China Monetary Policy Report

Quarter One, 2010

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

The Chinese economy performed well in the first quarter of 2010 as the economic upturn solidified. Domestic demand expanded rapidly, the foreign trade recovery accelerated, industrial output rebounded rapidly, consumption grew at a fast pace, growth of fixed-asset investment moderated, and the overall price level remained basically stable. In the first quarter, the Gross Domestic Product (GDP) registered 8.06 trillion yuan, representing year-on-year growth of 11.9 percent, and the Consumer Price Index (CPI) picked up 2.2 percent year on year.

In line with the overall arrangements of the State Council, the People's Bank of China (PBC) continued the relatively easy monetary policy during the first quarter. While maintaining policy consistency and stability, the PBC implemented policies better targeted and more flexible to respond to new developments, contributing to the sound and stable performance of the financial system. It deployed a wide range of measures to strengthen liquidity management in the banking system and to guide financial institutions to properly manage the aggregate, pace, and structure of credit provision so as to support stable and healthy economic development. On the basis of these effective measures, money and credit growth are returning to their normal speed, and the performance of financial markets remains stable.

Broad money supply M2 recorded 56.0 trillion yuan at end-March, up 22.5 percent from the same period of last year, a deceleration of 3.0 percentage points. Narrow money supply M1 stood at 22.9 trillion yuan, up 29.9 percent from the first quarter in 2009, an acceleration of 12.9 percentage points. Deposits at financial institutions grew at a slower pace, with RMB and foreign currency deposits at financial institutions growing by 21.7 percent at end-March, which is 4.0 percentage points lower year on year. Growth of lending by financial institutions moderated, with medium- and long-term loans accounting for a larger share. At end-March, RMB loans had grown 21.8 percent year on year, down 8.0 percentage points, or an increase by 2.6 trillion yuan from the beginning of 2010, representing a deceleration of 2.0 trillion yuan. Lending rates offered by financial institutions went up slightly, with the weighted average lending rate for non-financial enterprises and other sectors standing at 5.51 percent in March, up 0.26 percentage points from the beginning of the year. The RMB exchange rate remained basically stable at an adaptive and equilibrium level. The central parity of the RMB against the US dollar posted 6.8263 yuan per dollar at end-March.

The Chinese economy is supported by a host of favorable elements, including an overall recovery in the global economy, a stronger momentum for economic improvements at home, new growth drivers brought about by urbanization and the upgrading of the consumption structure, as well as nationwide enthusiasm to boost development, all of which point to ample space for stronger growth. However, it should be noted that the economy faces a rather complex environment. Uncertainties about global economic performance persist as the European sovereign debt problem unfolds and new sources of global growth remain unclear. In the domestic economy, the recovery of domestic demand needs to be established on a more balanced foundation, while expanding consumption, improving income distribution, and optimizing the economic structure remain daunting tasks. The potential risks in public finance must not be overlooked. And as a growing number of factors that will push up the price level emerge, inflationary expectations are on the rise. It is important to take actions to support the current sound and relatively rapid development momentum while creating favorable conditions for development over the long term. It is also important to accelerate the transformation of the pattern of economic development.

During the next stage, the PBC will continue to follow the scientific outlook on development and implement the relatively easy monetary policy in line with the overall arrangements of the State Council. It will properly manage the intensity, pace, and focus of policies and make policies better targeted and more flexible while also maintaining policy consistency and stability. It will strike a balance between supporting sound and relatively rapid development, restructuring the economy and managing inflationary expectations, strengthening the sustainability of financial support to economic development, and ensuring that the financial system performs in a sound manner. The PBC will enhance liquidity management to maintain proper growth of money and credit. It will step up financial support to the shift in the development pattern and the economic restructuring. Moreover, the PBC will advance the market-based interest rate reform and improve the RMB exchange rate regime to promote healthy development of financial markets.

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Part 1 Monetary and Credit Performance

In the first quarter of 2010, the momentum for an economic upturn in China was enhanced, with sound financial performance, sufficient liquidity in the banking system, and money and credit growth gradually returning to their normal levels.

I. Growth of money supply fell from high levels

At end-March, the outstanding balance of broad money M2 grew 22.5 percent year on year to 65.0 trillion yuan, a deceleration of 3.0 and 5.2 percentage points from the same period of 2009 and end-2009 respectively. The outstanding balance of narrow money M1 reached 22.9 trillion yuan, an increase of 29.9 percent year on year, representing an acceleration of 12.9 percentage points from the first quarter of 2009 and a deceleration of 2.4 percentage points from end-2009. Cash in circulation M0 grew 15.8 percent year on year to 3.9 trillion yuan, up 4.9 percentage points from the growth in the first quarter of 2009. Net cash injections in Q1 of 2010 totaled 84.3 billion yuan, 130.7 billion yuan more than that recorded in the first quarter of 2009.

In general, money aggregates still remained at high levels, but they were growing at a decelerated pace. In particular, the growth of M2 continued to decline for four consecutive months, which was due not only to the high base growth recorded the previous year, but also due to monetary policy that was conducted in a targeted and flexible manner since the beginning of 2010. Liquidity remained abundant, with a higher growth of M1 compared to that of M2 since September 2009.

II. Growth of deposits of financial institutions slowed down

At end-March, the outstanding balance of deposits of all financial institutions (throughout this Report, “all financial institutions” includes also foreign-funded financial institutions) denominated in both RMB and foreign currencies increased 21.7 percent year on year to 65.3 trillion yuan, 4.0 percentage points lower than the growth in the same period of 2009, representing an increase of 4.1 trillion yuan from the beginning of the year and a deceleration of 1.6 trillion yuan year on year. In particular, the outstanding balance of RMB deposits rose 22.1 percent year on year to 63.8 trillion yuan, 3.6 percentage points lower than the growth during the same period of 2009, representing an increase of 4.0 trillion yuan from the beginning of the year and a deceleration of 1.6 trillion yuan year on year. Outstanding foreign currency deposits rose 6.5 percent to US$213.4 billion, an increase of US$4.7 billion from the beginning of the year and a deceleration of US$2.8 billion year on year.

Broken down by sectors and maturities, the growth of household deposits and non-financial corporate deposits decelerated, with demand deposits accounting for a larger share. At end-March, the outstanding balance of household RMB deposits had gown 15.1 percent to 28.5 trillion yuan, 14.7 percentage points lower than the growth during the first quarter of 2009, representing growth of 2.0 trillion yuan from the beginning of 2009 and a deceleration of 536.1 billion yuan year on year. The outstanding balance of non-financial corporate RMB deposits stood at 26.5 trillion yuan, an increase of 26.6 percent year on year, 1.2 percentage points lower than the growth during the same period of 2009, representing an increase of 1.3 trillion yuan from the beginning of the year and a deceleration of 1.5 trillion yuan year on year. In the first quarter, the proportion of demand deposits among new household deposits and non-financial corporate deposits registered 42 and 43 percent, up 10 and 8 percentage points respectively from the previous year, indicating a stronger willingness of households to invest and more dynamic operations by enterprises. By end-March，the outstanding balance of fiscal deposits had increased 45.3 percent year on year to 2.5 trillion yuan, growth of 252.4 billion yuan from the beginning of the year and an acceleration of 340.5 billion yuan from that registered at end-March 2009.

III. Loans issued by financial institutions decelerated at a steady pace

At end-March, the outstanding balance of loans issued by all financial institutions in both RMB and foreign currencies stood at 45.4 trillion yuan, representing year-on-year growth of 24.1 percent, 2.9 and 8.9 percentage points lower than the growth during the same period of 2009 and end-2009 respectively, and representing an increase of 2.8 trillion yuan from the beginning of the year or a deceleration of 1.7 trillion yuan year on year.

Broken down by sectors and maturities, the growth of household loans accelerated, with medium- and long-term loans accounting for a large share. At end-March, the outstanding balance of RMB loans had grown 21.8 percent year on year to 42.6 trillion yuan, 8.0 percentage points lower than the growth during the same period of 2009, representing an increase of 2.6 trillion yuan from the beginning of the year and a deceleration of 2.0 trillion yuan year on year. Broken down by institutions, loans extended by large national banks, small and medium-sized national banks, and small and medium-sized regional banks decelerated on a year-on-year basis. In terms of loan destinations, household loans posted relatively rapid growth, whereas lending to non-financial institutions and other sectors decelerated notably. By end-March, the outstanding balance of household loans had grown 51.5 percent year on year, representing an increase of 920.2 billion yuan from the beginning of the year and an acceleration of 497.9 billion yuan year on year. In particular, housing mortgage loans for individuals grew rapidly and saw an increase of 482.5 billion yuan from the beginning of the year, accounting for 52.4 percent of household loans. The outstanding balance of loans issued to non-financial institutions and other sectors had grown 15.4 percent year on year, an increase of 1.7 trillion yuan from the beginning of the year or a deceleration of 2.5 trillion yuan year on year. In particular, medium- and long-term loans had grown 1.8 trillion yuan from the beginning of the year, and had accelerated by 104.2 billion yuan year on year. Paper financing had decreased by 624.3 billion yuan from the beginning of 2010, a deceleration of 2.1 trillion yuan year on year, and was still on a declining trend since the second half of 2009, which mainly was due to the intensified asset restructuring in financial institutions.

Table 1: RMB loans of financial institutions in the first quarter of 2010

Unit: 100 million yuan

	Q1 of 2010	
	New loans	Acceleration year on year
Large national banks①	13777	−14649
Small and medium-sized national banks②	6253	−5856
Small and medium-sized regional banks③	1691	−590
Rural cooperative financial institutions④	4763	538
Foreign-funded financial institutions	511	775

Note: ① Large national banks refer to banks with total assets denominated in both RMB and foreign currencies exceeding 2 trillion yuan (based on statistics at end-2008).

② Small and medium-sized national banks refer to banks with total assets, denominated in both RMB and foreign currencies, less than 2 trillion yuan and operating across provinces.

③ Small and medium-sized regional banks refer to banks with total assets denominated in both RMB and foreign currencies, less than 2 trillion yuan and not operating across provinces.

④ Rural cooperative financial institutions include rural cooperative banks, rural commercial banks, and rural credit cooperatives.

Source: The People's Bank of China.

Financial institutions further strengthened their credit support to small and medium-sized enterprises (SMEs). In the first quarter, lending to SMEs by banking institutions increased by 1.2 trillion yuan, or 22.9 percent year on year, 5.5 percentage points more than the year-on-year growth of loans to large enterprises. In particular, lending to small enterprises grew 445.5 billion yuan in the first quarter, or 23.9 percent year on year.

Foreign exchange loans continued to play a significant role in supporting foreign trade and the "going global" strategy. By end-March, the outstanding balance of foreign exchange loans had grown 74 percent year on year to US$408.7 billion, representing an increase of US$29.2 billion from the beginning of the year or an acceleration of US$37.7 billion year on year. In terms of loan destinations, foreign trade financing had increased by US$17 billion, an acceleration of US$18.55 billion yuan year on year; overseas loans issued to support the "going global" strategy of enterprises and medium- and long-term loans increased by US$7.84 billion, an acceleration of

US$6.51 billion year on year.

Box 1 Analysis of Medium- and Long-term Loans

Since the beginning of 2010, medium- and long-term loans of financial institutions continued to grow at a rapid pace. According to statistics, at end-March outstanding medium- and long-term loans (denominated in both RMB and foreign currencies) of major financial institutions (including the China Development Bank, the policy banks, state-owned commercial banks, joint-stock commercial banks, postal savings banks and city commercial banks) to primary, secondary, and tertiary industries increased by 36.4 percent to 17.9 trillion yuan, an acceleration of 6.2 percentage points from the previous year. In the first quarter, new medium- and long-term loans issued to industrial sectors registered a total of 1.6 trillion yuan, a deceleration of 52.2 billion yuan year on year.

