth with the financial industry performing in a sound manner. The growth of money and credit moderated, suggesting that the monetary policy had achieved its initial effects.

I. Growth of money supply fell

At end-March, the outstanding balance of broad money M2 amounted to 42.3 trillion yuan, an increase of 16.3 percent year on year, down 1.0 percentage points from the same period of the last year. The outstanding balance of narrow money M1 reached 15.1 trillion yuan, an increase of 18.3 percent year on year, down 1.6 percentage points over the growth in the previous year. Cash in circulation M0 grew by 11.1 percent year on year to 3.0 trillion yuan, a deceleration of 5.6 percentage points from the same period of the last year. Net cash injections in the first quarter totaled 5.8 billion yuan, 25.8 billion yuan less than that recorded in the same period of the previous year.

M2 decelerated month by month, with growth recorded at end-March decreasing by 2.7 and 1.2 percentage points respectively from end-January and end-February. Broken down by the components of the money supply, in the first quarter, demand deposits in M1 dropped rapidly, a deceleration of 314.7 billion yuan from the increase recorded a year earlier; among the various components of quasi-money in M2, deposits in margin accounts of securities companies decreased by a large margin, 385.5 billion yuan less than that recorded in the same period of 2007. These changes were associated with the fluctuations in the capital market, the structured interest rate hikes in the previous year, and the tight money and credit control.

II. Deposits of financial institutions increased at a steady pace

At end-March, outstanding deposits of all financial institutions (including foreign-funded financial institutions, as throughout this Report) denominated in both RMB and foreign currencies increased by 16.2 percent year on year to 42.7 trillion yuan, an acceleration of 0.9 percentage points from the same period of the last year and an increase of 2.6 trillion yuan from the beginning of 2008, 661.7 billion yuan more than the increase recorded in the same period of 2007. In particular, outstanding RMB deposits rose by 17.4 percent year on year to 41.6 trillion yuan, an increase of

2.6 trillion yuan from the beginning of the year and an acceleration of 760.6 billion yuan from the growth in the previous year; outstanding foreign currency deposits declined year on year by 5.8 percent to US$155.3 billion, a decrease of US$5.5 billion from the beginning of 2008.

Broken down by sectors and maturities, RMB deposits of households and non-financial companies increased steadily and fiscal deposits grew by a large margin. Affected by several factors such as the continued fluctuations in the capital market, the increasing gap between the demand and time deposit rate, and the enhanced awareness of enterprises and individuals of wealth management, time deposits increased rapidly. At end-March, outstanding household RMB deposits totaled 19.1 trillion yuan, representing a growth of 8.7 percent year on year, a deceleration of 4.2 percentage points from the same period of 2007, an increase of 1.5 trillion yuan from the beginning of 2008, and an acceleration of 392.7 billion yuan from the increase recorded in the same period of 2007. In particular, the growth of household time deposits increased by 644.6 billion yuan year on year. Outstanding deposits of non-financial companies stood at 19.4 trillion yuan, representing a growth of 22.7 percent year on year, an acceleration of 4.8 percentage points compared with the increase recorded in the same period of the last year, an increase of 573.5 billion yuan from the beginning of the year, and an acceleration of 147.6 billion yuan year on year. In particular, growth of corporate time deposits increased by 491.1 billion yuan from the increase in the previous year. Outstanding fiscal deposits amounted to 2.3 trillion yuan, representing an increase of 500.9 billion yuan over the beginning of 2008 and an acceleration of 187 billion yuan from the previous year.

III. RMB loans of financial institutions decelerated

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 29.4 trillion yuan at end-March, representing a growth of 16.2 percent year on year, an acceleration of 0.5 percentage points from the same period of the last year, and an increase of 1.6 trillion yuan over the beginning of the year, accelerating by 183 billion yuan compared with the growth during the same period of the last year. Growth of RMB loans slowed down noticeably. Outstanding RMB loans grew by 14.8 percent year on year to 27.5 trillion yuan, representing a deceleration of 1.5 percentage points from the same period of the last year and an increase of 1.3 trillion yuan over the beginning of the year, 89.1 billion yuan less than the increase recorded in the same period of the last year. Foreign currency loans maintained relatively rapid growth. At end-March, outstanding foreign currency loans had risen by 56.9 percent year on year to US$268.8 billion, representing an increase of US$48.8 billion over the beginning of the year and an acceleration of US$46.2 billion compared with the growth during the same period of the last year.

In terms of the sectoral distribution of RMB loans, growth of loans to households decreased year on year while growth of loans to non-financial companies and other sectors moderated. In the first quarter, loans to households increased by 239.4 billion yuan from the beginning of the year, a deceleration of 92.8 billion yuan from the previous year. Among the loans to households, consumer loans increased by 123.3 billion yuan from the beginning of 2008, 39.7 billion yuan less than the growth in the previous year. Affected by the wait-and-see attitude in the real estate market and the cautious stance of financial institutions in terms of credit extensions to individuals, consumer loans witnessed a quarter-on-quarter decrease for the first time since the second half of 2006, and close attention should be paid to their future movements. Household operational loans increased by 116.1 billion yuan from the beginning of 2008, a deceleration of 53.1 billion yuan year on year. Loans to non-financial companies and other sectors increased by 12.5 percent year on year and grew by 1.1 trillion yuan from the beginning of the year. In particular, short-term loans grew by 513.2 billion yuan and paper financing dropped by 79.5 billion yuan, whereas medium- and long-term loans grew by 644.3 billion yuan.

Broken down by financial institutions, lending by policy banks and foreign financial institutions accelerated compared to that during the same period of the last year, while lending of other financial institutions decelerated year on year.

Table 1 RMB Lending by Financial Institutions in the First Quarter of 2008

Unit: 100 million yuan

	In the first quarter of 2008		In the first quarter of 2007	
	New loans	Year-on-year acceleration	New loans	Year-on-year acceleration
Policy banks	1602	744	858	−36
State-owned commercial banks	5227	−721	5948	−57
Joint-stock commercial banks	2699	−817	3517	653
City commercial banks	687	−207	894	479
Rural financial institutions	2323	−252	2575	679
Foreign financial institutions	389	165	224	64

Note: Rural financial institutions include rural cooperative banks, rural commercial banks, and rural credit cooperatives.

Source: The People's Bank of China.

The bulk of RMB medium- and long-term loans went to infrastructure, real estate, and the manufacturing sectors. In the first quarter, total RMB medium- and long-term loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) extended to infrastructure sectors (including the transportation, storage and postal services, electricity, gas, and water production and supply, water conservancy, and environmental and public facility management sectors), the real estate sector, and manufacturing sectors amounted to 510.6 billion yuan, accounting for 72.4 percent of the total new medium- and long-term loans.

Box 1: Credit growth analysis

In the first quarter, the growth of RMB loans slowed down, foreign currency loans increased rapidly, and the payment capability of enterprises remained strong.

I. The growth of RMB loans moderated and the growth of loans to households decelerated year on year

With the credit controls gradually producing an effect, RMB loans of financial institutions decelerated. At end-March, outstanding RMB loans had grown by 14.8 percent year on year, down 1.3 percentage points from end-2007, representing an increase of 1.3 trillion yuan over the beginning of the year and a deceleration of 89.1 billion yuan from the previous year. In particular, loans in January witnessed a large acceleration year on year while loans in February and March saw a small deceleration. In terms of the credit structure, the extension of credit in the first quarter decelerated noticeably in the following two respects. First, the growth of loans to households dropped obviously on a year-on-year basis. In the first quarter, the growth of household loans decreased by 92.8 billion yuan year on year. In particular, consumer loans decelerated by 39.7 billion yuan and operational loans decelerated by 53.1 billion yuan. Second, commercial banks reduced paper financing, resulting in a deceleration of 161.5 billion yuan in paper financing in the first quarter compared with the growth of paper financing recorded the previous year. Driven by the strong growth of new short-term loans as well as medium- and long-term loans, the growth of new loans to the corporate sector increased by 3.7 billion yuan year on year. Broken down by months, short-term corporate loans decelerated by 47.6 and 90.3 billion yuan in February and March respectively, and medium- and long-term corporate loans also experienced a deceleration in March.

II. Foreign currency loans grew rapidly to satisfy the reasonable needs of enterprises

Foreign currency loans continued to grow at a rapid pace. At end-March, outstanding foreign currency loans amounted to US$268.8 billion, representing an increase of

US$48.8 billion over the beginning of the year and an acceleration of US$46.2 billion compared with the growth in the same period of 2007. In particular, foreign currency loans issued to support the overseas investment of enterprises reached US$35.7 billion, accounting for 73.2 percent of the new foreign currency loans in the first quarter, the major reason behind the rapid increase in the demand for foreign currency loans. By investing in overseas equity with foreign currency loans, enterprises are able to achieve a good currency balance between new assets and liabilities as well as a currency balance between investment returns and interest payments, through which risks can be hedged. However, if enterprises use foreign currency loans instead of foreign exchange purchased with domestic currency to import equipment and raw materials, they will face the risk of a currency mismatch among assets, liabilities, and cash flows. With an abundant supply of foreign exchange in China, apparently foreign currency loans are used to seek returns from an RMB appreciation.

Since 2007, by reducing the short-term foreign debt quotas of financial institutions, the foreign exchange regulatory authorities have required major commercial banks to hold a certain proportion of overseas liquid assets in their total foreign exchange assets. This measure, together with the drop in foreign currency deposits, tightened the liquidity of domestic foreign exchange, resulting in a rise in domestic foreign currency interest rates. These factors played an active role in reining in inappropriate needs for foreign currency loans and were conducive to commercial banks strengthening the building of foreign exchange liquidity management and price transmission and risk prevention mechanisms. In the coming period, the liquidity of foreign exchange may continue to be tightened, which will play a further role in curbing improper needs for foreign currency loans.

III. After the tight monetary policy was adopted, enterprises still maintained a strong payment capability.

In the first quarter of 2008, new RMB loans to the corporate sector stood at 1.1 trillion yuan. Meanwhile, with the development of direct financing, the sources of enterprise financing were further diversified. In the first quarter, financing through bonds (including short-term financing bills) in the corporate sector totaled nearly 80 billion yuan, and financing through domestic and overseas stock markets reached nearly 150 billion yuan. At end-March, outstanding corporate deposits had increased year on year by 24.1 percent, up 6.7 percentage points from growth of the previous year, representing a growth of 487.6 billion yuan over the beginning of the year and a deceleration of 192.7 billion yuan year on year, among which corporate demand deposits fell by 109.9 billion yuan, 232.5 billion yuan less than the increase a year earlier; while time deposits increased by 597.5 billion yuan, 425.2 billion yuan more than the growth recorded in the same period in the previous year. The large acceleration of corporate time deposit growth was mainly due to the backflow of funds used by enterprises for new share subscriptions. In general, the payment capability of enterprises remained strong.

Although money and credit controls have achieved their initial effects, the effects have not yet consolidated. As the inflation remains high and the BOP surplus may continue to increase money and credit expansion pressures, credit controls still need to be strengthened. Commercial banks should be fully aware of the economic and financial situations both at home and abroad, concretely implement a tight monetary policy, appropriately balance the pace of credit extensions during the year, and prevent excessive fluctuations of loans. Moreover, steps should be taken to continue the differentiated treatment of different borrowers to optimize the credit structure, restrain lending to enterprises with high energy consumption or heavy pollution, and to strengthen credit support to the rural economy, the services sector, small- and medium-sized enterprises, independent innovation, resource conservation and environmental protection, economic restructuring, and other sectors.

IV. Base money grew at a stable pace after deducting the effect of the reserve requirement ratio adjustment

At end-March, the outstanding balance of base money amounted to 10.4 trillion yuan, 285.3 billion yuan more than that at the beginning of 2008 and representing a year-on-year growth of 35.9 percent, up 12.8 percentage points from the previous year. Since the second half of 2006, the PBC has raised the reserve requirement ratio several times, resulting in an acceleration of base money growth as required reserves are included in base money. Excluding the liquidity frozen by the higher reserve requirement ratio, the growth rate of base money would be less than 8 percent. At end-March, the money multiplier (broad money/base money) was 4.06, down 0.67 from the same period of 2007, indicating a weakened money creation capability.

At end-March, the excess reserve ratio of financial institutions stood at 2 percent,[1] down 1.3 percentage points from the end of 2007. In particular, the excess reserve ratio of state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 1.5 percent, 1.3 percent, and 5.4 percent respectively. In recent years, the excess reserve ratio of financial institutions gradually declined from a average monthly ratio of 4 percent in 2004 to 2.9 percent in 2007. There are several factors behind the decline in the excess reserve ratio. First, the capability of the central bank

[1] In February 2008, the methods for calculating the excess reserve ratio of financial institutions were adjusted, with the deposits of postal savings banks no longer being deducted from the deposits of financial institutions. The excess reserve ratios in January 2008 and December 2007 were adjusted accordingly.

to analyze and predict liquidity was strengthened, and the effectiveness of open market operations in adjusting liquidity in the banking system and guiding interest rate expectations was gradually enhanced. Second, the reform of commercial banks was steadily advanced, the financial market became broader and deeper and continuously expanded, and the liquidity management of commercial banks was greatly improved. Third, the building of payment and clearing systems such as a large-value real-time payment system, a small-value batch payment system, and an intra-city bill clearing system were actively promoted, reducing floating funds and enhancing payment and settlement efficiency.

V. Lending rates of financial institutions continued to rise

Driven by the six hikes in the benchmark deposit and lending rates since the beginning of 2007, the lending rates for loans of different maturities continued to rise. In March, the weighted average lending rate of 6 month to 1 year (including 1 year) RMB loans was 8.72 percent, up 0.4 percentage points from January. In particular, the weighted average lending interest rate of commercial banks was 7.67 percent, 1.03 times the benchmark rate. The share of loans with interest rates floating downward from the benchmark rate decreased noticeably. Among all loans issued by financial institutions in the first quarter of 2008, the share of loans with interest rates floating downward was 23.63 percent, down 4.4 percentage points from the previous quarter, whereas the share of loans with interest rates at the benchmark rate or floating upward were 30.51 and 45.86 percent respectively, increasing by 2.82 and 1.62 percentage points over the last quarter.