Broken down by industries, medium- and long-term loans to tertiary industries maintained rapid growth. At end-March, growth of medium- and long-term loans to tertiary, secondary, and primary industries registered 43.4, 24.3, and 15.3 percent respectively. In the first quarter, new medium- and long-term loans to tertiary, secondary, and primary industries amounted to 1.2 trillion yuan, 354.2 billion yuan, and 2.8 billion yuan respectively, accounting for 77.0, 22.8, and 0.2 percent of the total medium- and long-term loans.

Broken down by sectors, the bulk of new medium- and long-term loans went to the infrastructure sector (transportation, warehousing and postal services, production and supply of electricity, gas, and water, water conservation, environmental protection, and public facility management), the real estate sector, and the manufacturing sector. Both the growth and amount of new medium- and long-term loans to the infrastructure sector fell sharply from the previous year. At end-March, medium- and long-term loans to the infrastructure sector had risen by 33.3 percent, 5.2 percentage points lower than the growth recorded the previous year, among which new loans registered 710.8 billion yuan in the first quarter, accounting for 45.8 percent of all medium- and long-term loans, down 8.0 percentage points year on year. New medium- and long-term loans to the infrastructure sector tilted further toward transportation and warehousing and postal services, with loans to these sectors accounting for 43.8 percent of the infrastructure loans, up 9.4 percentage points from the previous year. New medium- and long-term loans to the production and supply of electricity, gas, and water, and water conservation and environmental protection, and public facility management accounted for 8.6 percent and 47.7 percent of all new medium- and long-term infrastructure loans respectively, 4.9 and 4.5 percentage points lower than the growth in the first quarter of 2009. Medium- and long-term loans to the real estate sector grew rapidly. By end-March, medium- and long-term real estate loans had increased by 38.5 percent, up 20.4 percentage points on a year-on-year basis. In the first quarter, new medium- and long-term real estate loans registered 339.4 billion yuan, accounting for 21.9 percent of all medium- and long-term loans, up 9.4 percentage points from the same period of 2009. Recently, a battery of differentiated credit policy measures were introduced to promote the sound and healthy development of the real estate market, with the effects on future movements of real estate loans not yet clear. In addition, the growth of medium- and long-term loans to the manufacturing sector rebounded, reaching 30.9 percent at end-March, up 7.9 percentage points from the previous year. In the first quarter, new medium- and long-term loans to the manufacturing sector amounted to 174.4 billion yuan, accounting for 11.2 percent of all medium- and long-term loans, up 1.6 percentage points from the same period of 2009.

In the first quarter of 2010, in line with the spirit of the Central Economic Work Conference and the overall arrangements of the State Council, the PBC will continue to pursue an appropriately accommodative monetary policy, maintain policy consistency and stability, and make its policies better targeted and more flexible in response to new developments, with money and credit gradually returning to their normal levels. Meanwhile, it should be noted that the growth of medium- and long-term loans were still at high levels and the momentum of credit expansion remained strong, giving rise to potential problems and risks. First, there was a booming demand for medium- and long-term loans. In 2009, the total planned investment for projects under construction rose 34.0 percent year on year to 42 trillion yuan. Massive unfinished projects, inelastic extension of medium- and long-term loans, and vibrant extension of loans via local investment and financing platforms boosted the demand for project loans. Second, the rapid growth of medium- and long-term loans gave rise to liquidity risks for financial institutions. At present, the share of demand deposits and the share of medium- and long-term loans have obviously increased, aggravating the maturity mismatch in financial institutions, and the relevant risks should be monitored. Third, attention should be paid to problems that might emerge from lower investment efficiency and increasing overcapacity in certain sectors and areas.

Going forward, while carrying out an appropriately accommodative monetary policy, the PBC will properly manage the intensity, pace, and focus of policy implementation, provide intensified guidance to financial institutions, work to improve the credit structure, implement differentiated credit policies, tightly control lending to new projects, strictly restrain lending to high energy-consuming, heavily-polluting industries, and industries with excess capacity so as to ensure that credit extensions are conducive to economic restructuring, and concretely enhance the quality and sustainability of credit support to economic growth.

IV. Liquidity in the banking system was sufficient

At end-March, the outstanding balance of base money had increased by 20.7 percent to 15.0 trillion yuan, an increase of 604.8 billion yuan from the beginning of the year. The money multiplier at end-March was 4.35, up 0.08 percentage points from the same period of 2009 and 0.24 percentage points from the end of 2009, indicating a stronger capacity for money creation At end-March, the excess reserve ratio of financial institutions stood at 1.96 percent. Specifically, the excess reserve ratio of large, medium-sized, and small domestic commercial banks as well as rural credit cooperatives was 1.43 percent, 1.90 percent, 3.15 percent, and 4.67 percent respectively.

V. The lending rate of financial institutions rose slightly

In the first quarter of 2010, the interest rate for loans to non-financial institutions and other sectors rebounded slightly month by month. In March, the weighted average interest rate for loans to non-financial institutions and other sectors stood at 5.51 percent, up 0.26 percentage point from the beginning of the year. In particular, the general weighted average lending rate and the weighted average paper financing rate stood at 6.04 percent and 3.55 percent, up 0.16 and 0.81 percentage point from the beginning of the year respectively. In March, the weighted average interest rate of housing mortgage loans rose to 4.63 percent, up 0.21 percentage points from the beginning of 2010.

As for the adjusted interest rate, the proportion of loans with interest rates adjusted downward or at the benchmark rate declined, registering 30.05 percent and 28.91 percent in March, down 3.14 and 1.35 percentage points respectively from the beginning of the year; the share of loans with interest rates adjusted upward from the benchmark rate accounted for 41.04 percent, up 4.49 percentage points from the beginning of the year.

Table 2: Shares of loans with rates adjusted at various ranges, January through March 2010

Unit: Percent

	Adjusted downward	At benchmark	Adjusted upward					
	[0.9，1)	1	Sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2
January	35.38	31.18	33.44	11.92	8.74	4.42	5.71	2.65
February	32.64	31.95	35.41	12.77	9.21	4.31	6.09	3.03
March	30.05	28.91	41.04	13.12	10.91	5.45	7.11	4.45

Source: The People's Bank of China.

Affected by movements in the global financial markets and changes in supply and demand for domestic funds, on an overall basis the interest rates on domestic foreign currency increased. In March, the weighted average US dollar lending rate for maturities of less than three months and for between three months and six months in the domestic market stood at 1.69 and 1.82 percent respectively, up 0.10 and 0.16 percentage points from the beginning of the year. The weighted average rate of domestic US dollar demand deposits and large-value US dollar deposits with a maturity of less than 3 months stood at 0.15 and 0.76 percent respectively, up 0.02 and 0.30 percentage point from the beginning of the year.

Table 3: The average interest rates of large value deposits and loans denominated in US dollars, January through March 2010

unit: %

	Large value deposits						Loans				
	Demand Deposits	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year
January	0. 12	0. 62	0. 88	1. 07	1. 88	2. 96	1. 55	1. 91	2. 07	2. 09	3. 04
February	0. 15	0. 70	0. 85	1. 50	1. 65	1. 75	1. 68	1. 88	1. 90	2. 16	2. 79
March	0. 15	0. 76	0. 81	1. 34	2. 32	0. 82	1. 69	1. 82	2. 03	2. 32	2. 87

Source: The People's Bank of China.

VI. The RMB exchange rate remained broadly stable at an equilibrium and adaptive level

Since the beginning of 2010, the RMB exchange rate remained broadly stable at an equilibrium and adaptive level to cope with the global financial crisis. At end-March, the central parity of the RMB against the US dollar was 6.8263 yuan per US dollar, an appreciation of 19bps, or 0.03 percent, from the end of 2009; the central parity of the RMB against the euro and Japanese yen was 9.1588 yuan per euro and 7.3421 yuan per 100 yen respectively, appreciations of 6.97 percent and 0.49 percent from the end of 2009. From the initiation of the reform of the exchange rate regime in July 2005 to end-March 2010, the RMB had appreciated 21.24 percent against the US dollar and 9.34 percent against the euro, and had depreciated 0.49 percent against the Japanese yen. According to the BIS calculation, from the initiation of the reform of the exchange rate regime to March 2010, the nominal effective exchange rate of the RMB had appreciated by 14.33 percent, whereas the real effective exchange rate had appreciated by 18.28 percent.

In the first quarter, the peak and trough central parities of the RMB against the US dollar were 6.8261 yuan per US dollar and 6.8281 yuan per US dollar respectively. Among the 58 trading days, the inter-bank foreign exchange market saw RMB appreciations on 35 days, at par on 3 days, and RMB depreciations on 20 days. Since 2010, the RMB exchange rate against the US dollar has remained stable, moving within a band between 6.81 and 6.85 yuan per US dollar, with relatively stable expectations.

Part 2 Monetary Policy Conduct

In accordance with the overall arrangements of the State Council, the PBC continued to implement a moderately easy monetary policy in 2010. While ensuring policy consistency and stability, the PBC worked to make policies better targeted and more flexible in response to new developments. It strengthened management of liquidity in the banking system and guided financial institutions to properly manage the aggregate, pace, and structure of credit provision. These measures greatly promoted steady and healthy economic development.

I. Open market operations were conducted in a flexible manner

Keeping a close watch on global and domestic economic and financial developments and movements of liquidity in the banking system, and in line with the relatively easy monetary policy stance, in the first quarter of 2010 the PBC conducted open market operations in a flexible manner and made liquidity management more forward-looking, scientific, and effective. First, the PBC properly managed the intensity and pace of open market operations. Central bank bills and short-term repurchases were used in a flexible combination to conduct sterilization operations. In the first quarter, on a cumulative basis the PBC issued 1.43 trillion yuan of central bank bills and conducted 893 billion yuan of short-term repurchase operations. Outstanding central bank bills stood at 4.37 trillion yuan at end-March. Second, the PBC enhanced the role of open market operations in making proactive adjustments and micro-adjustments. To deal with the seasonal problem of enormous cash supplies and withdrawals around the Spring Festival and the massive operations maturing in the open market, the PBC refined the mix of instruments on a dynamic basis and flexibly adjusted the maturity and frequency of short-term repurchases in line with the pace of the supply and withdrawal of cash, successfully ironing out the short-term liquidity fluctuations caused by seasonal factors. Third, the PBC properly strengthened the flexibility of interest rates of open market operations. It guided the interest rate for central bank bill issuances to move upward in January and to stabilize in February. By making the open market interest rates more flexible, the PBC effectively guided market expectations and enhanced the role of market interest rates in adjusting the supply and demand of funds. At end-March, the interest rates of 91-day repo, 3-month central bank bills, and 1-year central bank bills stood at 1.41 percent, 1.4088 percent, and 1.9264 percent respectively, up 8 percentage points, 8.08 percentage points, and 16.59 percentage points from end-2009. Fourth, the PBC carried out time deposits of state treasury funds with commercial banks in a timely manner. In an effort to enhance coordination between monetary policy and proactive fiscal policy, the PBC completed three such deposits in the first quarter, with a total value of 100 billion, i.e., 40 billion in 3-month deposits, 30 billion in 6-month deposits, and another 30 billion in 9-month deposits.

II. The reserve requirement ratio was raised

In an effort to enhance liquidity management, encourage proper money and credit growth, and manage inflationary expectations, the PBC raised the reserve requirement ratio for RMB deposits in depository financial institutions on January 18 and February 25, each time by 0.5 percentage points. The reserve requirement ratio for rural credit cooperatives and other small financial institutions remained unchanged to support agriculture, rural areas and farmers, and county-level development, reflecting the focus and flexibility of monetary policy. The higher reserve requirement ratio helped sterilize part of the excess liquidity in the banking system. After these policy moves, there was still sufficient liquidity available in the market to support proper money and credit growth and economic development.

III. Rediscounts and central bank lending were improved to guide the flow of credit and to promote adjustments in the credit structure

The PBC believes that rediscounts are important to encourage more credit support for agriculture, rural areas and farmers, small- and medium-sized enterprises (SMEs), as well as other weak parts of the economy. The PBC improved rediscount management and focused its support by giving rediscount priority to a range of selected bills, including commercially accepted bills, agro-linked bills, and bills issued, accepted, and held by county-level enterprises and small- and medium-sized financial institutions. In a review of the distribution of the rediscount quota at the beginning of the year, the PBC added 14 billion yuan of rediscount quota to 14 provinces (municipalities) where the volume of bill business is relatively large and consists of a large share of agro-linked bills and SME bills. Outstanding rediscounted bills recovered in the first quarter and reached 26.3 billion yuan at end-March, up 25.7 billion yuan year on year. Of the bills rediscounted, 19 percent were agro-linked and 63 percent were issued by SMEs, a structure that suggests that agro-linked financing and financing by SMEs have been boosted.

The PBC properly designed plans for central bank lending to boost agriculture, supported a greater amount of agro-linked credit, and improved financial services in counties and rural areas. In 2010, the PBC stepped up efforts to rebalance the allocation of the quota of agro-linked central bank lending across regions and, in an effort to enhance positive incentive mechanisms, shifted 10 billion yuan of the quota to the western regions and major grain-producing provinces that have a large share of agro-linked loans and have achieved noteworthy progress in reform, including 1 billion yuan to areas hit by the blizzards in Xinjiang Autonomous Region and 3 billion yuan to the 5 drought-stricken provinces in southwestern China. After the quota realignment, the geographic distribution of agro-linked central bank lending was improved, with the share of the quota granted to the western regions and major grain-producing provinces reaching 93 percent. Total agro-linked central bank lending totaled 149.7 billion yuan as of end-March and amounted to 1.35 trillion yuan cumulatively since the business was introduced in 1999.

IV. Window guidance and credit policy guidance were enhanced

The PBC encouraged financial institutions to properly manage aggregate credit provision, to optimize the credit structure, and to pace credit extensions through enhanced window guidance and credit policy guidance for financial institutions. In line with the differentiated credit policy, the PBC improved window guidance for financial institutions, urging them to focus on projects under construction, to support spring farming activities and drought relief efforts in the southwestern regions, and to step up support for small enterprises and agriculture, rural areas, and farmers. The PBC strengthened coordination between credit and industrial policy and environmental protection policy. In particular, it supported the structural adjustment and revitalization of key industries, promoted the development of the culture industry, outsourcing services, emerging industries of strategic importance and the development of low-carbon economy. It took action to reduce overcapacity in certain industries and to rein in lending to heavy energy-consuming and polluting industries. In implementing the credit policy for the real estate market, the PBC adopted more stringent differentiated housing credit policies in accordance with the *Notice of the State Council on Containing Excessive House Price Increases in Several Cities*. It supported affordable housing projects, strengthened management of credit used for real estate development, and promoted the stable and healthy development of the real estate market. Moreover, the PBC improved financial services that directly relate to people's livelihood as well as financial services for employment programs, students facing financial difficulties, and poverty reduction. It developed consumer credit to support expansion of domestic demand and improved financial support for balanced economic development across regions. The PBC also encouraged financial institutions to update their examination system and properly pace credit extensions to moderate lending fluctuations between months and quarters.

V. Reform of financial institutions proceeded steadily

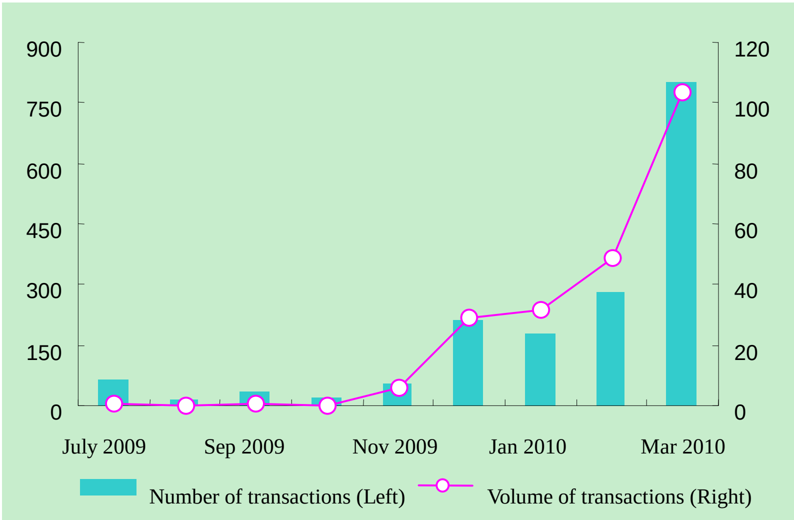
Reform was deepened at the four listed large state-owned shareholding commercial banks, i.e., the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB), and the Bank of Communications, and the governance structure in these banks was improved. As of end-2009, the capital adequacy ratio in the ICBC, BOC, CCB, and Bank of Communications stood at 12.4 percent, 11.1percent, 11.7 percent, and 12.0 percent respectively; the non-performing loan (NPL) ratio in these banks posted 1.54 percent, 1.52 percent, 1.50 percent, and 1.36 percent, while profits before taxes were recorded at 167.2 billion yuan, 111.1 billion yuan, 138.7 billion yuan, and 38.2 billion yuan. Reform of the Agricultural Bank of China (ABC) was advanced following the principle of overhauling the overall system to shift to commercial operations and to prepare for listing while remaining focused on agro-linked businesses. It took action to build sound corporate governance and improve business operations and made progress in seeking investment and preparing for public offerings. The China Development Bank continued the market-oriented reform, supporting development in key areas of the economy and sound and rapid economic and social development. Progress was made in the Export and Import Bank of China and the China Export & Credit Insurance Corporation specially tailored to their individual circumstances, improving their capacity to support foreign trade and the going global initiative. Preliminary work to deepen internal reform in preparation for overall reform was launched at the China Agricultural Development Bank.

Major progress was achieved in the reform of the rural credit cooperatives (RCCs). First, the quality of RCC assets was greatly improved. Based on the four-category loan classification, NPLs in RCCs registered 361.4 billion yuan at end-March, or 7.7 percent of their total lending, and the NPL ratio declined 0.43 percentage points from end-2009. Second, lending capacity was enhanced substantially. At end-March, RCC deposits registered 7.6 trillion yuan, while RCC lending was recorded at 5.2 trillion yuan, making up 12 percent of the total lending by financial institutions, up 0.39 percentage points from end-2009. Third, support for agriculture was strengthened significantly. At end-March, agro-linked loans totaled 3.4 trillion yuan, up 300 billion yuan from end-2009, and lending to rural households had increased 162.6 billion yuan from end-2009 to 1.8 trillion yuan. Fourth, progress was made to reform the property rights system. As of end-March, a total of 2,023 RCCs, 46 rural commercial banks, and 205 rural cooperative banks had been established, all with a legal person status at the county (city) level.

VI. The pilot program for RMB settlement of cross-border trade transactions was advanced

Cross-border trade transactions settled in RMB in regions where the pilot program was launched grew notably in 2010. The volume of RMB settlement of cross-border trade soared over 5 times from the second half of 2009 to 18.35 billion yuan in the first quarter of 2010, and from when the pilot program started to end-March totaled 21.94 billion yuan at end-March, comprising 1.86 billion yuan of export goods, 18.13 billion yuan of import goods, and 1.95 billion yuan in services trade and other items under the current account. Agent banks in the mainland opened 205 inter-bank RMB transfer accounts for overseas participating banks, with a balance of 3.18 billion yuan. Overseas RMB settlement was concentrated in Hong Kong and Singapore, which together accounted for 88 percent of the total RMB payment and receipt business. To ensure effective functioning of the Cross-border RMB Receipt and Payment Information Management System (RCPMIS), on March 8, 2010 the PBC published the *Temporary Measures for the Management of the Cross-border RMB Receipt and Payment Information Management System*. The regulation provides that financial institutions allowed to conduct cross-border RMB business should join the RCPMIS and submit accurate and complete data on cross-border RMB receipts and payments and other relevant businesses timely and in accordance with the relevant regulations.

Figure 1. Monthly RMB settlement of cross-border trade transactions



Source: People's Bank of China.

VII. Reform of the foreign exchange administration system was deepened

In response to heightened pressures of net foreign exchange inflows in the first quarter, the foreign exchange administration authority launched a special campaign against irregular fund inflows in 13 provinces and municipalities. The campaign focused on banks, enterprises, and individuals, and examined key channels of fund flows, such as trade of goods, services trade, foreign direct investment (FDI), external debt, and individual activities. The authority will impose penalties for irregularities identified during the campaign and will step up efforts to fight various kinds of unusual cross-border fund flows so as to deter hot money inflows and to safeguard economic and financial security.

VIII. The RMB exchange rate regime was improved

The PBC improved the managed floating exchange rate regime, which is based on market supply and demand and adjusted with reference to a basket of currencies, in accordance with the principle of making it a self-initiated, controllable, and gradual process. It enhanced the fundamental role of market supply and demand in exchange-rate formation, and kept the RMB exchange rate basically stable at an adaptive and equilibrium level.

Part 3 Financial Market Analysis

In Q1 2010, China's financial market performed in a healthy and sound manner and market liquidity was adequate. Performance of the money market was stable and interest rates fluctuated upward. Indices on the bond market went up slightly and bond issuances grew significantly. Stock indices declined while the volume of funds raised on the stock markets surged.

In Q1 2010, the aggregate financing volume of the domestic non-financial sector (including the household, corporate, and public sectors) stood at 3.3 trillion yuan. Loans dominated the financing structure but their share of the total financing declined remarkably year on year. The volume of financing through enterprise bonds increased rapidly and the share of financing through stocks rose notably. Bonds and stocks played a more important role in financing.

Table 4: Financing by domestic non-financial sectors in Q1 2010

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	Q1 2010	Q1 2009	Q1 2010	Q1 2009
Financing by domestic non-financial sectors	32784	47757	100.0	100.0
Bank loans	28000	45235	85.4	94.7
Equities[1]	1919	266	5.9	0.6
Government securities [2]	280	63	0.8	0.1
Enterprise bonds[3]	2585	2193	7.9	4.6

Notes: 1. Equity financing in this table excludes financing by financial institutions on the stock markets.

2. The financing volume of government securities in 2009 includes municipal bonds issued by the Ministry of Finance on behalf of local governments.

3. Enterprise bonds include enterprise bonds, corporate bonds, short-term financing bills, and medium-term notes.

Source: The People's Bank of China, China Banking Regulatory Commission.

I. Financial market analysis

1. Performance of the money market was stable and interest rates fluctuated upward

In Q1 2010, growth of repo trading on the money market slowed down while inter-bank borrowing rose remarkably. The turnover of bond repos totaled 17.1 trillion yuan, with an average daily turnover of 285 billion yuan, up 1.2 percent year on year.

The turnover of inter-bank borrowing reached 5.2 trillion yuan, with an average daily turnover of 87.5 billion yuan, an increase of 62.6 percent year on year. Overnight products dominated bond repo and inter-bank borrowing transactions, accounting for 80.4 percent and 87.8 percent of their total turnovers. The total turnover of repos on the stock exchanges soared 99.1 percent to 1.2 trillion yuan.