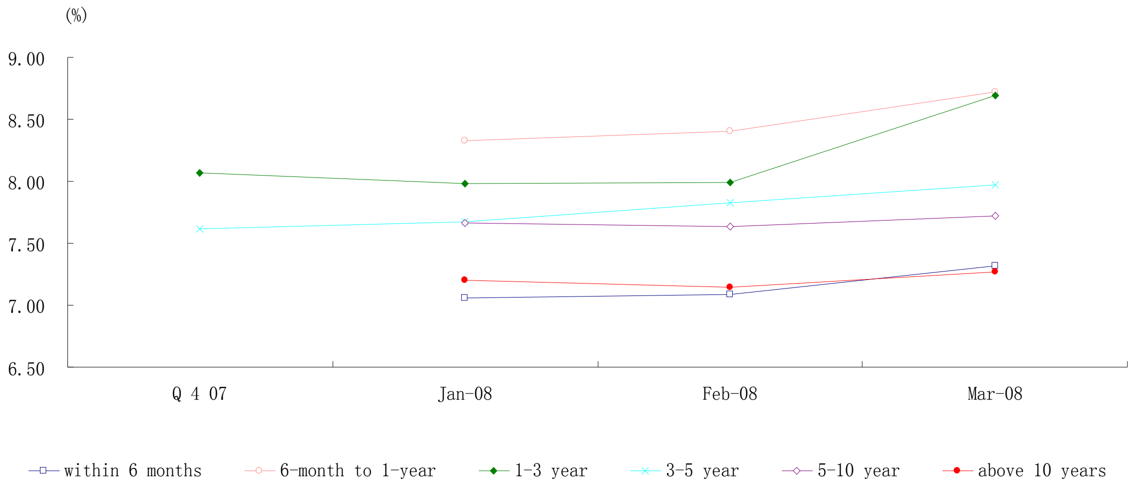

Figure 1 Interest rates of loans of different maturities

Source: The People's Bank of China.

Table 2 Average lending rates of financial institutions in Q1, 2008

Unit: percent

Maturity	within 6 months	6 month-1year	1-3 year	3-5 year	5-10 year	over 10 years
Q4 2007	7.93		8.07	7.62	7.35	
Jan-08	7.0575	8.3258	7.9839	7.6774	7.6591	7.2021
Feb-08	7.0863	8.4018	7.9881	7.8238	7.6319	7.1436
Mar-08	7.3169	8.7244	8.6935	7.9759	7.7169	7.2737

Source: The People's Bank of China.

Table 3 Share of loans with rates floating at various ranges in Q1, 2008

Unit: percent

Financial institutions	Floating downward	At benchmark	Floating upward					
	[0.9，1)	1	Sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	above 2
State-owned commercial banks	31.12	32.41	36.47	18.72	15.34	1.97	0.42	0.01
Joint-stock commercial banks	28.01	36.42	35.57	22.62	11.86	0.8	0.16	0.13
Foreign commercial banks	43.52	27.15	29.33	19.72	8.77	0.83	0	0.01
City commercial banks	15.17	26.47	58.36	15.65	22.98	12.8	5.96	0.97
Urban and rural credit cooperatives	2.36	8.55	89.09	5.34	16.98	27.86	34.1	4.82
Policy banks	28.82	69.84	1.34	1.17	0.16	0	0	0
Totals	23.63	30.51	45.86	15.69	14.2	7.53	7.37	1.06

Note: The floating range of the interest rate for urban and rural credit cooperatives is [0.9，2.3].

Source: The People's Bank of China.

Inter-bank RMB deposit rates of financial institutions increased slightly. In March, the weighted average interest rate of inter-bank demand deposits was 1.85 percent, up 0.34 percentage points from the beginning of 2008; the weighted average interest rate of time deposits was 2.93 percent, up 0.03 percentage points from the beginning of the year. The interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) increased slightly. In March, the weighted average interest rate of negotiable deposits with maturities of between 3 and 5 years and over 5 years stood at 5.92 and

5.75 percent respectively, up 0.13 and 0.05 percentage points from the beginning of the year. The domestic interest rates for domestic foreign currency loans and large-value foreign currency deposits (above US$3 million) fluctuated slightly.

Table 4 Average interest rates of large-value dollar deposits and loans in Q1, 2008

Unit: percent

		Dec-07	Jan-08	Feb-08	Mar-08
Large-value deposits	Demand		1.95	1.61	1.69
	Within 3 months	3.77	3.77	3.36	3.36
	3—6 months	4.81	4.21	3.84	3.33
	6—12 months	5.08	3.81	3.35	3.43
	1 year	5.55	4.21	4.67	4.98
	Above 1 year		5.43	——	5.62
Loans	Within 3 months		6.04	6.02	6.55
	3—6 months		5.95	5.82	5.82
	6—12 months		5.68	5.71	6.28
	1 year		5.30	5.29	5.82
	Above 1 year		4.42	3.94	4.98

Source: The People's Bank of China.

VI. The RMB exchange rate floated in both directions with strengthened flexibility

Since the beginning of 2008, the fundamental role of market supply and demand continued to function well, and the RMB appreciation accelerated. At end-March, the central parity of the RMB against the US dollar was 7.0190 yuan per US dollar, appreciating by 2856 base points or 4.07 percent over the end of the last year, above the appreciation of 2.82 percent in the first quarter of 2007; the central parity of the RMB against the euro and the Japanese yen was 11.0809 yuan per euro and 7.0204 yuan per 100 Japanese yen, a depreciation of 3.74 percent and 8.75 percent respectively over end-2007. From the exchange rate regime reform on July 21, 2005 to end-March 2008, the RMB cumulatively appreciated by 17.92 percent and 4.07 percent against the US dollar and the Japanese yen respectively, and cumulatively depreciated by 9.63 percent against the euro.

The flexibility of the RMB exchange rate was further strengthened, and the linkage of the RMB exchange rate with the major currencies was obvious. In the first quarter, the peak and bottom central parities of the RMB against the US dollar were 7.0130 yuan per US dollar and 7.2996 yuan per US dollar respectively. Among the 59 trading days, the inter-bank foreign exchange market saw an RMB appreciation in 40 days, an RMB depreciation for 18 days, and a flat rate on one day. The largest appreciation of the RMB central parity against the US dollar in a single business day was 0.35 percent (246 basis points) and the largest depreciation in a single business day was 0.18 percent (127 basis points). The daily fluctuation of the central parity averaged 83 basis points, further widening the average of 62 basis points recorded in 2007.

The movements of the RMB exchange rate against a basket of currencies remained stable. According to the statistics published by the BIS on May 11, 2008, the nominal effective RMB exchange rate at end-March appreciated only 0.09 percent from the end of 2007. With the depreciation of the US dollar further accelerating, the sharper RMB appreciation against the US dollar reduced its fluctuations against the euro and the Japanese yen and maintained the stability of the RMB exchange rate against a basket of currencies, easing the impact on the Chinese economy of the dramatic changes in exchange rates in the international market caused by the sub-prime crisis. In the first quarter, the US dollar depreciated 6.75 and 11.54 percent against the euro and the Japanese yen respectively. The appreciation of the RMB against the US dollar alleviated the depreciation of the RMB against the euro and the Japanese yen. Since the adoption of a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies on July 21, 2005, the RMB is no longer pegged to the US dollar and has steadily appreciated against a basket of currencies, indicating an overall appreciation of the RMB exchange rate against the currencies of China’s major trading partners. This has not only helped the market better predict the movements of the RMB exchange rate, but has also helped keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

Part 2 Monetary Policy Conduct

In the first quarter of 2008, according to the State Council's overall arrangements, the PBC implemented a tight monetary policy and took comprehensive measures to appropriately handle the pace, priorities, and strength of financial macro management and to maintain a balance at the aggregate level. Efforts were made to strengthen liquidity management in the banking system, to guide the appropriate growth of money and credit and the optimization of the credit structure, to steadily promote financial institution reform, to further enhance the flexibility of the RMB exchange rate, and to improve the reform of foreign exchange administration so as to promote balanced economic and financial development.

I. Open market operations were conducted flexibly

In the first quarter of 2008, the PBC further strengthened liquidity management and flexibly conducted open market operations. First, sterilization instruments were flexibly used to strengthen open market operations. Due to the large amount of cash injections and withdrawals around the Spring Festival and the issue of large-cap stocks, short-term demand for liquidity in the banking system fluctuated dramatically. The PBC flexibly arranged a portfolio of open market operation tools with different maturities and used both central bank bills and repos of special treasury bonds in an effort to drain the lax liquidity in the banking system. In the first quarter, the issuance of central bank bills totaled 1.78 trillion yuan and the amount of repos reached 1.84 trillion yuan. At end-March, outstanding central bank bills amounted to 4 trillion yuan, 0.5 trillion yuan more than that at the end of the last year; outstanding repos reached 0.78 trillion yuan, up 0.16 trillion yuan from end-2007. Second, efforts were made to strengthen the role of pre-emptive adjustments and fine-tuning of open market operations to effectively alleviate the impact of seasonal factors on the banking system. Based on scientific analysis and prediction of the liquidity situation in the run-up to the Spring Festival, the PBC, through a flexible arrangement of maturities of repo operations, achieved a good match between the due date of repo operations with different maturities and the peak time of cash injections before the Spring Festival, thus satisfying the commercial banks' demand for funds for payment and settlement purposes before the Spring Festival. Third, the interest rates of open market operations remained stable and guided market expectations. At end-March, the issuance rates for 1-year, 3-month, and 3-year central bank bills stood at 4.0583, 3.3978, and 4.56 percent respectively, flat with those recorded at the beginning of 2008. Fourth, coordination of a sound fiscal policy and a tight monetary policy was promoted, and a total of 30 billion yuan of 3-month time deposits was deposited in commercial banks for treasury cash management on January 30, which not only helped enhance the efficiency of the use of treasury cash but also to a certain extent satisfied the liquidity needs in the banking system before the Spring Festival.

II. The reserve requirement ratio was raised four times

In order to further implement a tight monetary policy, to strengthen liquidity management in the banking system, and to guide the appropriate growth of money and credit, the PBC announced a rise in the reserve requirement ratio of deposit-taking financial institutions by 0.5 percentage points on January 16, March 18, April 16, and May 12, effective on January 25, March 25, April 25, and May 20 respectively. The reserve requirement ratio for the local currency of financial institutions reached 16.5 percent. Meanwhile, a relatively low reserve requirement ratio was maintained for rural credit cooperatives so as to encourage financial support to the rural economy.

III. Window and credit policy guidance was strengthened

To cope with the increasing pressures to extend credit, the PBC continued to strengthen window and credit policy guidance to call attention to strengthening credit control, to appropriately balance the pace of credit extensions within the year, and to prevent excessive loan fluctuations. In line with the principle of differentiated treatments for different sectors, the PBC guided commercial banks to optimize the credit structure, strongly limiting lending to low-quality enterprises in industries with high energy consumption, heavy pollution, or excess production capacity, strengthening credit support to the rural economy, job creation, students, the service sector, small and medium-sized enterprises, self-initiated innovation, energy conservation and environmental protection, and promoting economic restructuring. Steps have also been taken to guide financial institutions to intensify lending for snow disaster relief, to encourage financial institutions to properly adjust the pace of credit extensions according to the agricultural production cycle so as to satisfy credit needs in preparation for the spring farming, and to strengthen credit support for the production of necessities such as grain, edible oil and meat, and other commodities in short supply.

IV. The reform of financial institutions was promoted steadily

The joint-stock reform of state-owned commercial banks was deepened. After completing the reform, the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications continued to improve corporate governance, vigorously promote business transformation, and steadily advance internal reform, further improving their management, profitability, and performance. At end-March, the capital adequacy ratio of the four banks registered 11.9, 13.3, 12.4 and 14.0 percent respectively, their NPL ratio recorded 2.5, 2.8. 2.2, and 1.9 percent respectively, and profits before tax reached 33.28, 21.62, 32.13, and 7.88 billion yuan respectively.[2] Meanwhile, the four banks promoted cross-sectoral operations in a sound manner. After the Industrial and Commercial Bank of China, the China Construction Bank, and the Bank of Communications established their own respective financial leasing companies at end-2007, the Bank of China carried out an equity transfer to Bank of China Investment Management. A platform for cross-sectoral operations has been gradually improved by these banks.

The Agricultural Bank of China made concrete efforts in preparation for financial restructuring. At present, the Bank has basically completed the external auditing, clearing of non-performing loans, legal due diligence, calculation of expected liabilities as a result of staff adjustments, and assessments of assets, land, and infrastructure. The internal reform was accelerated, and a reform plan was formulated and implemented on a pilot basis in line with the principle of serving the rural economy and conducting commercial-based operations. Based on the guidance of the National Financial Work Conference, the PBC, together with other relevant departments, accelerated deliberation of the joint-stock reform plan of the Agricultural Bank of China. In addition, China Everbright Bank steadily improved corporate governance and promoted preparatory work for a public listing. Reform of the China Development Bank also advanced at a steady pace.

The reform of the rural credit cooperatives (RCCs) also underwent important advances and produced good results. At end-March, 60 percent of the work for the redemption of special bills had been completed, with the cumulative redemption amounting to 101.6 billion yuan and the issuance of special loans amounting to 1.2 billion yuan, effectively reducing the historical burdens of the RCCs. With the remarkable capital improvements, the RCCs' credit support to the rural economy and rural households further increased. At end-March, the outstanding loans of the RCCs amounted to 3.4 trillion yuan, accounting for 12 percent of the total credit of financial

[2] The capital adequacy ratio of the Bank of China was recorded at end-2007, and the NPL ratio of the Bank of Communications was the impaired loan ratio.

institutions, up 1.6 percentage points from the beginning of the reform. Their agricultural loans reached 1.55 trillion yuan, accounting for 46 percent of their total loans, up 6 percentage points from the beginning of the reform. The reform of the property rights regime advanced smoothly. At end-March, 17 rural commercial banks, 120 rural cooperative banks, and 1,841 rural credit cooperatives with a unified legal entity at the county (city) level had been established nationwide.

V. The RMB exchange rate formation mechanism was improved, and the reform of the foreign exchange management system was accelerated to promote an equilibrium in the BOP account

Efforts have been made to continue to improve the managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies, to further promote the fundamental role of market supply and demand in the RMB exchange rate formation mechanism, to strengthen the flexibility of the RMB exchange rate, and to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. At the same time, active efforts were made to improve foreign exchange management, strengthen the management of foreign exchange receipts and surrenders for trade, foreign direct investment, and individual and external debts, and to intensify the monitoring, analysis, and management of cross-border fund flows. Capital movement channels were expanded in an orderly manner with the aim of promoting a BOP equilibrium, and the investment quota and investment scope of the Qualified Domestic Institutional Investors (QDII) were further enlarged, with the newly authorized investment quota of two QDIIs totaling US$525 million. The Qualified Foreign Institutional Investor (QFII) system was improved, with the newly approved investment quota of one QFII reaching US$200 million. Moreover, measures were adopted to adjust the liquidity of foreign exchange in the banking system in a market-based approach, to further improve the price transmission mechanism among financial institutions, enterprises, and households, and to guide different market participants to effectively diversify exchange rate risks with price instruments. Steps were also taken to increase the members of the inter-bank RMB foreign currency swap market, to diversify the trading products in the RMB derivatives market, and to promote the market to becoming more active so as to help enterprises, households, and financial institutions better manage exchange rate risks.

Part 3 Financial Market Analysis

In the first quarter of 2008, the financial market continued to perform in a sound and steady manner, featuring abundant market liquidity, brisk trading activity on the money market and capital market, stable interest rates on the money market, good performance of bond issuances, a slight increase of the bond index, the sound performance of the foreign exchange market, more innovation in financial products, and improved institutional building of the financial market.

Financing by the domestic non-financial institution sector (including households, enterprises, and the government sector) increased 23.7 percent, continuing a relatively strong momentum. In terms of the financing structure, loan financing continued to play a dominant role; the share of enterprise bond financing and equity financing increased notably, indicating a strengthened role of direct financing in allocating social funds; due to the large redemption of government securities, the amount of net financing in this category declined.

Table 5 Financing by Domestic Non-financial Sectors in the First Quarter of 2008

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	Q1 2008	Q1 2007	Q1 2008	Q1 2007
Financing by domestic non-financial sectors	18104	14631	100	100
Bank loans	16123	14293	89.1	97.7
Equities①	1489	316	8.2	2.2
Government securities	-247	-19	-1.4	-0.1
Enterprise bonds	739	41	4.2	0.3

Note: Equity financing does not include financing by financial institutions on the stock market.

Source: The People's Bank of China.

I. An overview of financial market operations

1. Trading on the money market was active, with stable market interest rates

and diversified fund lenders

Transactions on the inter-bank repo market and borrowing market were active, with average daily transactions climbing to new highs. In the first quarter of 2008, the turnover of bond repos registered 12.1 trillion yuan on the inter-bank market, with the daily turnover averaging 198.6 billion yuan and with year-on-year growth of 50.6 percent. Inter-bank borrowing registered 3.5 trillion yuan, with the daily turnover averaging 57.6 billion yuan and with year-on-year growth of 2.5 times. Most of the transactions on the repo and borrowing markets were overnight products; the proportions of overnight products were 52.5 percent and 68.4 percent respectively. The turnover of government bond repo on the stock exchanges increased 24.4 percent year on year to 471.4 billion yuan. The turnover of interest rate derivative transactions increased rapidly.

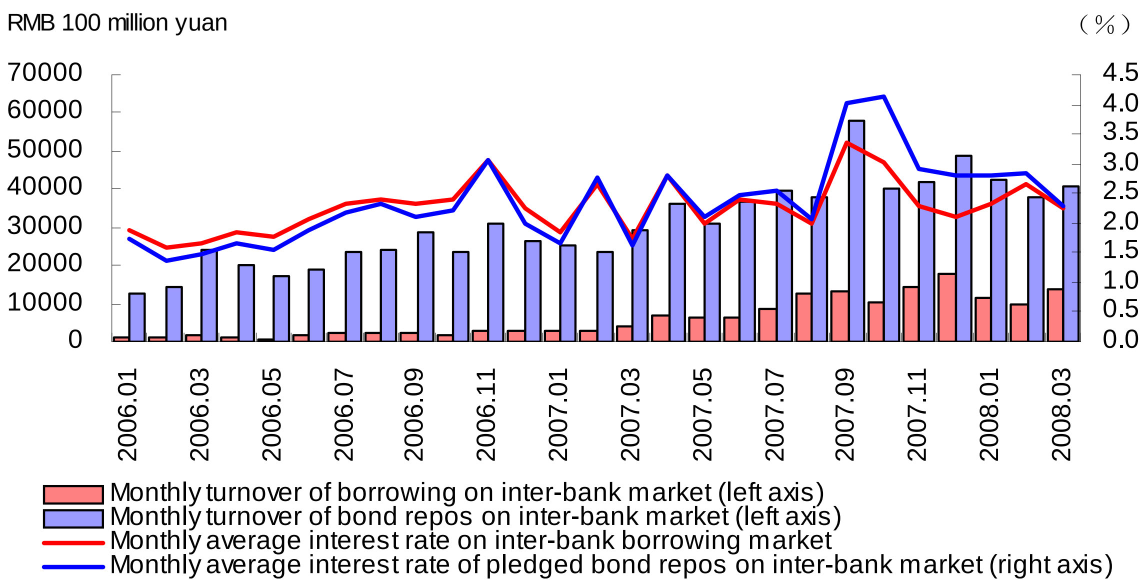

Figure 2 Turnover of Borrowings and Repos on the Inter-bank Market Since 2006

Source: The People's Bank of China.

Table 6 Transactions of Interest Rate Derivatives

	Bond forward		Interest rate swap		Interest rate forward	
	Transactions	Notional principal amount (RMB100 million yuan)	Transactions	Notional principal amount (RMB100 million yuan)	Transactions	Notional principal amount (RMB100 million yuan)
2005	108	177.99	—	—	—	—
2006	398	664.46	103	355.7	—	—
2007	1238	2518.09	1978	2186.9	14	10.5
Q1 2008	441	1512.72	591	837.16	24	14.1
Total	2185	4873.26	2672	3379.76	38	24.6

Source: China Foreign Exchange Trading System.

Inter-bank borrowing showed two distinct features. First, lenders were diversified. Other commercial banks, previously net borrowers, became net lenders, and state-owned commercial banks reduced their net lending. Second, mainly affected by the large volatility on the capital market, the funding demand of other financial institutions, securities firms, and fund management companies moderated; foreign financial institutions showed a strong demand on the money market due to their rapid asset expansions.

Table 7 Fund Flows among Financial Institutions in Q1 2008

RMB100 million yuan

	Repos		Inter-bank Borrowings	
	Q1 2008	Q1 2007	Q1 2008	Q1 2007
State-owned commercial banks	-22396	-29494	7155	-313
Other commercial banks	-401	3112	-8577	-2328
Other financial institutions	13686	20277	-389	1980
Of which: Securities and fund management companies	2221	3213	1329	1439
Insurance companies	6909	5512	—	—
Foreign financial institutions	9111	6105	1811	661

Note: A negative sign indicates a net fund outflow; a positive sign indicates a net fund inflow.

Source: The People's Bank of China.

Supply on the money market was relatively abundant, displaying an increasing trend before declining. In March, due to relatively fewer IPOs and funds flowing back to the banking sector after the Spring Festival, the weighted average interest rate of pledged bond repos was 2.27 percent, down 0.54 percentage points and 0.57 percentage points from that in January and February respectively; the weighted average interest rate on the inter-bank borrowing market was 2.26 percent, down 0.06 percentage points and 0.39 percentage points from that in January and February respectively. The Shibor moved in parallel with borrowing and repo interest rates on the money market, and the spread between the Shibor rates within 2-week maturities and the interest rates of borrowing and repos basically was within 10 basis points. The Shibor rates above 3 months were basically stable. The Shibor gradually played a role in the pricing of interest rate derivative products. Interest rate swaps based on the Shibor accounted for 19 percent of all RMB interest rate swaps, and all forward interest rate contracts were based on the 3-month Shibor.

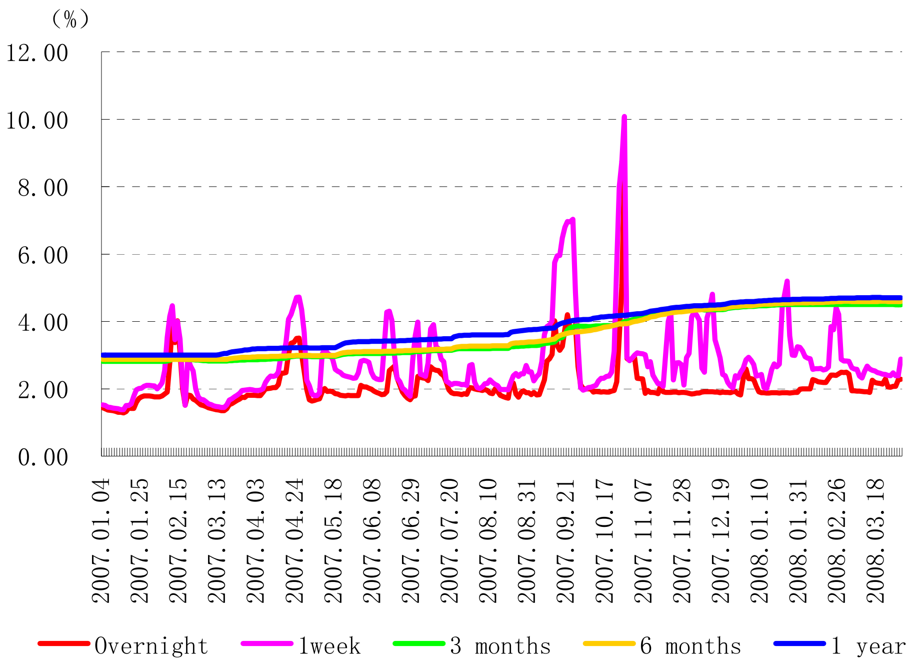

Figure 3 Movements of the Shibor since 2007

Source: National Inter-bank Funding Center.

2. Brisk issuances and transactions on the bond market were accompanied by a slight decline in bond issuing rates

Due to factors such as funds flowing back to the banking system from the stock market and bond price hikes, outright bond trading was brisk on the inter-bank market. The turnover in the first quarter totaled 7.6 trillion yuan, with the daily average turnover hitting a historic high of 125.2 billion yuan, representing year-on-year growth of 1.9 times. The turnover of outright government bonds trading on the stock exchanges registered at 31.6 billion yuan, at par with that in the previous year. On the inter-bank outright bond market, except for other commercial banks that sold 537.9 billion yuan of bonds on a net basis, other financial institutions were net purchasers, with the net purchases of state-owned commercial banks and other financial institutions at 149.8 billion yuan and 207.4 billion yuan respectively.

Both the inter-bank bond market index and the stock exchange bond index displayed an upward trend. The inter-bank bond market index climbed from 114.8 at beginning-2008 to 118.4 at end-2008, or 3.1 percent; the stock exchange bond index increased from 110.8 points at beginning-2008 to 113.1 points at end-March, or 2.1 percent. The yield curve of the inter-bank bond market displayed an overall downward trend.

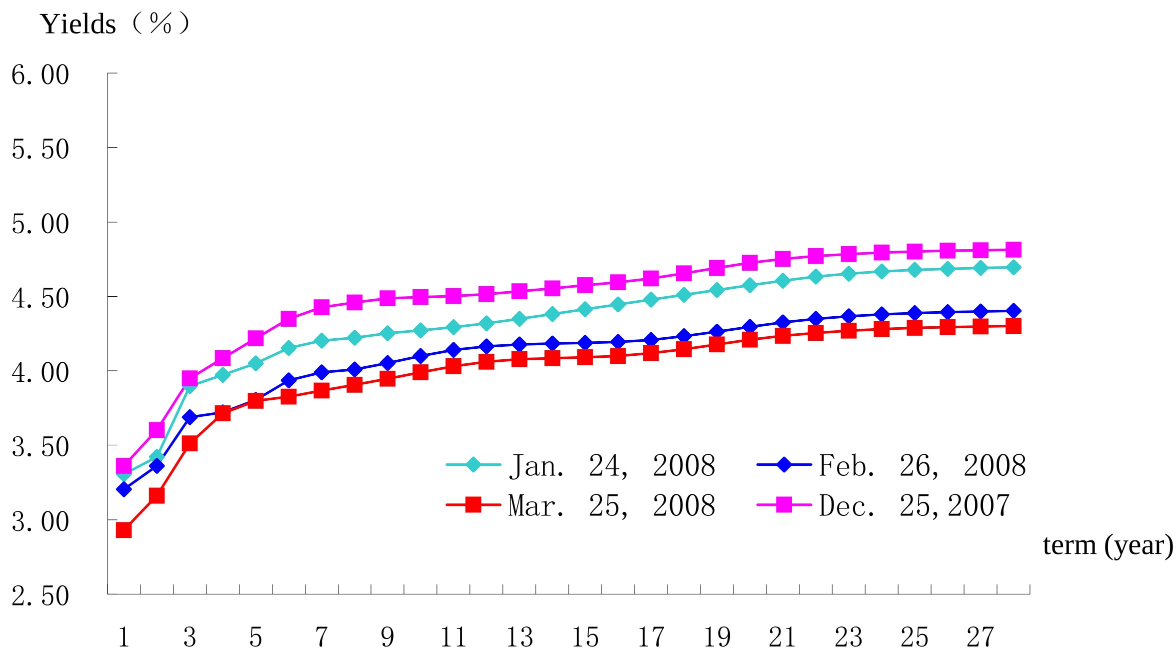

Figure 4 Yield Curves of Government Securities on the Inter-bank Bond Market in 2008

Source: China Government Securities Depository Trust and Clearing Co., Ltd.