The financing structure on the money market was characterized by the following: 1) due to the large cash supply in the run-up to the Spring Festival and strong lending motivation of financial institutions, net lending of state-owned commercial banks declined and other commercial banks became net borrowers in Q1 2010, rather than net lenders as in Q1 2009. Net lending of state-owned commercial banks registered 7.2 trillion yuan, down 906.9 billion yuan year on year. Net borrowing of other commercial banks stood at 2.4 trillion yuan, 2.8 trillion yuan more year on year; 2) Due to heightened fluctuations on the stock market, changes in expectations, and improved balance sheets, securities and fund management companies and insurance companies showed a much lower demand for funds, illustrated by a year-on-year decline of 30.7 percent and 73.5 percent respectively in Q1; 3) Foreign-funded financial institutions still had a strong demand for funds and their net borrowing in Q1 posted 796.4 billion yuan, accounting for 11 percent of the total net borrowing.

Table 5: Fund flows among financial institutions in Q1 2010

Unit: 100 million yuan

	Repo		Inter-bank borrowing	
	Q1 2010	Q1 2009	Q1 2010	Q1 2009
State-owned commercial banks	-62499	-77238	-9800	-4130
Other commercial banks	17958	-3740	6282	-103
Other financial institutions	38133	72118	1962	1790
Of which：Securities and fund management companies	19943	28767	224	317
Insurance companies	3335	12595	—	—
Foreign-funded financial institutions	6408	8860	1556	2443

Note: “Other financial institutions” in this table include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies. A negative sign indicates net lending; a positive sign indicates net borrowing.

Source: The People’s Bank of China.

Trading of interest rate derivatives grew rapidly. In Q1 2010, there were 552 bond forward transactions with a total turnover of 195.14 billion yuan, up 113.7 percent year on year. A total of 1,872 transactions in RMB interest rate swaps were conducted, with an aggregate nominal principal of 209.81 billion yuan, up 162.0 percent year on year. Two-to-seven day bond forward products were the most frequently traded among all maturities, with a total turnover of 149.01 billion yuan, accounting for 76.4 percent of the total. The trading of interest rate swaps with a maturity of 1 year or less was fairly brisk, with a total principal of 115.37 billion yuan, accounting for 55 percent of the total turnover. The Shibor played a more important role in pricing interest rate derivatives and the turnover of Shibor-based interest rate swaps posted 60 billion yuan, accounting for 29 percent of the total turnover of interest rate swaps.

Table 6: Transactions of interest rate derivatives

	Bond forwards		Interest rate swaps		Forward rate agreements	
	Transactions	Value (100 million yuan)	Transactions	Value of nominal principal (100 million yuan)	Transactions	Value of nominal principal（100 million yuan）
2006	398	664.5	103	355.7	—	—
2007	1238	2518.1	1978	2186.9	14	10.5
2008	1327	5005.5	4040	4121.5	137	113.6
2009	1599	6556.4	4044	4616.4	27	60.0
Q1 2010	552	1951.4	1872	2098.1	0	0

Source: China Foreign Exchange Trade System.

Interest rates on the money-market fluctuated upward. The huge demand for cash pushed short-term money-market rates to a high since the beginning of 2010 in the run-up to the Spring Festival; these rates gradually reverted to normal after the Spring Festival as massive cash flowed back into the banking sector. In Q1, the monthly weighted average interest rates of bond-pledged repo and inter-bank borrowing hovered within the range of 1.16 percent to 1.55 percent. In March, the monthly weighted average interest rates of bond-pledged repo and inter-bank borrowing were both 1.40 percent, up 14 basis points and 15 basis points respectively over end-2009. At the end of March of this year, overnight and 7-day Shibor stood at 1.34 percent and 1.60 percent respectively, increasing by 19 basis points and 4 basis points over end-2009. The three-month and 1-year Shibor registered 1.94 percent and 2.35 percent, up 11 basis points and 10 basis points respectively.

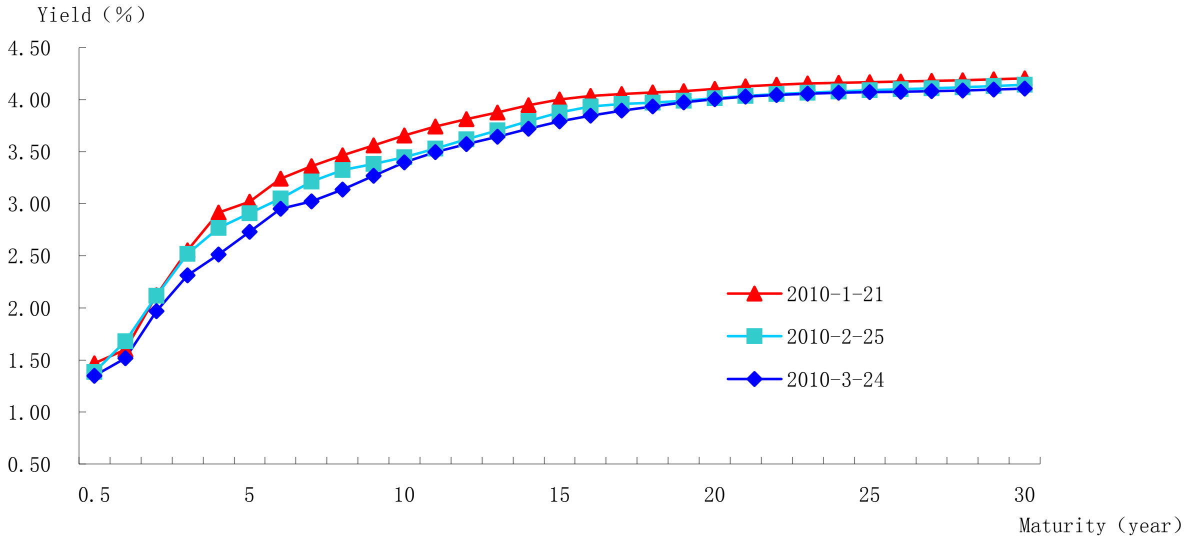
2. Indices on the bond market went up slightly and bond issuances posted rapid growth

Spot trading on the inter-bank bond market was stable. In Q1 2010, the turnover of spot bond trading on the inter-bank bond market totaled 10.8 trillion yuan, with a daily turnover of 180.2 billion yuan, up 6.5 percent year on year. All financial institutions were net bond buyers except for other commercial banks, whose net bond sales posted 398.5 billion yuan. In particular, state-owned commercial banks dominated bond purchases, with total bond purchases registering 277.6 billion yuan. Bond purchases by other financial institutions and foreign-funded financial institutions stood at 89.5 billion yuan and 31.4 billion yuan respectively. The turnover of spot government securities trading at the exchanges in Q1 2010 registered 52.8 billion yuan, down 5.4 billion yuan year on year.

Bond indices on the inter-bank bond market steadily increased. In Q1 2010, bond indices on the inter-bank market and on the stock exchanges both went up. The index of total returns on the inter-bank bond market rose 2.6 points, or 1.97 percent, from 130.2 points at the beginning of the year to 132.8 points at end-March. The index of government securities on the stock exchanges increased 2.0 points, or 1.63 percent, from 122.3 points at the beginning of 2010 to 124.3 points at end-March.

The yield curve of government securities moved upward. Due to abundant market liquidity, lower stock markets, and changes in market expectations, the yield curve of government securities went downward. Take the yield curve of government securities on the inter-bank market on March 24, for example, compared with January 6, the yield of 1-year, 5-year, 10-year, and 20-year government securities declined 1 basis point, 28 basis points, 26 basis points, and 10 basis points respectively.

Figure 2. Yield curve of government securities on the inter-bank market in Q1 2010



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

Bond issuances grew rapidly. In Q1 2010, a total of 921.6 billion yuan of bonds (excluding central bank bills) was issued on the primary bond market, up 54.3 percent year on year. The issuance of government securities, bonds issued by policy banks, and short-term financing bills grew significantly by 105.5 percent, 152.9 percent, and 75.2 percent respectively to 230 billion yuan, 278.9 billion yuan, and 162.1 billion yuan. At end-March, outstanding bonds deposited with the China Government Securities Depository Trust and Clearing Co. Ltd. totaled 16.5 trillion yuan, up 23.1 percent year on year (without taking into account special government securities).

Bond issuance rates were generally on a decline. As a result of abundant market liquidity and strong demand for bond investment, bond issuance rates went down despite the rapid growth in issuances. The interest rate for 10-year book entry government securities issued in March 2010 was 3.36 percent, 7 basis points and 32 basis points lower than February 2010 and November 2009 respectively. The interest rate of 20-year fixed-rate bonds issued by the China Development Bank in March 2010 stood at 4.3 percent, down 40 basis points from those issued in December 2009. The issuance rate of 1-year short-term financing bills hovered within a range from 2.50 percent to 4.50 percent.

Table 7: Issuance of bonds in Q1 2010

Type of bonds	Total value (100 million yuan)	Year-on-year growth (%)
Government securities	2300	105.5
Bonds issued by policy banks	2789	152.9
Bank subordinated bonds and hybrid capital bonds	332	-32.3
Bank ordinary bonds	0	—
Enterprise bonds ①	3862	18.5
Of which: short-term financing bills	1621	75.2
medium-term notes	1149	-31.2
corporate bonds	70	—

Note: ① Including enterprise bonds, short-term financing bills, medium-term notes, and corporate bonds.

Source: The People's Bank of China.

The Shibor played a greater role in bond pricing. In Q1 2010, all 40 fixed-rate enterprise bonds were priced based on the Shibor, with a total issuance value of 89.2 billion yuan, and 37 percent of the fixed rate short-term financing bills worth 58.4 billion yuan were priced based on the Shibor. In addition, 5 floating-rate bills, 1 enterprise bond, and 4 short-term financing bills were issued based on the Shibor, with a total worth of 3.4 billion yuan.

3. Bill financing continued the downturn

Bill acceptances maintained steady growth whereas bill discounts continued to decline.

Bill interest rates remained at a heightened level. In Q1, commercial drafts issued by enterprises valued 2.8 trillion yuan, down 6.9 percent year on year. Discounted bills declined 0.3 percent year on year to 6.2 trillion yuan. At end-March, the total value of outstanding commercial drafts dropped 1.5 percent year on year to 4.4 trillion yuan. Outstanding discounted bills registered 1.8 trillion yuan, plummeting 48.3 percent over Q1 2009. Since 2010, the outstanding value of bill financing has been on a decline. The value at end-March was 624.3 billion yuan lower than that at the beginning of this year and accounted for 4.1 percent of the total outstanding loans, 6 percentage points lower year on year. Since 2010, as interest rates on the money market rose, bill interest rates gradually went up and remained at an elevated level.

4. Stock indices declined while the volume of funds raised on the stock markets surged

Trading and investment on the stock markets were brisk in Q1 2010 due to rapid economic growth, abundant market liquidity, and buoyant trading on stock markets outside of mainland China. In Q1, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 11.6 trillion yuan, up 2.3 trillion yuan year on year, and the daily turnover rose 23.1 percent year on year to 200.6 billion yuan. By end-March 2010, market capitalization had grown 3.5 percent over end-2009 to 15.7 trillion yuan.

The stock indices declined. After last year's boom, the Shanghai Stock Exchange Composite Index hovered within a band from 2900 points to 3300 points. At end-March, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index dropped 5.1 percent and 8.8 percent respectively year on year to close at 3109 points and 12494 points. Average P/E ratios on the A-share markets in Shanghai and Shenzhen posted 28 times and 41 times, down 1 time and 6 times respectively over end-2009.