The bond market developed rapidly and market products further diversified. A total of 543.3 billion yuan of bonds (excluding central bank bills) was issued on the primary bond market, a year-on-year increase of 199.9 billion yuan, or 58.2 percent, among which, policy financial bonds and short- and long-term enterprise bonds increased rapidly. The GMAC-SAIC Automotive Finance Company, Ltd., China Construction Bank, and Industrial and Commercial Bank of China issued a total of 12.77 billion yuan of asset-backed securities. In addition, 85 enterprise short-term financing bills were issued, and four listed companies issued a total of 6.5 billion yuan of corporate bonds. In terms of maturities, 55.8 percent of the bonds had a maturity of more than five years, down 6.8 percentage points from the previous year, and the proportion of bonds with a maturity of less than one year was down 16.8 percentage points from the previous year. At end-March 2008, outstanding bonds totaled 13.2 trillion yuan, a year-on-year increase of 29.4 percent, including 12.1 trillion yuan of outstanding bonds on the inter-bank market and 322.8 billion yuan on the stock exchange market.

Table 8 Issuances of Major Bonds in Q1 2008

Types of Bonds	Issuances (RMB 100 million yuan)	Year-on-year growth (%)
Government securities	1149	-0.9
Policy financial bonds	2678	128.7
Bank subordinated bonds and hybrid capital bonds	77	-69.2
Bank common bonds	0	——
Enterprise bonds	1336	101.3
Of which: short-term enterprise financing bills	1116	79.8
Corporate bonds	65	——
Asset-backed securities	128	——

Source: The People's Bank of China.

With weakening expectations of interest rate hikes and the flow of funds back from the capital market, financing costs fell moderately on the bond market. The issuing rate of seven-year book-entry government bonds issued in February was 3.95 percent, down 0.4 percentage points from that of government bonds with the same maturity issued last November. The issuing rate of seven-year fixed-rate bonds issued by the China Development Bank was 4.83 percent, down 0.11 and 0.31 percentage points from that of No.27 and No.29 bonds with the same maturity issued last December. The issue rate of 10-year fixed-rate corporate bonds issued by the State Grid was 5.35 percent, down 0.67 to 1.33 percentage points from that of enterprise bonds with the same maturity issued last December.

The Shibor has played an increasing role in pricing bonds. In the first quarter, a total of 5 fixed-rate enterprise bonds was issued based on the Shibor rates, totaling 21.99 billion yuan in volume; and 60 short-term financing bills based on the Shibor were issued, totaling 55.1 billion yuan in volume, accounting for 49 percent of the total issuances. On March 20, the Shenzhen Development Bank issued a 10-year floating-rate subordinated option bond, totaling 500 million yuan, which was based on the 3-month Shibor plus a spread of 140 basis points.

3. Growth of commercial paper financing slowed down

In the first quarter, a total of 1.5 trillion yuan of commercial bills was issued by the corporate sector, up 5.3 percent year on year; discount bills totaled 2.9 trillion yuan, up 11.6 percent year on year; rediscount bills totaled 1.78 billion yuan, an increase of 1.23 billion yuan. At end-March, outstanding commercial bills amounted to 2.5 trillion yuan, up 7.3 percent year on year; outstanding discount bills totaled 1.2 trillion yuan, down 33.4 percent year on year; and outstanding rediscount bills amounted to 3.63 billion yuan, 3 billion yuan more than that during the same period of the last year.

The growth of acceptances of commercial bills decelerated, and rediscount bills declined on a net basis. At end-March, outstanding acceptances of commercial bills increased 70.9 billion yuan from the beginning of the year, a deceleration of 59.3 billion yuan year on year; outstanding discount loans decreased 79.5 billion yuan from the beginning of the year, whereas there was growth of 81.9 billion yuan in the same period of the last year. With the implementation of a tight monetary policy, commercial banks have made efforts to control credit growth. Due to the short maturity, rapid circulation, controllable risks, and stable costs and returns of commercial paper financing, reducing discount loans has become an important means for commercial banks to adjust the scale and structure of assets and liabilities.

4. The stock market saw relatively large fluctuations

In the first quarter, the total turnover of the Shanghai and Shenzhen Stock Exchanges registered 9.62 trillion yuan, and the daily trading volume averaged 163 billion yuan, down about 40 percent from the second quarter of last year that saw the most brisk transactions in 2007, but the daily trading volume was up 23.8 percent and 9.4 percent from the first and fourth quarter of last year, indicating active market transactions. At end-March, market capitalization amounted to 7.6 trillion yuan, down 17.9 percent from end-2007.

The stock index edged up between the beginning of the year and mid-January before going down substantially amid fluctuations. At end-March, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 3473 points and 1098 points respectively, losing 1789 points and 349 points, or decreasing 34 percent and 24.1 percent from the beginning of the year, basically returning to the level in the corresponding period of the last year. At end-March, the average P/E ratio of A-shares on the Shanghai Stock Exchange was 39.5, about the same level as at end-February 2007.

Stock market financing was massive. In the first quarter, a total of 148.9 billion yuan was raised by Chinese enterprises through IPOs, additional offerings, and rights issues on equity markets at home and abroad, an acceleration of 60.2 billion yuan year on year. Raised funds hit a historic high, registering an increase of 67.8 percent year on year.

At end-March, the number of securities investment funds increased by 7 to 353 from end-2007, and fund units registered a total value of 2.28 trillion yuan, with their number growing 45.4 billion units or 2 percent from end-2007. Net assets under management reached 2.66 trillion yuan, a decrease of 619.9 billion yuan or 18.9 percent from end-2007.

5. The total premium income increased rapidly, and claim payments increased modestly

In the first quarter, the total premium income in the insurance industry amounted to 297.9 billion yuan, up 51.6 percent year on year, among which property insurance premium income increased 24.7 percent year on year and life insurance premium income increased 61.2 percent year on year. As a result of the unusual snowstorms and frost that occurred at the beginning of the year, claim payments and benefits increased rapidly, and the demand for insurance by enterprises and individuals increased noticeably. Claim and benefit payments in the insurance sector amounted to 84.4 billion yuan, an acceleration of 14.8 billion yuan from the previous year, among which claim payments of property insurance were 28.9 billion yuan, an acceleration of 8.2 billion yuan, or up 39.6 percent year on year.

Due to the large volatility in the capital market and the large amount of claim payments, the growth of total assets in the insurance industry moderated. At end-March, the total assets in the insurance industry amounted to 2.94 trillion yuan, an increase of 31.2 percent year on year, down 5.9 percentage points from the same period of the last year. In terms of structure, investment-type assets grew rapidly, and their share of total assets continued to rise.

Table 9 Use of Insurance Funds at End-March 2008

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	End-March 2008	End-March 2007	End-March 2008	End-March 2007
Total assets	29438	21809	100	100
Of which: bank deposits	6906	6210	23.5	28.5
Investment	19695	13416	66.9	61.5

Source: China Insurance Regulatory Commission.

6. The foreign exchange market developed in a sound manner and RMB swap transactions were active

The number of participants in the foreign exchange market further increased. The inter-bank spot foreign exchange market operated smoothly and the dominant role of OTC transactions was strengthened. RMB swap transactions were brisk, and the turnover of foreign currency pairs decreased to some extent. In the first quarter, the turnover on the RMB swap market amounted to US$103.8, an increase of 86.4 percent year on year; the turnover on the inter-bank forward market amounted to US$7.75 billion, an increase of 45.7 percent year on year; the turnover of eight currency pairs totaled US$17.8 billion, a decrease of 27.5 percent year on year, with transactions in the USD/HKD and EUR/USD currency pairs accounting for 70.7 percent of the total trading volume.

II. Financial market institutional building

1. The self-regulating mechanism of the inter-bank bond market was strengthened

In order to improve the management of the inter-bank bond market and to promote development of direct debt financing of non-financial enterprises, on April 9 the PBC released the *Administrative Rules on Debt Financing Instruments for Non-financial*

Enterprises on the Inter-bank Bond Market, which established the role of the National Association of Financial Market Institutional Investors (NAFMII) to organize market participants to develop and manage the direct financing products, and emphasized that the NAFMII should vigorously strengthen self-regulation of the market in terms of registering, issuing, trading, and information disclosure of debt financing instruments for non-financial enterprises. The *Administrative Rules* highlighted the fundamental role of the market in allocating financial resources and signaled a major transformation in the regulation of the inter-bank bond market.

2. Interest rate swap transactions were comprehensively promoted

In order to further promote the development of the financial derivative market, deepen the risk-prevention function of the market, advance the market-based reform of the interest rate, and on the basis of drawing on the experiences of the pilot RMB interest swap, in January 2008 the PBC released the *Notice on the Conduct of RMB Interest Rate Swaps* so as to fully launch the interest swap business. The *Notice* expanded the participants to include all participants in the inter-bank bond market, lifted the limitation to only swaps between fixed-rates and floating-rates, and helped market participants use interest rate swaps to hedge risks. In the meantime, the risk-prevention requirement for the participants was further strengthened so as to promote the steady and healthy development of the interest rate swap business.

3. Institutional building of the securities market made progress

First, efforts were made to forcefully crack down on illegal security activities and to maintain the normal order of the securities market. In order to further combat illegal security activities and to clarify the division of labor and cooperation among different departments and some policy and legal issues, in January 2008 the Supreme People's Court, the Supreme People's Procuratorate, the Ministry of Public Security, and the China Securities Regulatory Commission jointly promulgated the *Notice on Cracking Down on Illegal Securities Activities*, which provided a legal and policy framework for addressing four kinds of issuances, including companies or their shareholders transferring shares to the general public without permission. The *Notice* not only solved relevant legal issues in legal practices and improved the legal system to combat illegal securities activities, but also was a valuable cooperative experiment among the regulatory authority, public security department and judicial department. It provided a new mode for promptly and effectively combating all sorts of newly-emerging illegal activities and crimes. Second, efforts were made to improve the management system of the Growth Enterprise Market (GEM) and to promote the growth of multi-layered capital markets. On March 21, the China Securities Regulatory Commission began to seek public opinions on the *Administrative*

Measures on IPOs and Listings on the Growth Enterprise Board, which provided a standard for IPOs and listings by growth enterprises.

4. The internal control of life insurance companies was improved

In March 2008 the China Insurance Regulatory Commission released the *Notice on Strengthening the Self-Assessment of Internal Control of Life Insurance Companies*, which further specified the rating rules and requirements for the internal control of life insurance companies. This will help standardize the internal operations of insurance companies and solidly promote the internal control of life insurance companies.

Part 4: Macroeconomic Analysis

I. Global economic and financial developments

Since the beginning of 2008, the global economy has experienced a broad-based slowdown. Rising inflation pressures have created growing macroeconomic policy challenges for the major economies. Signs of recession emerged in the U.S. Downward risks became larger in the euro area and Japan. The emerging market economies maintained a robust but somewhat slower growth momentum. The major stock indexes fluctuated substantially as did the foreign exchange markets and debt securities markets. In April 2008 the IMF forecast that the global economy would grow by 3.7 percent in 2008, 1.2 percentage points lower than that in 2007; among the major economies, the U.S. would grow by 0.5 percent, down from 2.2 percent in 2007; the euro area by 1.4 percent, down from 2.6 percent; and Japan by 1.4 percent, down from 2.1 percent. The IMF also claimed that there was a 25 percent chance that global growth would decline by 3 percent or less in 2008 and 2009.

1. Economic development of the major economies

Signs of recession emerged in the U.S. In the first quarter, seasonally adjusted annualized GDP growth was 0.6 percent, the same level as the last year. Upward inflation pressures heightened with the year-on-year CPI reaching 4.3 percent, 4.0 percent, and 4.0 percent in the three months respectively, averaging 4.1 percent and representing an acceleration of 1.7 percentage points from the previous year. The employment situation was not encouraging as the average unemployment rate rose to 4.9 percent, or 0.4 percentage points higher year on year and the monthly unemployment rates in the first three months reached 4.9 percent, 4.8 percent, and 5.1 percent respectively. The trade deficit in goods and services trade grew slightly to US$178.88 billion in the first quarter, representing an increase of US$263 million over that in the first quarter of 2007.

The downside risks facing the euro area rose. In 2007, GDP grew 2.6 percent, a deceleration of 0.2 percentage points from the previous year. Inflation pressures continued to build up. The HICP in the first three months reached 3.2 percent, 3.3 percent, and 3.6 percent respectively, with the average standing at 3.4 percent, which was an acceleration of 1.6 percentage points from the previous year. The HICP has been higher than the target of 2 percent for the seventh consecutive month. The employment situation has been improving. The first quarter unemployment rate stabilized at 7.1 percent. In the first two months of 2008, the accumulated trade deficit reached 3 billion euro, down by 20.3 billion euro year on year.

The outlook for the Japanese economy was not optimistic. In 2007 GDP grew 2.1 percent, a deceleration of 0.3 percentage points from the previous year. Prices continued to increase, with the CPI growing 0.7 percent, 1.0 percent, and 1.2 percent year on year respectively in the first three months (the highest in the past ten years), averaging a significant jump of 1.0 percent. Unemployment in the first three months turned for the better, reaching 3.8 percent, 3.9 percent, and 3.8 percent respectively. The accumulated trade surplus in the first quarter was 1.99 trillion yen, 578 billion yen lower year on year.

The major emerging economies and developing countries maintained robust momentum, but inflation pressures rose in all countries. The emerging economies in Asia experienced rapid growth driven by strong domestic and external demand while those in Latin America maintained relatively stable growth.

2. Global financial market development

Since the beginning of 2008, the depreciation of the US dollar against the euro and the yen accelerated. On March 31, the euro/dollar and dollar/yen rate closed at 1.5772 dollar per euro and 99.81 yen per dollar respectively. In Q1 the dollar depreciated by 8.1 percent against the euro and 11.5 percent against the yen.

The trend in the yield of major debt securities was significantly lower since the beginning of the year. On March 31, the yield of 10-year treasury bonds in the U.S., euro area, and Japan were 3.43 percent, 3.91 percent, and 1.28 percent respectively, 0.60, 0.42, and 0.22 percentage points lower than the level at the beginning of the year.

The major stock indices tumbled lower. Affected by the disclosure of huge losses in the sub-prime mortgage crisis by large financial institutions and the expectation of a pending U.S. recession, during the period from January 15 to 20, 2008, stock markets around the globe plunged. Some indexes even experienced their largest losses since September 11. Thereafter, the markets went up and down. On March 31, the Dow Jones Industrial Average was down 7.55 percent from the beginning of 2008, closing at 12262.89 points; the Nasdaq was down 14.07 percent to 2279.10 points; the STOXX50 was down 17.54 percent to 3628.06 points, and the Nikkei Index was down 18.18 percent to 12525.54 points.

3. Housing market development in the major economies

The U.S. housing market worsened. In January and February 2008, the national housing price index went down 2.7 percent and 2.4 percent year on year respectively. At the same time, the start of new homes, sales of new homes, and new homes yet to be sold fell noticeably. In March, the start of new home construction, sales of new homes, and new homes yet to be sold reached 947,000, 526,000, and 468,000 respectively, down 36.5 percent, 36.6 percent, and 14.6 percent in seasonally adjusted annualized terms.

The European housing market also was not encouraging. The market slid markedly in Spain with home prices, trading volume, and mortgage loans dipping 3.1 percent, 27.1 percent, and 25.7 percent in January. House prices in the UK edged lower for several successive months. Markets in Germany and Portugal remained sluggish.

The Japanese housing market showed signs of slowing down. In 2007 the average listed land price in Japan grew 1.7 percent year on year, up for the second consecutive year, while the price of land for commercial use grew 3.8 percent, and the price of land for residential housing grew 1.3 percent. Since the latter half of 2007, growth of land prices in downtown areas, which had pushed up the overall housing price level, began to decelerate, signaling the greater risks of a market cooling. In the first three months of 2008, the start of new home construction dropped 5.7 percent, 5.0 percent, and 15.6 percent yoy respectively.

4. The monetary policy of the major economies

The Fed FOMC cut the target Fed fund rate by 75, 50, 75, and 25 basis points to 2 percent on January 22, January 30, March 16, March 18, and May 1 respectively, and lowered the discount rate by the same basis points to 2.25 percent on the same dates. The ECB kept its major refinancing rate unchanged at 4 percent. The BOJ announced that uncollateralized overnight call rate would be maintained at 0.5 percent. The BOE lowered the official interest rate by 25 basis points on February 7 and April 10 respectively to 5 percent.

5. World economic outlook

Major risks threatening world growth include lower growth in the major industrial economies triggered by uncertainties in the unfolding of the sub-prime turmoil and its negative effects on the emerging economies; rising global inflationary pressures; the dilemma facing the central banks of the major economies in that they have to both prevent recession and curb inflation; the significant depreciation of the US dollar; and the resurgence of trade protectionism.

At present, there are significant uncertainties in the development of the U.S. sub-prime mortgage crisis. With few signs of recovery in the housing market and the ongoing credit crunch, the risks of the crisis spreading to commercial real estate, and credit card, auto, and corporate loans remain. In this context, there is little doubt that the major economies will slow down. Against the background of globalization, as the emerging market economies still depend to a large extent on the industrial economies in terms of trade and capital, they cannot be isolated from the aftermath of the sub-prime loan crisis. Strong domestic demand, a growing proportion of intra-regional trade and investment, and a sound macroeconomic environment will make the emerging economies more self-dependent and less dependent on the industrial economies, and the slowdown in the developed world will have less of an effect on the emerging economies.

At the same time, against the background of an excess of global liquidity, inflationary pressures continued to rise around the world, making it more difficult to carry out monetary policy as the major central banks are caught between raising interest rates to drain liquidity and curb inflation and lowering interest rates to prevent recession. The recent rate cuts by the U.S. authorities also added to the difficulties of monetary policy conduct by other central banks.

The depreciation of the US dollar accelerated as a result of rising recession expectations and the consecutive interest rate cuts by the Fed. In the short run, this will increase the appreciation pressures on the major currencies such as the euro and the yen and push up the prices of oil, gold, and other commodities, increasing uncertainties in global capital flows. In the long run, the depreciation of the dollar will have far-reaching effects on the world monetary system, as it will weaken the role of the dollar in the global exchange rate system, international trade settlement, and international reserves.

Against the backdrop of slowing growth and worsening employment, and given the political considerations, some countries have witnessed sentiments of rising anti-globalization such as protectionism, which will unfavorably affect the sustainable and healthy growth of the world economy and the orderly adjustment of the global imbalances.

Box 2 Global Inflationary Pressures are Rising

Since the beginning of 2008, driven by huge increases in international energy and food prices, the consumer indexes in the major countries and regions witnessed marked increases, indicating rising global inflationary pressures and forming a major risk for global growth.

Inflation increased in most countries. In the first three months of 2008, the U.S. core CPI was above 2.3 percent, higher than the 1.5-2 percent range acceptable to the authorities; the euro area HICP was higher than the 2 percent inflation target of the ECB for seven consecutive months; in March, Japan’s CPI rose to a ten-year high of

1.2 percent. In addition, the emerging market economies also experienced higher inflation as a result of domestic demand and rising food and energy prices. In March 2008, the CPI in Korea, Singapore, Indonesia, Argentina, Turkey, and Vietnam rose 8.8 percent, 8.5 percent, 8.2 percent, 8.8 percent, 9.2 percent, and 19.4 percent respectively.

The underlying reasons for the rising global inflation are the following. First, the dividends of globalization diminish as globalization deepens. The decreasing advantage of the marginal gains from higher productivity in the emerging market economies and the rapidly rising labor costs have greatly reduced the ability of the advanced countries to avoid domestic inflation by taking advantage of cheap overseas labor. Second, global imbalances against the background of globalization directly led to an excess of global liquidity. After the Asian financial crisis, the Asian countries and the emerging countries such as Russia, Brazil, and Argentina adopted a pro-export strategy and accumulated huge foreign exchange reserves, strengthening their resilience against external shocks; at the same time, the major industrial countries such as the U.S. adopted a low interest rate policy after the burst of the high-tech bubble and the September 11 event, which aggravated the excess liquidity. On the other hand, with capital account liberalization and financial integration and innovation, persistent and large international capital flows further lowered the risk premium and pushed asset prices higher. Third, to deal with credit stresses caused by the sub-prime crisis, the Fed and other central banks cut interest rates substantially and injected large amounts of liquidity in the market, giving further support to the excess liquidity and rising inflation pressures in the short- and medium-term. Fourth, prices of commodities have been generally raised. Since the beginning of 2008, international energy, food, and metal markets have become tighter, and prices have risen to record highs. Higher food prices can be attributed to the combined effects of the following factors: the rapid growth of the developing countries has increased their demand for food; there is a shortage of supply due to climatic change and natural disasters; demand for corn has increased as a result of the development of bio-energy; and higher prices of production inputs have also contributed to higher food prices.

One major characteristic of this round of global inflation is that it is food-price driven. According to classical economic theory, monetary policy has a limited role in curbing inflation driven by food prices. A central bank can stabilize inflation expectations through stabilizing market confidence. Facing rising food prices, many countries adopted measures to control food exports. In 2007 Argentina raised the food export tax on two occasions; Ukraine adopted a wheat export licensing system; the major rice exporters, such as Vietnam, Egypt, India, and Thailand, imposed limits on rice exports; Europe, Korea, and Japan also adopted measures to restrict the export of agricultural products. It is worth noting that although food price rises may increase political frictions among the major countries and living pressures for low-income countries, increase political and fiscal pressures on some governments, and may lead to instability, there is no substantive global short supply of food as the recent price rise is caused by food export restrictions by some countries due to domestic food security considerations. In fact, the potential to increase the food supply is significant. The existence of idle farmland and the rapid development of biotechnology can increase supply in the short run and stabilize prices.

Another noticeable characteristic of this round of inflation is that it is associated with the global slowdown caused by the sub-prime crisis in the U.S. Under normal circumstances, central banks usually adopt an inflation-targeting regime and tighten monetary policy to fight inflation. However, facing the dual risks of an excess liquidity-led inflation and a recession, the major monetary authorities including the Fed are caught in a dilemma. In order to prevent a recession, the Fed adopted an accommodative monetary policy, combining many rate cuts with massive liquidity injections while a fiscal stimulus was also launched by the government. Similarly, central banks in Canada and the U.K. also lowered policy rates to avoid a slowdown. In contrast, the monetary authorities in Australia and Sweden raised the policy rate to deal with the upward risks of inflation; the ECB and BOJ left the policy rates unchanged after weighing the risks of a slowdown and higher inflation in order to maintain medium- and long-term price stability and to anchor inflation expectations.

At present, rising international food and energy prices have increased imported inflation pressures in China. Measures have been taken to maintain production, secure supply, and strengthen market supervision and to provide support to low-income people through fiscal subsidies. The next step will be to improve the effectiveness of anti-inflation policies through comprehensive measures to increase supply, stabilize expectations, and strengthen coordination among monetary, fiscal, and industrial policies.

II. Analysis of China's macroeconomic performance

In Q1 2008, despite the changes in the international economic environment and the impact of the snowstorms, the national economy maintained a momentum of stable growth and overall performance exceeded expectations. The agricultural sector developed steadily, industrial production registered rapid growth, consumer demand continued to expand in a stable and rapid manner, and household income, corporate profits, and fiscal revenue all made fresh gains and trade imbalances were eased. However, due to the natural disasters and other factors, consumer prices soared. In Q1, GDP grew 10.6 percent year on year to 6.1 trillion yuan, a deceleration of 1.1 percentage points from the previous year; the consumer price index was up 8.0 percent, an acceleration of 5.3 percentage points; the trade surplus posted US$41.4 billion, a decline of US$4.9 billion from that in the same period of the last year.

1. **Consumption growth was rapid while growth of investment remained high. The trade surplus was smaller than that during the same period of the last year**

Household income continued to rise, and domestic demand remained strong. In Q1, the per capita disposable income of urban residents registered 4,386 yuan, a year-on-year growth of 11.5 percent or 3.4 percent in real terms; the per capita cash income of farmers was 1,494 yuan, a year-on-year growth of 18.5 percent or 9.1 percent in real terms. The urban household survey by the PBC showed that the current income sentiment index of households in Q1 was significantly higher. The share of households that believed their income was higher accounted for a larger share, 6.7 percentage points more than that during the previous quarter. The stable increase in income of urban and rural residents supported the continuous growth of consumption. In Q1, the gross volume of retail sales reached 2.6 trillion yuan, representing nominal growth of 20.6 percent or real growth of 12.3 percent, as compared with the 12.5 percent real growth in the same period of the last year. Among the total, retail sales in urban China and in counties, townships, and villages grew 21.2 percent and 19.3 percent respectively, resulting in a gap of 1.9 percentage points, 0.1 percentage points larger than the gap during the same period of the last year.

Box 3 Increasing consumer demand and promoting the growth of domestic demand

Increasing consumer demand is the key to promoting stable and rapid economic growth. According to the theory of macroeconomic equilibrium in an open economy, the savings gap equals the trade gap, i.e., inadequate domestic consumption must be balanced by overseas consumption, leading to reliance on external demand and subsequently to an excess surplus in the balance of payments and stronger appreciation pressures. From the point of view of an internal economic equilibrium, inadequate consumption is the main reason behind excessive savings, which is likely to lead to a rapid expansion of investment and a series of other problems, such as blind investment, repetitive construction, and excess capacity buildup. Inadequate consumption may also create distortions in the supply structure. When growth is driven by investment and export results, the industrial structure tends to have a large share of heavy chemical and manufacturing industries, making it difficult to slow down the depletion of natural resources and pollution and to achieve sustainable growth.

China’s final consumption ratio, i.e., final consumption as a percentage of GDP, is much lower than that of other countries. According to World Bank statistics, the world average consumption ratio was 62 percent in 2006, that for the developing countries was 58 percent, and that for China was less than 50 percent. Although consumption-boosting measures taken in the past years led to accelerated consumption growth, in 2007 the contribution of final consumption to GDP growth, i.e., the ratio of the increase in consumption to the increase in the GDP, exceeded that of investment; the contribution of consumption to GDP growth between 2000 and 2007 was lowered from 63.8 percent to 39.7 percent, while the contribution of investment increased from 21.7 percent to 38.8 percent and the contribution of trade in goods and services increased from 14.5 percent to 21.5 percent.