Funds raised from the stock markets rose remarkably. In Q1 2010, a total of 191.9 billion yuan was raised by non-financial enterprises and financial institutions on the domestic and foreign stock markets by way of IPOs, secondary offerings, rights issuances, stock vesting, and convertible bond issuances, a surge of 162.4 billion yuan or 550.8 percent year on year. Among this total, 181.4 billion yuan was raised through IPOs and rights issuances on the A-share market, soaring 154.9 billion yuan or 585.5 percent over Q1 2009.

5. Total assets in the insurance industry continued fairly rapid growth

Total premium income increased significantly. In Q1 2010, the aggregate insurance premium grew 38.6 percent year on year to 454.1 billion yuan, 28.6 percentage points more than the growth during the same period of the last year. The premium income of life insurance grew 38.7 percent year on year, 29.2 percentage points more than in Q1 of the previous year. The premium income for property insurance rose 38.4 percent, an acceleration of 26.4 percentage points year on year. Total compensation and claim payments declined 9.1 billion yuan over Q1 in the previous year to 73.2 billion yuan.

Total assets of the insurance industry maintained fairly rapid growth. Since 2010, the share of investment products in the total assets of insurance companies increased by 2.5 percentage points year on year. By end-March, total assets in the insurance industry had grown 21.2 percent to 4.3 trillion yuan. Among this total, investment assets were enhanced by 26 percent year on year, an acceleration of 13.4 percentage points. Bank deposits were up 15.9 percent over Q1 2009, a deceleration of 29 percentage points.

Table 8: Use of insurance funds at end-March 2010

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-March 2010	End-March 2009	End-March 2010	End-March 2009
Total assets	42929. 4	35434. 7	100. 0	100. 0
Of which: Bank deposits	11594. 7	10004. 7	27. 0	28. 2
Investment	27943. 3	22178. 5	65. 1	62. 6

Source: China Insurance Regulatory Commission.

6. Trading on the foreign exchange market was brisk

The foreign exchange spot market operated soundly. The trading volume of swap transactions continued to rise and the trading volume of forward transactions increased by a large margin. In Q1 2010, the turnover of spot RMB foreign exchange swaps continued its stable growth and OTC transactions remained the major trading transactions. The total turnover of RMB foreign exchange swaps registered 285 billion yuan and the daily turnover soared 165.9 percent year on year. Among this total, overnight RMB/USD swaps accounted for 60 percent of the total, 3.7 percentage points more than during the same period of the last year. The share of transactions with short maturities increased. The turnover on the RMB foreign exchange forward market totaled US$3 billion, and the daily turnover rose 71.6 percent over Q1 2009. The turnover of 8 foreign currency pairs amounted to US$12.5 billion, and their daily turnover increased 25.8 percent year on year. The USD/HKD and EUR/USD currency pairs accounted for 64.5 percent of the total.

7. Performance of the gold market was basically stable

In Q1 2010, trading on the Shanghai Gold Exchange was basically stable. A total of 1437.7 tons of gold was traded, up 36 percent year on year. The total turnover rose 65.8 percent year on year to 351.97 billion yuan. The trading volume of silver surged 386.2 percent over Q1 2009 to 6848.2 tons and its turnover soared 581.2 percent year on year to 27.24 billion yuan. The trading volume of platinum declined 13.4 percent year on year to 13.1 tons and its turnover rose 28.4 percent over Q1 2009 to 4.66 billion yuan.

The movement of gold prices on the Shanghai Gold Exchange was consistent with that on international gold markets. During the last ten days of January and the first ten days of February, gold prices stabilized after a downturn. The domestic price of gold had been higher than the international price of gold and the gap between the two widened significantly. The price of gold reached a peak of 255.10 yuan per gram and a trough of 233.10 yuan per gram. It closed at 244.40 yuan per gram at end-March, up 1.34 percent over the beginning of the year.

II. Financial market institutional building

1. Improvements in institutional arrangements for the inter-bank bond market

A pilot program for margin trading and short selling was launched. On March 31, a trading system for margin trading and short selling was launched on the Shanghai Stock Exchange and the Shenzhen Stock Exchange and they started to accept applications for transactions by pilot members. The launch of margin trading and short selling is an important measure to improve institutional arrangements on China's capital market, helping to improve the pricing mechanism and enhance market liquidity in China's capital market.

Stock index futures were launched. As approved by the State Council, stock index futures were launched on April 8 and the first batch of Shanghai-Shenzhen 300 index futures contracts began trading on the China Financial Securities Exchange on April 16. China is an emerging transition economy. In order to satisfy the needs of capital market development during this stage, institutional arrangements of stock index futures need to be improved to lay a solid foundation for the smooth functioning and healthy development of the financial securities market.

Long-term mechanisms for the protection of securities investors improved. On March 15, the CSRC issued the *Rules on Contributions Made by Securities Exchanges and Securities Companies for the Securities Investors' Protection Fund*, further defining the details. Improvements in the fund-raising mechanism in the securities investors' protection fund are significant to make securities institutions more legally compliant, to reinforce the competition, and to protect the legal rights and interests of the investors.

2. Strengthening basic institutional arrangements on the insurance market

In order to improve the management of directors, supervisors, and senior executives in insurance companies, in January the China Insurance Regulatory Commission (referred to as CIRC hereinafter) issued the *Rules on the Qualification of Directors, Supervisors, and Senior Executives of Insurance Companies*. The Rules raised the threshold for taking such jobs and defined how to verify the qualifications, facilitating improvements in the governance structure of insurance companies.

The *Administrative Measures on Terms and Insurance Premium Rates of Property Insurance Companies* and the *Rules on Basic Services for Life Insurance* were launched in succession in February 2010. The Measures improve the terms of insurance policies, the approval and filing of insurance premium rates, and the implementation of contractual insurance premium rates. The Rules further define details concerning telephone services and claim settlements for life insurance, which help improve order on the property insurance market and tackle problems such as difficult claim settlements and misleading sales on the life insurance market.

At present, there are 8 insurance groups (holdings) in the insurance industry in China. The aggregate of their total assets, net assets, and premium income accounted for more than 75 percent of the industry's total, playing a dominant role. In order to reinforce supervision of the insurance groups, the CIRC issued the *Administrative Measures on Insurance Groups (Provisional)* in March, defining details on eligibility of access, scope of business, corporate governance, capital management, and information disclosure by insurance groups.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q1 2010, the world economy was off on an overall rebound, but it was proceeding at different speeds in the various economies and regions. The emerging market and developing economies experienced a relatively rapid recovery and the United States also witnessed marked growth. However, the euro areas and Japan were lagging behind, especially conditions in Eastern and Southern Europe that remained alarmingly sluggish. Major risks facing the world economy now include: rising sovereign debt risks and trade protectionism, uncoordinated exits from stimulus policies across the various countries due to different recovery speeds, and ballooning asset prices in some areas. Looking ahead, the world economy is expected to further solidify, with better readings of consumption, investment, and export indices in the major economies and a decline in the risks of a double-dip.

1. Economic developments in the major economies

Most economic indices in the U.S. moved upward but the recovery was yet to solidify. In Q1 2010, the annualized GDP growth after seasonal adjustments reached 3.2 percent, which was the third positive reading over three consecutive quarters. But it will take more time for the economy to be back on track and to realize full employment, which means government support is indispensable to the still-fragile recovery. Unemployment rates for the three months in Q1 after seasonal adjustments all stood at 9.7 percent, down 0.3 percentage points compared with December 2009 but still at a high level. Trade volume picked up gradually and the trade deficit edged up a bit. In January and February 2010, total U.S. exports registered US$362.72 billion and total U.S. imports registered US$286.06 billion, and the accumulated trade deficit stood at US$76.66 billion, an increase of US$13.25 billion from the same period of the last year, which was US$63.41 billion. Though the fiscal deficit dropped a little, the outlook remained gloomy. The deficits for the three months in Q1 were US$42.6 billion, US$220.9 billion, and US$65.4 billion respectively, adding up to a 29.8 percent decline year on year. According to the budget released by President Obama on February 2, the deficit for the 2010 year registered US$1.56 trillion and expected expenditures for 2011 would be a record high of US$3.83 trillion. Price levels showed signs of stabilizing, with the seasonally adjusted year-on-year CPI growth for the three months in Q1 standing at 2.7 percent, 2.2 percent, and 2.4 percent respectively and the month-on-month figures were 0.2 percent, 0.0 percent, and 0.1 percent respectively. Credit was still tight but the crunch eased somewhat. For the three months of Q1 2010, annualized month-on-month bank credits after seasonal adjustments dropped by 8.5 percent, 7.3 percent, and 5.1 percent respectively, showing a slowdown in the decline.

The economy in the euro area continued to rebound but with a weakened momentum.

Influenced by the sovereign debt crises in Greece, Portugal, and Ireland and against the background that the effect of the stimulus policy was phasing out, annualized GDP growth in Q4 2009 registered 0.0 percent after seasonal adjustments, remarkably lower than the 1.7 percent in Q3 of 2009. The employment condition was still serious, with unemployment rates after seasonal adjustments for the three months in Q1 standing at 9.9 percent, 10 percent, and 10 percent, better than those for Q4 2009. The growth of foreign trade was sluggish. In January and February 2010, year-on-year imports and exports after seasonal adjustments increased by 3.4 percent and 8.2 percent respectively, leading to a surplus of 5.17 billion euro in contrast to the 4.9 billion euro deficit in the same period of the last year. The public debt and deficit call for attention. According to statistics of the European Commission, the budget deficits of the countries in the EU area accounted for 6.9 percent of their GDP in 2010, up by 0.5 percentage points compared with the last year and only a few countries were able to keep their deficits below the standard of 3 percent of GDP. Prices increased moderately, with the month-on-month HICP growing by –0.8%, 0.3%, and 0.9% respectively, and the year-on-year figures edging up by 1.0 percent, 0.9 percent, and 1.4 percent respectively for the three months of Q1.

The Japanese economy rebounded strongly but deflationary pressures lingered. In Q4 2009, the seasonally adjusted annualized GDP was 3.8 percent, and the deflator slid by 2.8 percent compared with the same period of the last year. The employment situation showed signs of improvement, with unemployment rates for the three months in Q1 reading at 4.9 percent, 4.9 percent, and 5.0 percent respectively, decreasing for the first time since July 2009. Trade continued to pick up. In the first three months, imports and exports grew by 19.5 percent and 43.2 percent year on year, leading to a trade surplus of 1.7394 trillion yen, while the same period of the last year saw a deficit of 832.9 billion yen. The budget deficit of the government further expanded, with expenditures registering 92.3 trillion yen in the 2010 fiscal year, among which 44.3 trillion yen was financed through the issuance of treasuries. According to the statistics from the Ministry of Finance of Japan, public debts including those issued by local governments had soared to 174 percent of GDP and were projected to increase further. Demand from the private consumption side remained tepid. In February, household consumption calculated in real prices dropped by 0.5 percent year on year. Price levels fell steadily, with the year-on-year CPI for the three months in Q1 declined by 1.3 percent, 1.1 percent, and 1.1 percent respectively.

The recovery of the emerging market economies was proceeding at different speeds. Due to improvements in domestic and external demand, the economies of the emerging markets in Asia showed obvious signs of recovery. Economic growth in India gained momentum. But the recovery of Russia was yet to be firmed up, reflecting continually growing industrial production but remarkably sluggish retail sales. The major economies in Latin America enjoyed stable fiscal conditions and healthy international balances, contributing to a higher than average speed of recovery.

The Latin America Economic Climate Index in January was 5.6, a historical high since July 2007. The sovereign debt crisis in the European area cast shadows on the growth of the emerging market economies in Europe. The uncertainties facing the growth of some emerging market countries were increasing due to heavy fiscal burdens, fragile financial systems, and declining appeal to foreign capital.

2. International financial market

In Q1 2009, the exchange rates of the major currencies fluctuated within a narrow band. The euro slumped all the way down against the US dollar after the Fitch Rating suddenly degraded Portugal's sovereign rating and market concerns about the European countries' heavy debt heightened. The movement of the Japanese yen against the US dollar can be divided into two stages: in the first two months of Q1, the yen was pushed upward by the strong performance of the Japanese economy and the better-than-expected economic indices; but beginning in March, the yen was driven down by factors such as heightened expectations for a widening interest spread between the U.S. and Japan and the investors' removing the yen's long positioning right before Easter. The greenback gained against the currencies of most developed countries but depreciated against those of most developing countries. But the effective exchange rate of the US dollar remained generally stable. At the end of Q1, the euro traded at 1.3526 dollar per euro, down 5.6 percent from end-2009. The exchange rate of the yen against the US dollar closed at 93.28 yen per dollar, weakening slightly by 0.3 percent from end-2009. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, edged up cumulatively by 0.3 percent in the first quarter.

The US dollar Libor remained low and fluctuated a bit. On March 4, the 1-year US dollar Libor hit 0.83 percent, a record low for the year, and then rose gradually. On March 31, the 1-year US dollar Libor was fixed at 0.92 percent, down 0.06 percentage points from the beginning of the year. The Euribor fluctuated downward. On March 31, the 1-year Euribor read 1.21 percent, down 0.036 percentage points from the beginning of the year.

With the gradual recovery of the world economy and the firm expectation that inflation would remain low, fluctuations in the yields of U.S. and Japanese treasuries flattened. The yields of long-term U.S. treasuries dipped before rising again and yields of long-term Japanese treasuries gained slightly. Risk aversion demands stemming from the Greek debt crisis weighed on the yields of long-term euro treasuries. On March 31, the yield of 10-year treasury bonds of the U.S., euro area, and Japan closed at 3.832 percent, 3.095 percent, and 1.413 percent respectively, up 0.039 percentage points, down 0.286 percentage points, and up 0.122 percentage points compared with the beginning of the year.

The major stock markets rallied after initially dropping. Triggered by expectations of the exit of the stimulus policies and worries about the European sovereign debt crisis, the major stock markets all experienced a dramatic correction at the beginning of the year. But a new round of rallies began when the global economy showed signs of a firm recovery and the European sovereign crisis eased somewhat. On March 31, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 10857, 2398, 2931, and 11090 respectively, up 4.1 percent, 5.7 percent, 1.1 percent, and 5.2 percent from the beginning of the year.

Box 2 Carry Trade

Carry trade refers to a strategy in which investors borrow in a low interest currency, convert the borrowed sum into currencies with higher interest rates or an expectation of appreciation and make investments in the relevant capital markets. Earnings from carry trade include the interest spread, currency appreciation, and capital gains. Elements influencing carry trade involve interest rates, exchange rates, and risk preferences. The Japanese yen and Swiss franc, with their low interest rates, have been traditional funding currencies for carry trade. Since Japanese interest rates were set at low levels for a very long period of time, Japanese residents and households engaged in carry trade using yen as the vehicle, and made investments in the bond markets of countries with high-yielding currencies such as Australia and New Zealand to earn higher profits. Later, the huge interest spread attracted many international investors and made yen carry trade into a thriving strategy.

Since the outbreak of this round of the financial crisis, the interest rate of the US dollar was kept low, gradually making the US dollar a popular funding currency for carry trade. According to statistics from the U.S. banking sector, dollar carry trade rocketed to US$400 billion in the first half of 2009. The magnitude of US dollar carry trade is even larger compared with the yen carry trade because of the huge U.S. economic aggregate, the important status of the dollar, and the large number of investors. First, US dollar carry trade involves more investors and sectors. High-yielding currencies, emerging markets, and commodity markets are hot spots for US dollar carry trade, and major investors in dollar carry trade are institutional investors. Second, dollar carry trade adds to the complexity in the making and conduct of monetary policy in various countries. Capital inflows as a result of carry trade challenges the independence and effectiveness of the monetary policy of the emerging market economies. Meanwhile, dollar carry trade also keeps capital away from the real U.S. economy, expands the spillover effect of U.S. monetary policy, and dampens its recovery. Third, dollar carry trade increases global inflation pressures. When carry trade money goes into commodity markets, it increases the proportion of transactions that are made for financial purposes and distorts commodity prices from reflecting real demand, putting upward pressures on global inflation.

Normal carry trade helps narrow interest spreads among different countries and optimizes capital allocations. However, excessive carry trade might cause shocks in the financial markets, especially when large-scale carry trade closes its position. Asset prices might fluctuate dramatically, even triggering a regional financial crisis. Though the factors behind the 1997 Asian financial crisis were complicated, some scholars believe that the fast unwinding of large-scale yen carry trade was one of the contributing reasons.

The US dollar carry trade is developing very rapidly. However, the closing of the dollar position is also frequent in financial markets and causes money to reflow to the U.S. In the future, the US dollar interest rate, exchange rate, and risk preference might have a directional change, causing large uncertainties for the prospects of the US dollar carry trade. The development and the short selling of carry trade might have a great impact on the global economy and the functioning of financial markets, therefore it needs to be followed closely.

3. Housing market development in the major economies

The U.S. housing market continued to be sluggish. In February 2010, the national housing price index decreased by 0.58 percent month on month. In the same month, new home sales registered 575,000, up by 0.17 percent year on year; and the start of new homes registered 308,000, down by 13 percent year on year, indicating that the decline had leveled off.

The recovery of the European housing market was tepid. Since Q1 2010, the price hike in the British housing market slowed down. For the first three months of the year, the Halifax Housing Index rose by 0.42 percent, -1.64 percent, and 1.09 percent month on month after seasonal adjustments. In March, the start of new homes in France registered 33,457, up for two consecutive months. Since December 2009, the total number of building permits issued in Germany continued to drop. It is expected that the lingering sovereign debt crisis and the high unemployment rate will continue to drag down the European housing market for the near term.

The Japanese housing market remained weak. Since the outbreak of the financial crisis, the housing market was hit hard by the slumping demand and deflationary economy. In January and February, month-on-month new home starts decreased by 6.3 percent and 13 percent respectively, but they picked up by 15 percent in March. Land prices were restrained by the rising vacancy/rent rate of office buildings and falling rent. According to a survey conducted by the Ministry of Land, Infrastructure, Transport, and Tourism of Japan, land prices in Japan plummeted by 4.6 percent in 2009, among which the price of commercial land declined by 6.1 percent and that of residential land declined by 4.2 percent However, the speed of the decline in land prices slowed.

4. The monetary policies of the major economies

The unconventional monetary policies adopted by the central banks of the major economies for quantitative easing began to unwind, but the exit was proceeding at different speeds across the regions. The size of the central banks' balance sheets remained much larger than the during the crisis level. Although signs of a global recovery became stronger as time went on, economic growth was yet to be solidified due to the weak labor market, slow income growth, and still tight credit conditions. To support an economic rebound, the U.S. Federal Reserve, the ECB, and the Bank of Japan kept their benchmark interest rates unchanged at 0-0.25 percent, 1 percent, and 0.1 percent respectively in Q1 2010. In order to manage inflation expectations, except for Japan, the U.S. Federal Reserve and the ECB started to gradually exit from the accommodative monetary policy. On February 18, the Fed boosted its discount rate to 0.75 percent, the first increase in the interest rate since December 2008. On March 8, the Federal Reserve Bank of New York announced the beginning of a program to expand its counterparties for conducting reverse repurchase agreement transactions, so as to drain excessive liquidity from the U.S. banking system. On March 31, the Federal Reserve closed all the special liquidity facilities except for loans backed by new-issue commercial mortgage-backed securities under the Term Asset-Backed Securities Loan Facility. In line with the improved market conditions, the ECB, the Bank of England, the Bank of Japan, and the Swiss National Bank terminated the temporary US dollar swap arrangements with the U.S. Fed on February 1. On March 4, the ECB decided to continue the gradual phasing-out of its non-standard operational measures but it would continue to provide liquidity support to the banking system. On February 4, the Bank of England voted to maintain the stock of asset purchases at ￡200 billion and to suspend further purchases for the moment, the first suspension during the past 11 months. Against the backdrop of deflation, the Bank of Japan reiterated the importance of maintaining an accommodative monetary policy and vowed to prevent at any cost the economy from entering into a recession.

In contrast to the major developed economies, Australia and some emerging market economies experienced a strong rebound and accelerated the process of exiting from the accommodative monetary policy. The Reserve Bank of Australia boosted its cash rate by 25 basis points three times, on March 2, April 6, and May 4. Since October 2009, the Reserve Bank of Australia has increased its policy rates five times to the current 4.5 percent. On January 29, the Reserve Bank of India increased the Cash Reserve Ratio by 75 basis points to 5.75 percent And on March 19, the Reserve Bank of India raised the repo rate and the reverse repo rate by 25 basis points to 5 percent and 3.5 percent respectively. On March 4, Bank Negara Malaysia announced it would raise the Overnight Policy Rate by 25 basis points to 2.25 percent, becoming the first Asian economy to boost policy rates since 2010. On April 14, the Monetary Administration of Singapore (MAS) decided to re-center its exchange-rate policy band upward, switching the “zero percent appreciation” path of the Singapore dollar implemented since October 2008 to a “moderate and gradual appreciation.” This might mark the beginning of monetary tightening in Singapore.

5. Global economic outlook

According to the IMF projection in April, as the global economy came out of recession, the recovery evolved better than expected but was proceeding at varying speeds across the countries. In 2010, world output was expected to rise by about 4.25 percent, an upward revision of 1 percentage point from the October 2009 projection and similar to the January 2010 projection. The growth rates for the U.S., the euro area, Japan, and the emerging market economies were estimated to be 2.3 percent, 1.0 percent, 1.9 percent, and 6.3 percent respectively, up by 5.5 percentage points, 5.1 percentage points, 7.1 percentage points, and 3.9 percentage points from real growth in 2009. The IMF believed that the still-low levels of capacity utilization and well-anchored inflation expectations would keep inflation under control in 2010, but conditions might vary across countries. For the developing economies, inflation expectations remained subdued and downward price rigidities became more binding. Overall inflation was estimated to increase from 0.1 percent in 2009 to 1.5 percent in 2010. For the emerging market and developing economies, inflation was expected to rise to 6.2 percent in 2010 because of the strong economic rebound and capital inflows.

Looking ahead, the global recovery might be undermined by factors such as untamed sovereign debt crises, battered fiscal conditions in some economies, high unemployment rates in the major economies, yet to be disclosed losses from crises and uncertainties about the influence of the policy exit. International communications and coordination should be enhanced to fight all kinds of trade and investment protectionism and to firmly facilitate economic globalization.

Box 3 The European Sovereign Debt Crisis

As a result of the financial crisis, fiscal expenditures in some economies in Europe soared, whereas their tax income declined, leading to a continual deterioration of their fiscal conditions. Worries about a sovereign default tightened in the market, causing large fluctuations in global stock markets, exchange markets, security markets, and commodity markets, casting shadows on a global recovery.

In January 2009, the sovereign ratings of Greece, Portugal, and Spain were downgraded due to the recession and the gloomy fiscal situation, adding to market worries about the solvency of the European countries. In October 2009, the Greek government unveiled a budget with a deficit and total debt standing at 12.7 percent of GDP and 113.0 percent of GDP respectively, and the market panicked. In December 2009, Fitch, Moody's and S&P again downgraded the sovereign ratings of Greece, Portugal and Spain. Portugal, Ireland, Italy, Greece, and Spain (PIIGS) were cited as the (PIIGS) were cited as the five Eurozone countries facing the greatest risks of sovereign defaults.