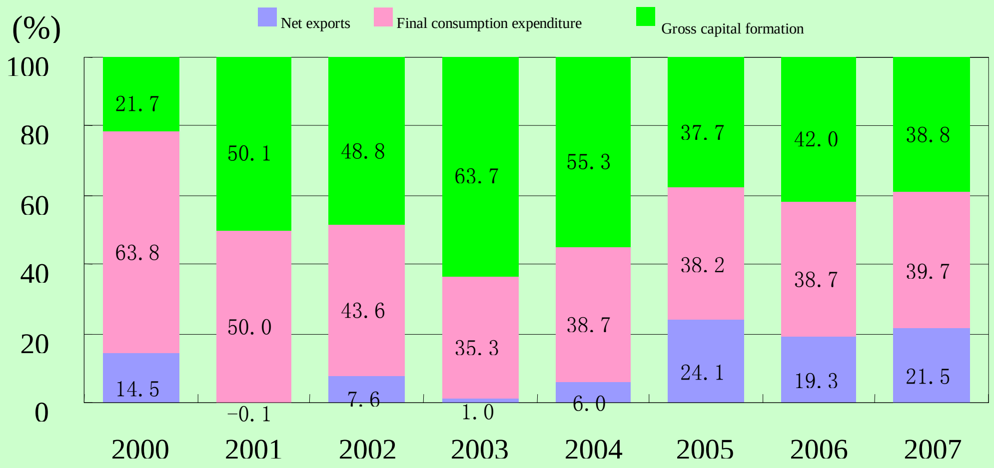

Figure 5 Contribution of Three Categories of Demand to GDP Growth

Source: National Bureau of Statistics. Data for 2007 are preliminary and those for other years are final. The contribution ratio is the ratio between the increase in the three categories of demand and the increase in expenditure-based GDP.

At present, effective measures should be taken to promote domestic consumption. For lower middle-income people, it is important to increase their consumption capacity through measures that improve the income distribution structure; for medium- and high-income people, it is important to increase their propensity to consume through measures that develop the services sector and create new consumption items to meet their needs.

Improving the structure of income distribution and increasing the consumption capacity of medium- and low-income people: In recent years, household income has witnessed rapid growth, but the pace is still slower than the growth of GDP and corporate and government income. Between 2000 and 2007, the annual per capita income growth of the urban and rural population reached 11.9 percent and 9.1 percent respectively, while the annual growth of GDP, the profits of statistically large enterprises, and government revenue reached 14.1 percent, 26.6 percent, and 21.1 percent respectively. Therefore, increasing the proportion of labor income in the national income shall be implemented as an important strategy to promote consumption. Increasing household disposable income can be achieved by establishing a normal wage increase scheme, increasing the proportion of capital income distribution to households, allocating state shares to build up individual pension accounts, improving and implementing measures to increase the farmers' income and to reduce their burden, and focusing tax collection on higher-income people and lowering the tax burden on low-income people. With the new Labor Contract Law as the starting point, work shall be done to establish a social security system that facilitates labor mobility and increases benefits for rural workers to the level enjoyed by the urban population, to provide technical training to migrant rural workers and to increase their ability to seek long-term employment in the cities, and to promote the transition of fiscal policy with a focus on enhancing comprehensive urban social security capacities and increasing investment in urban infrastructure such as housing, transportation, schools, and hospitals, and aiming at providing equal basic public services to the whole society.

Promoting consumption-related services and upgrading the consumption structure: Compared to the consumption structure of the advanced countries, China has a huge potential to develop consumption-related services. In 2006, China's urban service consumption ratio was 48 percent, while that in the U.S., UK, France, and Korea was 60 percent, 64 percent, 51 percent, and 57 percent respectively. In terms of consumption categories, China's consumption is mainly in traditional areas such as housing, dining, transportation, and telecommunications; while consumption in the advanced countries is mainly in health care, household services, tourism, and entertainment. In the future, comprehensive measures, including tax measures, need to be taken to develop housing services, household services, health care, tourism, cultural activities, sports, and entertainment to promote an upgrading and expansion of consumption.

Fixed-asset investment remained massive. In Q1, fixed-asset investment totaled 2184.5 billion yuan, representing a year-on-year growth of 24.6 percent and an acceleration of 0.9 percentage points, but real growth decelerated 6.2 percentage points from the previous year to 14.8 percent. Urban fixed-asset investment reached 1.8 trillion yuan, up 25.9 percent, while rural fixed-asset investment posted 352.9 billion yuan, up 18.3 percent, an acceleration of 0.6 and 1.6 percentage points respectively from the same period of the last year. In terms of geographical distribution, fixed-asset investment in central and western China accelerated by 1.5 and 0.2 percentage points respectively; investment in the urban areas of eastern, central, and western China increased 22.3 percent, 35.2 percent, and 27.7 percent respectively; in terms of the sectoral distribution, fixed-asset investment growth in primary industry enjoyed the largest growth with the support of the policy of building a socialist new countryside. Fixed-asset investment growth in the three industries registered 80.8 percent, 25.9 percent, and 25.3 percent respectively, with the primary and tertiary industries representing an acceleration of 60.5 and 1.3 percentage points and the secondary industry representing a deceleration of 1.1 percentage points.

Import growth outpaced that of export growth, resulting in a surplus smaller than that during the same period of the last year. In Q1, imports and exports totaled US$570.38

billion yuan, up 24.6 percent and an acceleration of 1.3 percentage points. Due to a weakening external demand and the snowstorm disaster, export growth declined modestly. Exports grew 21.4 percent, representing a deceleration of 6.4 percentage points from the same period of the last year, to US$305.9 billion, while imports increased 28.6 percent, representing an acceleration of 10.4 percentage points, to US$264.48 billion, resulting in a surplus of US$41.4 billion, US$4.9 billion less than during the same period of the last year but still fairly large. As for the monthly performance of exports, year-on-year growth was 6.5 percent in February, representing a deceleration of 45.2 percentage points, but in March there was a rebound to 30.6 percent, representing an acceleration of 23.7 percentage points, mainly caused by the sharp fluctuations in export volume during the corresponding months of the last year.

2. Agricultural production was stable and industrial production grew rapidly

In Q1, the added value of primary industry was up 2.8 percent to 472.0 billion yuan, a deceleration of 1.6 percentage points from the previous year; the added value of secondary industry was up 11.5 percent to 3077.8 billion yuan, a deceleration of 1.7 percentage points; the added value of tertiary industry was up 10.9 percent to 2599.3 billion yuan, a deceleration of 0.4 percentage points.

Agricultural production maintained a momentum of stable growth. Post-disaster recovery proceeded smoothly. The sowing area of grain expanded moderately. Although the snowstorms affected agricultural production to varying degrees, the affected areas made good progress in post-disaster recovery, and agricultural production recovered promptly in the affected areas. According to the planting intentions survey, the total sowing area for grain was estimated to be 105.62 million hectares in 2008, 90,000 hectares more than the last year, representing growth for five years in a row. In Q1, the output of pork, beef, mutton, and poultry totaled 19.17 million tons, up 3.7 percent year on year, including 12.84 million tons of pork (representing growth of 2.3 percent). The producer prices of agricultural products (the price at which a farmer sells his/her products) rose 25.5 percent, higher than the 17.5 percent growth in the prices of agricultural capital goods, a positive factor in the income gain of farmers.

Industrial production registered a rapid increase. The sales ratio of enterprises grew year on year. In Q1, the added value of statistically large enterprises rose 16.4 percent year on year, a deceleration of 1.9 percentage points from the previous year; the sales ratio of industrial enterprises was 97.7 percent, 0.5 percentage points higher than during the same period of the last year; in the first two months, the profits of statistically large enterprises totaled 348.2 billion yuan, a growth of 16.5 percent year on year based on the 43.8 percent increase registered in the same period of the last year. According to the entrepreneurs' sentiment survey of over 5,000 industrial enterprises conducted by the People's Bank of China, the index of general business conditions was 29.6 percent, a decline of 0.8 percentage points from the same period of the last year.

3. Rapid CPI growth

The consumer price index remained high. In the first three months of 2008, the CPI grew 7.1 percent, 8.7 percent, and 8.3 percent respectively, with the monthly average being 8.0 percent and 5.3 percentage points higher than the average growth during the same period of the last year. Food prices were up 21.0 percent, pushing up the CPI by 6.8 percentage points or contributing 85 percent to the CPI inflation, becoming the major factor shoring up the CPI inflation; housing-related consumer prices were up 6.6 percent, pushing up the CPI by 1.0 percentage point or contributing 12.5 percent to the CPI inflation. Non-food prices went up by 1.6 percent in Q1, a margin larger than the 1.1 percent in 2007 (representing an acceleration of 0.1 percentage points from 2006). The soaring food prices in February were closely related to the Spring Festival and the snowstorms disaster that both occurred in that month. Snowstorms disrupted transportation and agricultural production and caused supply shortages, while the Spring Festival boosted demand. As a result, the prices of meat, poultry, eggs, edible oil, and fresh vegetables sharply increased. As demand weakened after the Spring Festival and the weather turned warm, food prices fell back modestly in March.

Box 4 Seasonal adjustments of the price index

Just as changes in seasons have a close relation with the people's production activities, economic activities in different seasons reveal different patterns, making monthly or quarterly data series incomparable to some extent or making direct comparison inappropriate. Thus, estimating a seasonally adjusted price index that can timely and accurately reflect price trends is important to improve the system to monitor price indicators. This will not only contribute to appropriate judgments about price trends and the carrying out of macro-adjustments but also will be beneficial to stabilizing and guiding inflation expectations.

Traditionally, we used year-on-year comparisons of data in our analysis, which reduced the effects of seasonal factors and improved the comparability of data. There are two shortcomings to this method. One is that the method for year-on-year comparisons means the use of old figures cannot reflect the new dynamics in the economy. The other is that this method does not exclude moving holidays and trading day factors such that comparability of the data is weakened. The moving holiday factor refers to changes in the time series due to the move in holidays during a year, in which case a holiday occurs every year but on a different date. In different years, the holiday occurs on different dates. In China, the Spring Festival is not only a good example but also the most important moving holiday. Trading day factors refer to changes in the time series data due to changes in the structure of weeks in a month. For example, assume that most people go shopping on Fridays, then there are more sales on Fridays than during any other day. Because March 2008 had four Fridays and March 2007 had five Fridays, the data for these two months are not completely comparable, i.e., the working of the trading day factor. Under the above assumption, sales in March 2007 will be higher than sales in March 2008.

Looking at the historical time series of China's CPI month-on-month movements, in each year, the month-on-month CPI in the first two months of the year and in September are the highest, while those in March and June are low. In addition, among the first two months, the month-on-month CPI of the Spring Festival month is higher. The above shows that month-on-month movements of the CPI have significant seasonal and Spring Festival effects. Thus it is necessary to make seasonal adjustments by excluding moving holidays, trading days, and other seasonal effects. Compared to the original data, a seasonally adjusted month-on-month CPI is more comparable and can reflect price trends in a timely and accurate fashion.

The seasonal adjustment can be divided into three stages, including setting up the models, making seasonal adjustments, and diagnosing. During the modeling stage, regression can be used to estimate the moving holiday and trading day effects, then deducting the seasonal effects from the original data and making forward and backward ARIMA to expand the ending data of the series before going to the next stage. In the adjustment stage, decomposing the time series into different elements, such as seasonal elements, irregular elements, and trend elements through repetitive horizontal (using data of consecutive months or quarters) and vertical smoothing (using monthly or quarterly data from the same time of different years), i.e., weighted averaging. In the diagnosing stage, multiple variables are devised to test the effects of the seasonal adjustment.

Comparing the seasonally adjusted CPI and the original CPI, one can find that the original month-on-month CPI shows a sizable fluctuation, making it difficult to find a trend; while in the adjusted CPI, the trend is very smooth and is on a slow upward path .

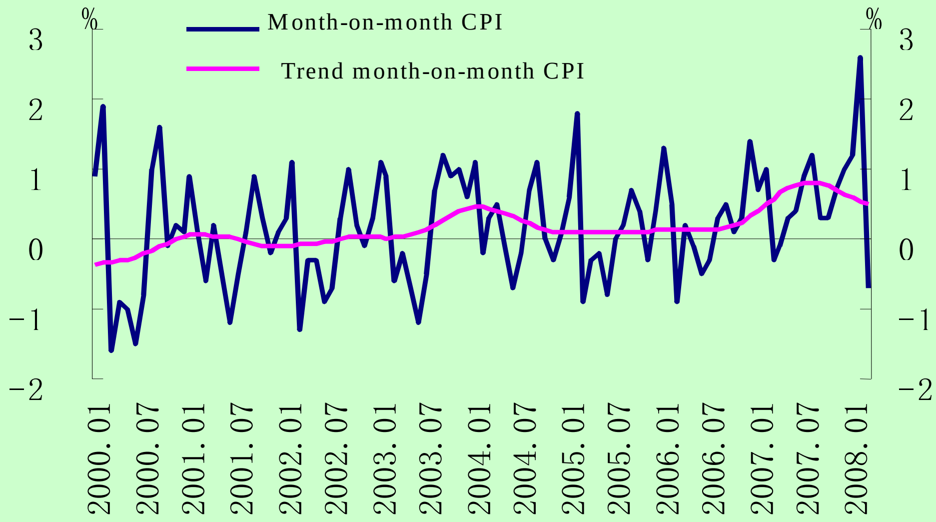

Figure 6 Month-on-month CPI and month-on-month CPI trend after seasonal adjustments

Source: National Bureau of Statistics, calculation by PBC staff.

A comparison of the annualized year-on-year CPI trend and the month-on-month CPI trend shows that the annualized month-on-month CPI trend changes ahead of that of the annualized year-on-year CPI trend, thus allowing prediction of present and future changes in the CPI in a timely and accurate way.

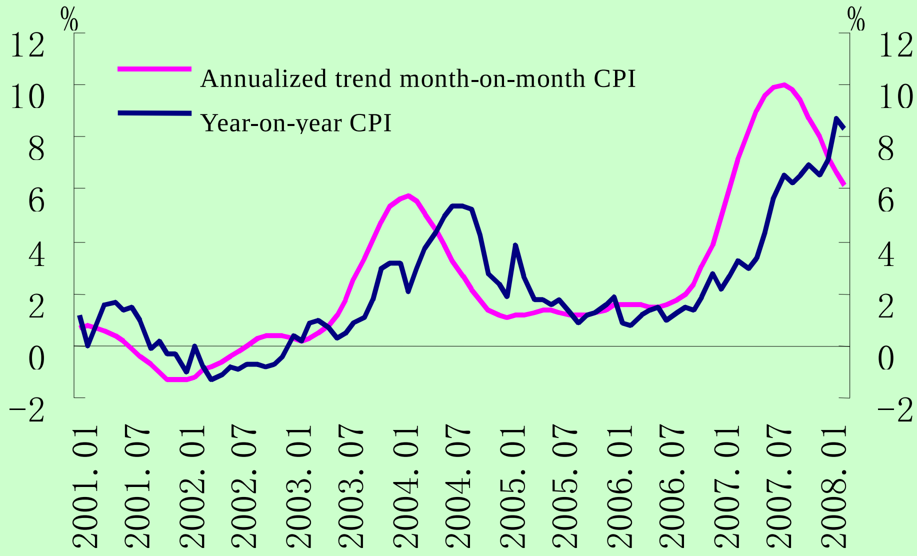

Figure 7 Year-on-year CPI and annualized month-on-month CPI trend

Source: National Bureau of Statistics, calculation by PBC staff

International bulk commodity prices rose sharply. In Q1, due to a lower inventory, supply tensions, a weak dollar, speculation, and other factors, bulk commodities including crude oil and raw materials experienced continued hikes. A end-March, crude oil future prices and spot prices closed at US$101.58 and US$100.92 respectively on the New York Commodity Exchange; copper and aluminum prices rose 27.81 percent and 24.08 percent respectively in Q1 on the London Metal Exchange. As China became further integrated into the global economy, the higher bulk commodity prices in the world market intensified pressures of imported inflation.

The growth of import and export prices was rapid, with import prices rising faster than export prices. In the first three months, import prices were up 14.8 percent, 18.1 percent, and 17.6 percent respectively, averaging 16.8 percent and representing an acceleration of 12 percentage points from the same period of the last year; import prices were up 6.5 percent, 11.9 percent, and 9 percent, averaging 9.1 percent and representing an acceleration of 3.8 percentage points from the previous year.

Due to the accelerating price hikes of coal, crude oil, and steel, the prices of industrial goods rose even more rapidly. In Q1, the growth of raw material, fuel, and power prices and producer prices of industrial goods accelerated month by month, by 9.8 percent and 6.9 percent respectively, representing an acceleration of 5.7 percentage points and 4.0 percentage points from the previous year. The producer prices of agricultural products surged 25.5 percent year on year, with the prices of grain and animal husbandry products up 11.4 percent and 44.9 percent respectively. The prices of agricultural capital goods increased 17.5 percent year on year, representing an acceleration of 13.3 percent. The large hike in agricultural capital goods such as seeds, piglets, fertilizer, pesticides, and diesel oil was associated with the rising costs of production, the greater willingness of farmers to engage in farming activities, and the subsequent stronger demand for agricultural capital goods. It is noteworthy that more expensive agricultural capital goods will depress the farmers' profit margins and reduce their willingness to engage in farming activities.

Labor compensation rose quickly. In Q1, the average salary of urban employees was 6,524 yuan, up 18.3 percent year on year. In particular, the average salary in state-owned entities was 6,960 yuan, up 17.7 percent; the average salary in collective-owned entities was 3,902 yuan, up 20.0 percent; the average salary in other types of entities was 6,328 yuan, up 19.0 percent. According to a sample survey, the average per capita salary income of farmers was 608 yuan, up 16.9 percent.

The GDP deflator moved up sharply year on year. The GDP in Q1 posted 6.1 trillion yuan, representing real growth of 10.6 percent. The GDP deflator (nominal GDP growth minus real GDP growth) was 8.2 percent, up 3.5 percentage points year on year. As the GDP deflator reflects changes in general prices, it is necessary to pay adequate attention to its movement since it has been increasing since Q2 2007.

The pricing reform of resource goods continued. In January 2008, the State Council *Circular on Promoting Economizing and Intensive Land Use* was issued to collect the additional income from the land price hikes from the holders of idle land; the resource tax system will be further reformed to move from a unit tax to an ad valorem tax and to impose an energy tax on more resource items. Although the resource price reform will face some pressures during the rapid CPI growth, the reform will enable prices to play a critical role in allocating resource goods and will reflect the scarcity of resources and market demand and supply, thus encouraging the rational development and utilization of resources and promoting transformation of the economic development pattern. Therefore, in the future, it is necessary to properly handle the relationship between inflation control and the reform of resource prices, and prudently promote the resource price reform while fully considering the affordability of the various parties in the society.

4. Fiscal revenue grew rapidly and the expenditure structure further improved

In Q1, total fiscal revenues (excluding debt income) reached 1597.13 billion yuan, up 33.5 percent year on year and representing an acceleration of 8.8 percentage points from the same period of the last year; fiscal expenditures totaled 950.67 billion yuan, up 30.4 percent year on year and representing an acceleration of 14.6 percentage points. As a result, revenue exceeded income by 646.46 billion yuan, representing a large increase of 196.98 billion yuan from the same period of the last year.

Tax revenue maintained rapid growth, including all kinds of tax revenue. The combined domestic value added tax, domestic consumption tax, and business tax revenue posted 754.1 billion yuan, up 25.2 percent year on year, representing a growth of 151.6 billion yuan from the same period of the last year and accounting for 39.7 percent in the total tax revenue gain; the corporate income tax and individual income tax revenue totaled 381.4 billion yuan, up 34.5 percent year on year, representing a growth of 97.8 billion yuan from the same period of the last year and accounting for 25.6 percent in the total gain in tax revenue. In terms of fiscal expenditures, agricultural, social security, and social undertaking expenditures increased by a large margin. In Q1, expenditures for agriculture, forestry, and water conservancy, for social security and employment, for education, for medical services and public health, and for environmental protection grew 37.7 percent, 30.9 percent, 24.4 percent, 40.6 percent, and 54.3 percent respectively year on year.

5. Balance of payments

The balance of payments account continued to have a large surplus, and official foreign exchange reserves increased rapidly. In Q1, the actual utilization of foreign direct investment totaled US$27.4 billion, up 61.3 percent year on year and representing an acceleration of 49.7 percentage points from the previous year. At end-March 2008, official foreign exchange posted US$1682.2 billion, representing a growth of US$153.9 billion from the end of 2007 or US$18.2 billion more than the gain in the corresponding period of the last year.

The external debt grew modestly. At end-2007, the outstanding external debt totaled US$373.6 billion, representing a growth of 15.7 percent from end-2006 and an acceleration of 0.8 percentage points. In particular, the outstanding registered external debt increased 9.8 percent from end-2007 to US$240.5 billion and the short-term external debt increased 19.9 percent from end-2007 to US$220.1 billion. The two items accounted for 58.9 percent of the total external debt, 2.1 percentage points more than that at end-2006.

Box 5 Analysis of Foreign Exchange Receipts and Expenses

In recent years, the balance of payments has had a large surplus, and foreign reserves have continued to grow rapidly. In the first quarter of 2008, there was a large volume of net foreign exchange inflows mainly due to the sound domestic economic fundamentals, large trade surplus, and continuous inflow of FDI. In addition, China is likely to become a "safe haven" for international capital against the backdrop of the deteriorating sub-prime crisis and international market turmoil. In general, foreign exchange flows through legitimate channels under conditions of the full convertibility of the current account and partial convertibility of the capital account, thus they are the result of enterprises and individuals making choices in their own interests in anticipation of a RMB appreciation. Profit-seeking foreign exchange inflows mainly take place through the following legitimate channels: first, trade in goods. Due to the high degree of trade facilitation, large volume of remittable funds, and no requirement for complete matches between funds and goods in timing, trade in goods has become a major channel for capital inflows. The second channel is direct sales of the "difference between investment and registered capital" under FDI. The prevailing foreign investment policies make it easy to convert the capital of foreign-invested companies and foreign debt into renminbi. The third channel is foreign exchange surrender by individuals. Foreign exchange for family support is sold to banks by individuals under the current transfer of the balance of payments. The fourth channel is through overseas equity financing by enterprises and individuals. After going public and raising funds in overseas stock markets, mainly the Hong Kong market, Chinese companies remit the proceeds back to China and surrender them to banks. In 2007, a total of 23.632 billion dollars of equity proceeds were surrendered mainly by non-financial institutions, including real estate development companies that are registered in China but listed in overseas markets. Moreover, in recent years, in order to avoid foreign exchange risks, commercial banks converted many of their own IPO proceeds from overseas markets into renminbi. The fifth channel is through trade in services. Trade in services belongs to intangible trade, another channel often used by profit-seeking capital. The Qualified Foreign Institutional Investors (QFIIs) scheme offers a sixth legitimate channel. The seventh channel is trading of gold, copper futures, and other commodities for hedging purposes.

To deal with the large volume of foreign exchange inflows, the reform of the foreign exchange administrative system has been carried forward, centering on the objective of promoting an equilibrium in the balance of payments, while measures have been taken to orderly broaden the channels for cross-border capital outflows and to facilitate the acquisition and use of foreign currencies by institutions and individuals. Management of foreign exchange inflows and surrender was strengthened by adopting categorized management of the receipt and surrender of foreign exchange from trading activities, restraining foreign capital inflows into the real estate market, reducing the short-term foreign debt quota in a phased manner, tightening management of the capital account and individuals' foreign exchange surrender, and examining foreign exchange capital inflows and surrender. All of the above measures helped rein in the excess foreign exchange inflows to some degree.

Going forward, given the uncertainties in global economic prospects, the positive interest rate spread between China and the U.S., and increasing arbitrage opportunities for international capital, more short-term capital might flow into China, making it more difficult to implement a tight monetary policy. In order to support the macroeconomic adjustment measures and provide a time window for domestic economic restructuring and improvements in the RMB exchange rate formation mechanism, it is necessary to strengthen the management of foreign exchange inflows and rein in the inflows of arbitrage-seeking capital.

Addressing the voluminous foreign exchange inflows should be seen within the framework of promoting an equilibrium of the balance of payments and begin by addressing the domestic economic imbalances. Efforts should be made to tackle both the symptoms and root causes by employing various methods, and pushing ahead with the reforms of priority areas. On the one hand, a framework that allows capital to flow in both directions should be established. Balanced management should be adhered to, appropriately strengthening management of capital inflows and foreign exchange surrender while steadily promoting the convertibility of the RMB capital account and broadening the channels for capital outflows. Foreign exchange-related services should be improved to liberalize and facilitate trade and investment. On the other hand, the RMB exchange rate and other policies should be weighed and selected with a view to enhancing the overall welfare of the people and establishing a long-term stable economic system. The managed floating exchange rate regime should be improved in a self-initiated, controllable, and gradual manner so as to enhance RMB exchange rate flexibility and to put the role of the exchange rate and other price instruments into a full play. Efforts will be made to shift the economic development pattern and trade growth pattern, to accelerate restructuring, to make domestic demand a stronger driver for economic growth, to optimize the import and export mix, and to improve the quality of foreign capital utilization.

6. Industrial analysis

In the first quarter, most industries witnessed a sharp improvement of profit gains. In January and February, driven by rising coal prices, among the 12 major industries the profit margin of the coal industry rose 66.8 percent; in pharmaceuticals, building materials, machinery, metallurgy, electronics sectors and light industry the gain in the profit margin was between 36.1-50.1 percent. Export growth of textiles, light industry, and other labor-intensive sectors slowed down and their profit margins remained stable. In January and February, the profit gains of the textile industry and light industry grew 14.2 and 36.1 percent. The production growth of the major highly energy-consuming sectors and products decelerated noticeably. In the first quarter, the output of raw steel and electrolytic aluminum grew 8.6 and 7.9 percent respectively, a deceleration of 13.7 and 28.7 percentage points respectively; the production growth of calcium carbide, ferrous alloy, cement and flat-panel glass decelerated to varying degrees. Coal, electricity, oil, and transportation registered rapid growth. In the first quarter, the output of crude coal and oil posted 569 million and 46.85 million tons respectively and electricity generation was 805.1 billion kilowatts, up 14.6, 2.2, and 14 percent respectively. Freight transportation increased 10.6 percent year on year to 5.53 billion tons.

(1) The real estate sector

In the first quarter, investment in real estate development increased rapidly and the development structure improved, with the area of sold commercial housing dropping modestly year on year. Sales prices rose rapidly but at a decelerated pace. Growth of commercial real estate loans slowed down.

Investment in real estate development grew rapidly and the development structure improved. In the first quarter, completed investment in real estate development registered 468.8 billion yuan, up 32.3 percent year on year, an acceleration of 5.4 percentage points over the same period of the last year and 6.4 percentage points higher than the growth of fixed-asset investment during the same period. Broken down, investment in commercial housing reached 331.65 billion yuan, representing a year-on-year increase of 34.7 percent and accounting for 70.7 percent of the total investment in development; investment in residential housing units with floor plans of less than 90 square meters was 75.85 billion yuan, up 91.5 percent year on year, accounting for 16.2 percent of the total and an acceleration of 5 percentage points over the same period of the last year. With the implementation of a series of real estate macroeconomic adjustment policies, more small- and medium-sized housing units and units at affordable prices became available. This will ease the structural supply problem in the housing market to some extent.