By end-February 2010, since there was still no rescue agreement for the Greek sovereign crisis, S&P and Moody's warned almost simultaneously that the sovereign rating of Greece might be decreased again in the following several months. On April 9, Fitch downgraded Greece to BBB-, making it more difficult for the Greek government to raise funds in the market. On April 27, S&P cut Greece's long-term debt rating to BB+ (junk bond status) and decreased Portugal's long-term rating to A-. Market confidence in the euro and the Eurozone was hit hard. On April 29, S&P downgraded Spain's sovereign rating from AA+ to AA. The European sovereign crisis showed signs of expanding.

On May 2, after rounds of tough negotiations, an agreement on a rescue package for Greece was finally reached between the EU and the IMF. The deal consisted of a loan of 110 billion euro to the Greek government for the following three years, among which 80 billion euro would come from the Eurozone countries while US$30 billion would come from the IMF. On May 3, 2010, as a rescue measure the ECB suspended its minimum threshold for Greek debts until further notice. These measures served as a sign of stability for the market. However, the rescue plan had to go through EU legal procedures and the terms were conditional, therefore possibilities for future setbacks and reversals remained and concerns about the outlook for the Eurozone still existed. The fragile confidence of investors in the Eurozone drove down the exchange rate of the euro to the dollar to a year low.

A major reason behind the European sovereign crisis was that some countries spent beyond their means. Those countries ended up in such a situation because they overlooked the risks of a rocketing fiscal deficit and issued too many debts. But from a deeper perspective, this crisis also reflected that the EU lacked effective ways to enforce fiscal discipline. The debt level of some countries far exceeded the level prescribed by the Growth and Stability Pact, eventually evolving into a crisis. The European sovereign crisis is also related to the excessive expenditures by the Western governments. According to Jean-Claude Trichet, president of the ECB, the Greek economic problem was not rare among the developed countries. If some developed countries fail to substantially cut expenditures and to increase income, a sovereign crisis might spread to other parts of the world.

The European sovereign crisis directly impaired the growth of the Eurozone and brought enormous uncertainties about a global recovery. It triggered large fluctuations in global stock markets, exchange markets, and securities markets. With the markets still fragile, the crisis might even lead to a chain reaction and systemic risks. Therefore, the development of the European sovereign debt crisis should be closely followed.

II. Analysis of China’s macroeconomic performance

In Q1 2010, Chinese economic performance was stable and displayed a stronger momentum for recovery and growth. Domestic demand continued to grow while external trade activities recovered in a more resilient manner; industrial output rebounded rapidly, consumption rose fairly quickly, and the growth of fixed-asset investment moderated. The general price level was stable. In Q1, GDP was up 11.9 percent year on year to 8.06 trillion yuan, representing an acceleration of 5.7 percentage points; CPI was up 2.2 percent year on year, 2.8 percentage points higher than in Q1 2009; the trade surplus was down US$47.77 billion year on year to US$14.49 billion.

1. Nominal growth of consumption accelerated, while growth of investment

Urban and rural household income increased further and domestic consumer demand remained stable. In Q1, the per capita disposable income of urban households registered 5,308 yuan, representing a nominal increase of 9.8 percent and real growth of 7.5 percent year on year; the per capita net income of farmers was 1,814 yuan, a nominal increase of 11.8 percent and real growth of 9.2 percent year on year. In Q1, per capita consumer spending of urban residents increased 8.7 percent to 3,475 yuan, down 0.9 percentage points from the previous year. In Q1, total retail sales rose 17.9 percent nominally and 15.4 percent in real terms, an acceleration of 2.9 percentage points and a deceleration of 0.5 percentage points respectively from the previous year. The gap between nominal and real growth rates reflected the impact of rising prices in recent months. Urban consumption grew faster than rural consumption, but the gap closed a bit. In Q1, retail sales in urban areas posted 3.06 trillion yuan, up 18.4 percent nominally and 16.1 percent in real terms year on year, whereas retail sales in rural China registered 0.58 trillion yuan, up 15.4 percent in nominal terms and 12.5 percent in real terms.

Fixed-asset investments rose in a moderate manner, with investment in tertiary industries remaining high. In Q1, fixed-asset investments totaled 3.53 trillion yuan, up 25.6 percent year on year nominally (representing a deceleration of 3.2 percentage points from the previous year), and up 23.3 percent in real terms. Fixed-asset investments in the urban areas posted 2.98 trillion yuan, up 26.4 percent year on year and representing a deceleration of 2.2 percentage points from the previous year; fixed-asset investments in the rural areas stood at 0.55 trillion yuan, an increase of 21.0 percent and representing a deceleration of 8.4 percentage points. Among the urban fixed-asset investments, investments in eastern, central, and western China rose 24.4 percent, 26.2 percent, and 30.0 percent respectively, with investment growth in the west exceeding that in the other areas; investment in the primary, secondary and tertiary industries increased 9.7 percent, 22.4 percent, and 30.0 percent respectively, with investment growth in tertiary industries surpassing the other two. In Q1, planned investment in urban construction projects was up 30.4 percent year on year to 27.96 trillion yuan, and projects under construction increased by 24,557 to 153,662.

Exports and imports recovered more vigorously and the trade surplus declined by a large margin. In Q1, exports and imports totaled US$61.785 billion, up 44.1 percent year on year and representing an acceleration of 69.0 percentage points. In particular, exports amounted to US$316.17 billion, up 28.7 percent year on year and representing an acceleration of 48.4 percentage points whereas imports totaled US$301.68 billion, up 64.6 percent and representing an acceleration of 95.5 percentage points, resulting in a surplus of US$14.49 billion, down US$47.77 billion year on year. Due to factors such as rising import prices and strong domestic demand, external trade showed a surplus of US$7.24 billion, the first time since May 2004. Improvements in the structure supported the continuous recovery of external trade. The export of electronics and high-tech products rose 31.5 percent and 39.1 percent respectively in Q1, both exceeding the growth of external trade. On the import side, ballooning resource and bulk commodity imports drove up imports. In Q1, the import of iron ore, crude oil, and finished oil products, primary shaped plastic, steel, aluminum oxide, and crude aluminum, crude copper, and soybeans grew 84.1 percent year on year to US$75.87 billion, accounting for 25.1 percent of total imports and far exceeding the growth of imports of electronics and high-tech products. In Q1, actually utilized foreign direct investment totaled US$23.44 billion, up 7.7 percent year on year and representing an acceleration of 28.2 percent.

2. Development of the agricultural sector remained stable and industrial production rebounded rapidly

The output of secondary industries rebounded. In Q1, the added value of primary, secondary, and tertiary industries reached 513.9 billion yuan (up 3.8 percent and representing an acceleration of 0.3 percentage points from the previous year), 3907.2 billion yuan (up 14.5 percent and representing an acceleration of 9.1 percent), and 3636.6 billion yuan (up 10.2 percent and representing an acceleration of 2.8 percentage points) respectively. The shares of the three industries were 6.4 percent, 48.5 percent, and 45.1 percent of GDP year on year respectively.

Development of the agricultural sector was stable and the grain-farming area continued to increase. It is estimated the grain-farming area will increase by 470,000 hectares year on year to 1094.6 million hectares in 2010. In Q1, pork, beef, mutton, and poultry output totaled 21.04 million tons, up 4.7 percent. In particular, pork output grew 5.2 percent to 14.27 million tons. In Q1, the producer price of agricultural products was up 6.7 percent year on year, representing an acceleration of 12.6 percentage points and 6.4 percentage points higher than the agricultural capital goods index. This positive gap helped to increase the income of the farmers.

Industrial production rebounded quickly and profits of industrial enterprises rose. In Q1, growth of industrial added value was up 19.6 percent year on year, representing an acceleration of 14.5 percentage points from the previous year and 1.6 percentage points from the previous quarter. Sales of industrial products were brisk, with their sales to output ratio up 0.5 percentage point year on year to 97.5 percent. With the domestic recovery on the fast track and the recovery of external demand, enterprise profits surged. According to statistics from 24 regions in China,[1] profits of statistically large industrial enterprises in the 24 regions increased 102.6 percent year on year to 690.9 billion yuan. In 39 industrial sectors, profits of 38 sectors increased year on year. The PBC's survey of industrial enterprises in 24 regions in Q1 showed that the enterprise business performance index was up 2.2 percentage points from the previous quarter to 62.9 percent, representing growth for four consecutive quarters, but lower than the pre-crisis level by 2.4 percentage points; generally, enterprise profits were on the rise, with their profitability index rising for four consecutive

[1] This includes statistically large industrial enterprises in 24 provinces (autonomous regions and municipalities directly under the central government), excluding Inner Mongolia, Hunan, Guangdong, Hainan, Chongqing, Yunnan, and Tibet. Their income from their main business accounts for 82 percent of the total of all statistically large enterprises in China, and their profits account for 84 percent of the total.

quarters to reach their pre-crisis level.

3. Consumer prices further recovered and producer prices rose quickly

Consumer prices rallied further. In the three months of Q1, the CPI was up 1.5 percent, 2.7 percent, and 2.2 percent respectively, averaging 2.2 percent and higher than in Q1 2009 by 2.8 percentage points. Food prices were up 5.1 percent and contributed 1.7 percentage points to CPI growth, whereas non-food prices were up 0.8 percent and contributed 0.5 percentage points to CPI growth. The month-on-month CPI was up 0.6 percent and 1.2 percent in the first two months and saw positive growth with the seasonal adjustments. The month-on-month CPI was down 0.7 percent in March, due to declining food prices after the Spring Festival. After seasonal adjustments, the March month-on-month CPI was positive. As for the contribution of base period and new rise factors, new rise factors played a greater role, with the base period factor averaging 1.0 percent and the new rise factor averaging 1.2 percent in Q1.

Producer prices went up sharply. In Q1, the producer price of industrial goods was up 5.2 percent year on year, representing an acceleration of 9.8 percentage points, or up 4.3 percent, 5.4 percent, and 5.9 percent monthly. In Q1, the purchase price of raw materials, fuel, and power was up 9.9 percent year on year, or up 8.0 percent, 10.3 percent, 11.5 percent respectively in the three months, representing an acceleration of 17.0 percentage points from the previous year. The price of agricultural capital goods was up 0.3 percent, or by -0.4 percent, 0.3 percent, and 0.9 percent respectively, representing a deceleration of 5.5 percentage points. In the CGPI, investment goods and consumer goods were up 5.9 percent and 3.8 percent respectively. The rising prices of primary products contributed to the growth of the CGPI. In the basket of the CGPI, the prices of agricultural products, mineral products, and coal and electricity were up 9.1 percent, 14.6 percent, and 17.6 percent respectively in Q1.

Import prices rose by a very large margin. In Q1, import prices were up 13.5 percent, 15.6 percent, and 17.6 percent in the three months respectively, representing an acceleration of 31.2 percentage points from the previous year; export prices were down 5.3 percent, 5.5 percent, and up 1.4 percent, averaging -3.1 percent and representing a deceleration of 1.2 percentage points from the previous year. The continued hike in international commodity prices contributed to the surge in import prices. In Q1, the crude oil futures price was up 3.6 percent quarter on quarter, and 82.2 percent year on year, on the New York Mercantile Exchange, whereas the Brent oil spot price was up 2.3 percent quarter on quarter and up 71.1 percent year on year. On the London Metal Exchange, spot copper and aluminum prices were up 8.9 percent and 8.1 percent respectively quarter on quarter and up 110.6 percent and 59.2 percent year on year.