Demand for housing remained stable. The areas of sold commercial housing dropped slightly year on year. In the first quarter, 104 million square meters of commercial housing were sold, representing a decline of 1.4 percent. The sales revenue of commercial housing stood at 411.1 billion yuan, up 1.5 percent. The areas of new construction projects and completed construction projects grew rapidly, posting 240 million square meters and 78.559 million square meters respectively, up 25.9 percent and 26.9 percent respectively. The areas of commercial real estate vacancies further declined. At end-March, the area of commercial real estate vacancies was 121 million square meters, representing a decrease of 3.9 percent. Among this total, residential housing vacancies declined 10.6 percent to 61.7 million square meters.

Home sales prices continued to surge but moderated. In the first quarter, home sales prices in 70 big and medium-sized cities rose by 11 percent year on year, an acceleration of 5.4 percentage points from that during the same period of the previous year. The month-on-month increase in January, February, and March registered 0.3, 0.2, and 0.3 percent respectively, lower than the average monthly increase of 1 percent in the same period of 2007. In March, home sales prices in 10 cities experienced a month-on-month decline. In the first quarter, the sales prices of new homes and pre-owned homes, land prices, and home rentals in 70 big and medium-sized cities increased by 11.8, 11.5, 16.5, and 2.1 percent respectively year on year. In the first quarter, the increase in home sales prices in Urumqi (24.5 percent), Bengbu (14.8 percent), Ningbo (14.6 percent), Nanning (14.5 percent), Beijing (13.9 percent), and Hangzhou (13.7 percent) were among the biggest across China, whereas cities where home sales prices had surged—such as Shenzhen—saw prices fall back slightly.

Commercial real estate loans grew at a moderate pace. Outstanding commercial real estate loans and home purchase loans decelerated from end-December 2007, hitting 25.7 and 29.8 percent at end-March 2008 from 30.6 and 33.6 percent respectively at end-December 2007. As of end-March 2008, national outstanding commercial real estate loans posted 5.01 trillion yuan, representing year-on-year growth of 25.7 percent. Among this total, outstanding real estate development loans and home purchase loans stood at 1.8 trillion and 3.1 trillion yuan, a growth of 19.1 and 29.8 percent respectively.

(2) The oil industry

Crude oil prices in the international market hit several new highs since 2007, breaking 120 dollars per barrel in the first ten days in May after hitting 110 dollars in March

2008. China is a net oil exporter, so the price surge further intensified domestic inflationary pressures, highlighting the distortion in the prices of oil products and the crude oil price in the domestic market and increasing the cost pressures on downstream petrochemical industries.

With the rapid development of the manufacturing industry and surging demand for household energy, the demand for oil jumped substantially, increasing the demand for imported oil. In 2007, crude oil production in China registered 187 million tons, consumption was 327 million tons, and imported crude oil totaled 163 million tons, accounting for 49.8 percent of domestic consumption. Since the first quarter, influenced by a combination of factors such as social development, spring farming, and oil hoarding by a small number of market players, oil products, diesel in particular, were in short supply in some regions. The oil crunch was eased at end-March through improved allocation of resources, informational guidance, and other measures to guarantee an oil supply to priority sectors and regions.

The soaring price of crude oil increased inflationary pressures in China. In recent years, the domestic crude oil price has been linked to the international market, with the crude oil price of the Daqing and Shengli oil fields highly aligned with the Minas and Brent prices. Domestic crude oil prices rose substantially as the international oil price frequently broke record highs. In the first three months, the monthly average crude oil price of the Daqing oil field stood at 92.0, 95.9, and 102.2 dollars per barrel.

There is much room for price increases of oil products. Given the price controls on oil products, the continuous price hikes of international crude oil worsen the price distortions between oil products and crude oil. Take petrol as an example. In March, the EXW price of petrol was 5480 yuan/ton, and only 4400 yuan/ton excluding the VAT and excise tax, but the crude oil price of the Daqing oil field was 5250 yuan/ton. At the same time, the prices of oil products were much lower than those in the international market. In March, No. 93 petrol was priced at 7000 yuan/ton, about 1500 yuan lower than the international price.

Due to the price mechanism and other factors, the profit gains of upstream industries improved, but downstream industries saw smaller profit margins. In particular, the refinery industry suffered more losses. Chinese petrochemical enterprises that are highly dependent on imports are feeling the pressures of the increasing costs. In January and February, the oil and natural gas exploration industry made a profit of 78.8 billion yuan, an increase of 61.2 percent year on year. The refinery industry suffered a loss of 23.9 billion yuan, in contrast to a profit of 15.6 billion yuan during the same period of the last year.

The price reform of oil and other resource products should be promoted against the backdrop of the large gap between oil product prices in the domestic and international markets and the distortion between crude oil prices and the prices of oil products in the domestic market. The slow adjustment of domestic oil prices, to some extent, encourages the consumption of artificially low-priced oil products, hence it is detrimental to the economic restructuring and impedes the transmission of an energy-saving mechanism. Given the denomination of oil prices in US dollars and the US dollar’s downward trend, the improved RMB exchange rate flexibility can help reduce the crude oil price denominated in renminbi and increase the oil product prices denominated in foreign currencies, hence easing the above-mentioned price distortion and bridging the gap between the prices of domestic and international oil products. At the same time, efforts should be made to carry forward the reform of the prices of oil and other resources, streamline the price formation mechanism for resources, and gradually make the prices of resources truly reflect the scarcity, supply, and demand and the environmental costs. This is very important for promoting resources conservation and environmental protection, and for curbing excess investment and export growth.

Part 5 Monetary Policy Stance to Be Adopted in the Next Period

I. Outlook for the Chinese economy

Since the beginning of 2008, affected by the weakening external demand and the sleet and snow disaster in southern China, economic growth slowed from its elevated path, completely maintaining a stable and strong momentum. Despite uncertainties in the global economy and their potential impact on the Chinese economy, the combined forces of industrialization, urbanization, globalization, and the structural upgrading of industrial production and consumption still provide strong support for relatively fast economic growth.

Investment will continue to grow relatively rapidly. Domestic demand, contained by weaker growth of external demand, may have an impact on investment. But generally the fundamentals supporting relatively rapid investment growth have not completely changed, and industrial upgrading, balanced regional growth, an improved housing supply, intensified efforts in energy saving and pollution reduction, and rebuilding efforts in the aftermath of the sleet and snow disaster are all creating investment demand. Furthermore, the expansion of on-going projects, high investment enthusiasm in different regions, and the improved profitability of enterprises and financial institutions all point to the potential risks of self-reinforcing expansion between investment and financing activities. The first quarter banking survey and business survey showed that the demand for loans index presented a strong rebound and reached its second highest level since the surveys began, the highest among all Q1 surveys. The demand for corporate borrowing bounced back greatly, and the expectation index for domestic orders for the next quarter in the business survey rose substantially to a record high, indicating to some extent that market demand is relatively stable and investment demand remains strong.

Consumption demand will maintain a steady and upward trend. In recent years, the share of consumption in economic growth has been on the rise due to accelerated structural adjustments and higher household income and propensity to consume. The urban household survey showed that the percentage of households that reported an income increase, though falling from the same period of the last year, still reached the second highest level since the survey began, and household income grew relatively rapidly. In the future, more policies to promote consumption and improve living conditions will be adopted and implemented. These policies, combined with the improved consumption environment, will stimulate a desire for household consumption. At the current stage, the potential influence of a price hike on consumer behavior should be monitored to maintain stable growth in consumption demand.

The trade surplus will remain large. External demand is expected to weaken as a result of the sub-prime mortgage crisis and the weaker global economy; the effects of the export tax rebate, the processing trade policy adjustment, and the improved RMB flexibility are gradually unfolding. The PBC business survey showed that in the first quarter of 2008 the export order index declined further to hit its lowest level in the recent two years. However, in the short run, the weakening external demand has not had an obvious impact on foreign trade. The emerging market economies are still fairly dynamic and trade diversification will alleviate the impact on trade due to a slowdown in certain regions. The PBC business survey showed that though declining somewhat from the same period of the last year, the export order index went up markedly quarter on quarter. In sum, although the growth of China's trade surplus may moderate somewhat, until the structural problems in the global division of labor and high domestic savings rate can be drastically changed, the trade surplus will remain at a significantly high level.

Inflation pressures will remain. There are some favorable factors for curbing inflation in the current stage. First, the government has placed price hike controls and reining in inflation high on its agenda. The tight monetary policy has produced results and the macroeconomic adjustment policies will gradually show their effects. Second, the state has increased fiscal inputs in agriculture to improve production conditions. This will promote agricultural production and increase the supply of farm products. Third, the oversupply of most manufactured goods cannot be reversed within a short period of time. Fourth, given the fact that energy and primary commodities in the global market are mainly priced in dollar terms and given the uncertainties in the trend of the dollar, a reversal of the depreciation of the dollar will help slow down the price hike for primary goods. However, due to a combination of factors, domestic prices will remain at a high level for some time going forward. First, food price increases may continue to push up the CPI. Second, necessary adjustments of resource prices and rising labor costs will constitute an upward pressure. Third, the pressure of an investment rebound and money and credit expansion will persist due to strong investment enthusiasm in different regions, likely pushing up the prices of production materials. Fourth, given the weak US dollar, speculative activities, and other factors, commodity prices will remain at a high level and create a risk of imported inflation. Fifth, inflation expectations will be unstable and are likely to translate into higher inflation.

In sum, the national economy will develop in the direction intended by the macroeconomic management, but it is still facing acute problems of high price levels, a variety of factors constraining agricultural production and income generation for farmers, persistent pressures of rebounds in fixed-asset investment, and a grave situation in terms of saving energy and reducing pollution. A relatively large BOP surplus and excess liquidity means the moderate money and credit growth is not yet solidly based. According to preliminary predictions, in the first half of 2008, with the changes in the international economic environment and the unfolding effects of the domestic macroeconomic adjustment measures, economic growth is likely to slow down modestly, the CPI will remain high, and the price trends should be closely watched.

II. Monetary policy stance in the next stage

The PBC will follow the overall arrangements of the CPC and the State Council, placing higher priority on its agenda to contain price rises and curb inflation, implementing a tight monetary policy, increasing the predictability and effectiveness of the adjustment policy, using a mix of monetary policy instruments, restraining the rapid growth of money and credit, guiding expectations, properly handling the pace, priorities, and intensity of the adjustment in a scientific manner based on the changing domestic and external environment, and adopting fine-tuning measures when appropriate, in order to create a sound monetary and financial environment for economic growth and structural adjustments.

First, the PBC will continue to strengthen liquidity management and guide an appropriate supply of money and credit. Efforts will be made to use policy tools such as open market operations and the reserve requirement ratio to absorb the liquidity in the banking system and to restrain the lending expansion of financial institutions. The combination of tools and the manner they are applied will be in accordance with the need for macro-adjustments to ensure the efficiency of all policy measures.

Second, the PBC will use appropriate pricing tools. Based on the development of the domestic and external economic and financial situations, the PBC will apply interest rate instruments discreetly and allow them to play a role in curbing demand expansion and in stabilizing inflation expectations. At the same time, measures will be taken to carry forward the interest rate reform, promote the development of the money-market benchmark rate system, and guide financial institutions to improve their interest rate pricing ability. The RMB exchange rate formation mechanism will be improved in a self-initiated, controllable, and gradual manner so as to allow market supply and demand to play a greater role, to enhance the exchange rate flexibility, and to bring into play the role of the exchange rate to optimize resource allocations and to rein in price rises.

Third, the PBC will strengthen window guidance and credit policy guidance. It will guide financial institutions to issue loans in an appropriate and balanced manner and to prevent drastic fluctuations. Efforts will be made to optimize the credit structure, to encourage growth in some sectors while discouraging growth in other sectors, to limit lending to high energy-consuming and high polluting industries and to industries with an overcapacity and to low-quality enterprises, to strengthen credit support to agriculture, to improve rural financial services, and to render greater credit support to structural adjustments and to such fields as the services sector, small and medium-sized enterprises, independent innovation, and energy saving and environmental protection. Real estate financial services will be improved to ensure the healthy development of the real estate sector. The PBC will also guide financial institutions to explore fee-based businesses, financial innovations, and new income-generating businesses.

Fourth, the PBC will adopt comprehensive measures to bring an equilibrium in the balance of payments. Efforts will be made to improve the RMB exchange rate formation mechanism, to foster the development of the foreign exchange market, and to encourage financial institutions to design better-targeted exchange rate risk management products for enterprises. The foreign exchange administrative reform will be deepened to guide capital flows in a balanced manner, to speed up "going global," and to improve the outward investment system featuring multiple players and multiple layers. Monitoring of cross-border capital flows will be reinforced.

Fifth, the PBC will devote great efforts to promoting direct financing. Efforts will be made to deepen the reform of financial enterprise and to encourage financial innovation so as to improve the competitiveness of financial institutions and the efficiency of the financial market in resource allocation, to develop a multi-layered direct financing system so as to better meet the financing needs of the market, especially those of small and medium-sized enterprises. Construction of a financial market infrastructure will be strengthened to promote balanced development among the money, capital, and insurance markets.

It is noteworthy that the above sterilization and credit policy measures cannot tackle the root cause of the excess liquidity and structural problems in the economy; instead, they are mainly aimed at creating a stable monetary and financial environment for economic growth and structural adjustments. Efforts will be made to deepen the structural reforms and to make substantial progress and breakthroughs in achieving balanced growth. Due to the impact of the U.S. sub-prime mortgage crisis, external demand has slowed down. It is necessary to expand domestic demand, consumer demand in particular, to accelerate the development of the services sector and to build up the capacity of the economy to resist external shocks. During the next stage, fiscal and taxation policies will be adjusted to create a more favorable environment for expanding consumer demand and for promoting development of the services sector, to speed up social security and other reforms, and to eliminate institutional factors that hinder the structural adjustments.