Labor compensation increased rapidly. In Q1, the average monthly salary of urban employees was up 13.1 percent year on year to 2,754 yuan, representing an acceleration of 0.3 percentage points. In particular, the average monthly salary in state-owned urban entities was up 13.0 percent to 2,928 yuan; that in collectively-owned urban entities was up 14.3 percent to 1,708 yuan; and that in other types of urban entities was up 13.2 percent to 2,666 yuan.

The GDP deflator rebounded fairly quickly. In the period under review, the GDP was up 11.9 percent in real terms to 8057.7 billion yuan. The rate of change in the GDP deflator (as a ratio of nominal GDP to real GDP) was 4.8 percent, up 7.3 percentage points from Q1 2009 and up 6.6 percentage points from 2009.

The reform of resource prices made further progress. The National Development and Reform Commission (NDRC) decided to raise the price of gasoline and diesel by 320 yuan per ton based on the improved pricing mechanism with reference to oil price movements on the international market. Going forward, it is necessary to continue the pricing reform of fuel, natural gas, water, and other resource goods and the reform of the mechanism for charging environmental fees based on the affordability of the various parties, improve the system where the polluters pay, enhance the fundamental role of the market in allocating resources, and increase resource supplies while suppressing irrational demands so as to promote the optimization of the economic structure and the transformation of the development pattern.

Box 4 Management of Inflation Expectations

Inflation expectations are the public's expectations of the future direction and range of movements in the inflation rate. Inflation expectations will have an impact on the level of general inflation, including asset prices from both the demand and supply sides. On the demand side, inflation expectations will reduce the public's demand for cash and increase their demand for assets and goods, thus pushing up the prices of assets and goods. On the supply side, inflation expectations will boost upward expectations of salary costs, and thus corporate expectations of higher manufacturing costs, which may prompt companies to raise factory prices. Inflation expectations have different impacts on the movement of various categories of prices. Generally, relative to the manufacturing sector where productivity is higher, the less productive and more labor-intensive agricultural and service sectors are more prone to inflation expectations; relative to the consumer goods market prices in asset market, which is more liquid and has a stronger ability for currency substitution, are more prone to inflation expectations.

All countries attach much importance to management of inflation expectations and usually take one or several of the following approaches. First, inflation targeting is adopted to boost public confidence in the effectiveness of monetary policy. Second, the central bank enhances communications with the public, increases monetary policy transparency, and guides public expectations. Third, when necessary, measures are taken to limit the prices of fundamental capital goods, for example making sure salary growth is not higher than the growth of labor productivity, to forestall inflation in the form of a price-salary spiral.

Since 2009, inflation expectations have become more pronounced. The future price expectation index in the PBC's urban depositor survey has been on the rise since Q1 2009 and has remained high in Q1 2010 after some moderation. Several factors have pushed up inflation expectations. First of all, with the major economies adopting exceptionally loose monetary policies and thus creating an easy monetary environment globally, the very low interest rates of the dollar and other major currencies have given rise to higher global inflation expectations, as reflected in the sharp rebound in the prices of primary product. Second, on the domestic front, the ballooning of money and credit aggregates as a result of measures taken to mitigate the impact of the international financial crisis have also led the general public to expect higher prices in the future. Third, despite the stable movements of indices, such as the CPI and PPI, prices of primary products, services, and assets including housing surged. Fourth, the recent extreme weather and natural calamities have led to expectations of higher prices for agricultural products.

On the track of the reform and transition, China faces an arduous task to transform the growth pattern and to adjust the economic structure. The domestic pricing mechanism of important resource products and other capital goods needs to be further adjusted. The factors giving rise to inflation expectations in China are more complex than and different from those in the advanced economies. The management of inflation expectations should be based on domestic circumstances while drawing reference from the experiences of other countries. Specifically, first, it is necessary to communicate with the general public and to guide public opinion and increase the public's confidence in price stability; it is necessary to explicitly state that price stability is an important policy goal and the measures taken by the government will keep prices stable; it is also necessary to explain to the public those factors affecting price levels, such as the energy and resource pricing reform that is designed to adjust the supply and demand relationship, to promote energy efficiency and conservation, and to create a good price environment for economic development and greater social welfare, and that such reforms will not mean higher general price levels. Second, monetary policy operations should manage liquidity, credit, and money aggregates effectively so that monetary policy instruments will play a role in managing inflation expectations. Third, given the large share of food in domestic consumption, and consequently the large impact of food prices on consumer prices, it is necessary to take measures to increase the domestic supply of agricultural products and to keep their prices stable. Fourth, due to the relatively underdeveloped state of the real estate market and the growing household demand for financial assets, it is necessary to take multiple measures to enhance macro-prudential management, keep the leveraging ratio within a safe range, and prevent excessive asset price inflation which would strengthen expectations of consumer price inflation. Fifth, with the investment ratio remaining high, resource consumption extensive, and upstream prices prone to the shock of international primary goods prices, China needs to continue the pricing reform of water, electricity, petroleum, gas, and other resource products and improve the basic welfare system for low-income groups by taking social welfare and subsidy measures to ease the impact of the reform on the livelihood of low-income people.

4. Fiscal revenue grew by a large margin

With the economic recovery on the way and a low year-on-year base, fiscal revenue (excluding debt income) surged in Q1. Fiscal revenue increased 34.0 percent year on year to 1962.71 billion yuan, representing an acceleration of 42.3 percent from Q1 2009, whereas fiscal expenditures grew 11.9 percent to 1433.00 billion yuan, representing an acceleration of 22.9 percentage points. Revenue exceeded expenditures by 529.71 billion yuan, representing an expansion of 346.60 billion yuan from Q1 2009.

In Q1, tax revenue was up 35.9 percent year on year, an acceleration of 46.2 percent from the previous year. In particular, domestic VAT revenue, business tax, and consumption tax revenue were up 11.3 percent, 41.2 percent, and 69.4 percent respectively, representing an acceleration of 13.7 percentage points, 42.7 percentage points, and 30.9 percentage points from the previous year. Due to the improved enterprise profits, VAT revenue was up 16.1 percent, representing an acceleration of 32.8 percentage points. Within the expenditure basket, the three largest items were education (216.49 billion yuan, or 15.1 percent of total spending), social security and employment (196.00 billion yuan, or 13.7 percent of total spending), and general public services (169.64 billion yuan, or 11.8 percent of total spending). As for item-by-item growth of expenditures, with the exception of spending on science and technology that grew by 66.6 percent year on year, faster than during the same period of the last year, growth of spending on other items all decelerated, i.e., general public services spending was up by 11.5 percent year on year, education was up 17.1 percent, medical and health care was up 6.5 percent, social security was up 9.1 percent, and environmental protection was down 21.1 percent.

5. The balance of payments remained in surplus

In Q1, net foreign exchange inflows expanded and foreign exchange reserves continued to build up. The oversupply of foreign exchange became more salient. In Q1, banks incurred a surplus in their foreign exchange surrender business that was 117 percent larger year on year, compared with a surplus that was 73 percent less year on year in Q1 2009. At end-March, official foreign exchange reserves posted US$2.45 trillion yuan, up US$47.9 billion from end-2009. Going forward, though a second-dip recession is unlikely, given the lingering risks in the financial sector, the global recovery may not be smooth and large fluctuations in cross-border capital flows cannot be ruled out. Therefore, the international environment remains very complex for China’s BOP account and the trend of net capital inflows will continue.

The size of the external debt expanded. At end-2009, outstanding external debt totaled US$428.65 billion, an increase of 14.4 percent or US$53.99 billion from end-2009. In particular, outstanding registered external debt increased 2.5 percent or US$6.39 billion, accounting for 62.3 percent of the total outstanding external debt; outstanding short-term external debt increase 23.0 percent, or US$48.47 billion, to US$259.26 billion, accounting for 60.5 percent.

6. Sectoral analysis

Industrial output recovered quickly and profits rose by a large margin. In January and February, profits of statistically large enterprises increased 119.7 percent to US$486.74 billion. Heavy chemical industries and transportation and communications industries contributed greatly to profit gains whereas light industries and those whose raw materials suffered from huge price fluctuations did not register large profit gains. Among the 39 sectors, 35 sectors reported a year-on-year growth of profits, two loss-making sectors began to make profits, and one loss-making sector reduced its losses. In particular, the electricity industry, transportation and communications sector, chemical fiber industry, chemical industry, oil and gas extracting industry, and electronic telecommunications equipment manufacturing industry showed profit gains of 17.8 times, 2.7 times, 86.1 times, 1.7 times, 3.5 times, and 5.6 times year on year, whereas the steel and iron industry turned from losing 720 million yuan to making 17.67 billion yuan, and the non-ferrous metal smelting and rolling industry turned from losing 1.63 billion yuan to making 14.07 billion yuan. The supply of coal, electricity, and oil remained generally stable. In Q1, the output of raw coal, power generation, and crude oil increased by 28.1 percent year on year to 750 million tons, or 20.8 percent to 948.9 billion kilowatts per hour and 4.6 percent to 48.19 million tons respectively; a total of 7.14 billion tons of freight volume was handled, up 16.5 percent year on year.

(1) Real Estate Sector

In Q1, the sold floor area and volume of commercial real estate continued to expand, the price of housing rose rapidly, and the growth of real estate development accelerated. The growth of commercial real estate development was fast but moderated by end-March.

Real estate development investment increased rapidly and land purchases and floor areas of newly started projects both registered large growth. In Q1, a total of 659.4 billion yuan was invested in real estate development, an increase of 35.1 percent year on year, representing an acceleration of 31 percentage points from Q1 2009 and 19 percentage points from 2009. In particular, investment in commercial residential property grew 33.0 percent to 455.2 billion yuan, representing an acceleration of 18.8 percentage points from 2009. In Q1, land purchases by real estate development enterprises increased 30.0 percent to 61.66 million square meters, as compared to a reduction of 18.9 percent year on year in 2009; the floor area of newly started housing projects increased 60.8 percent year on year to 323 million square meters, representing an acceleration of 48.3 percentage points from 2009.

The floor area and sales volume of sold commercial real estate continued to grow, albeit at a rate lower than that in 2009. In Q1, the total floor area of sold commercial real estate was up 35.8 percent to 154 million square meters, an acceleration of 27.6 percentage points from Q1 2009 but a deceleration of 6.3 percentage points from 2009. The sale of commercial real estate was up 57.7 percent year on year to 797.7 billion yuan, an acceleration of 34.6 percentage points from Q1 2009 but a deceleration of

17.8 percentage points from 2009.

Housing prices surged. In March 2010, housing prices in the 70 large and medium cities grew a record high of 11.7 percent year on year and 1.1 percent month on month, with the latter representing a deceleration of 0.2 percentage points from January and an acceleration of 0.2 percentage points from February. The price of new homes in these 70 cities was up 15.9 percent year on year, led by the five cities of Haikou (growing 64.8 percent), Sanya (growing 57.5 percent), Wenzhou (growing 22.3 percent), Jinhua (growing 20.9 percent), and Guangzhou (growing 20.3 percent); the price of pre-owned homes was up 9.5 percent year on year, led by Sanya (growing 50.4 percent), Haikou (growing 40.4 percent), Shenzhen (growing 23.9 percent), Wenzhou (growing 23.9 percent), and Yinchuan (growing 16.2 percent).

Growth of outstanding commercial real estate loans moderated but remained high. At end-March 2010, outstanding commercial real estate loans of major financial institutions were up 44.3 percent year on year to 8.18 trillion yuan, representing a deceleration of 0.6 percentage points from end-February 2010 and an acceleration of 6.2 percentage points from 2009. In particular, growth of land development loans continued to decline as they grew 80.2 percent year on year to 745.3 billion yuan, representing a deceleration of 24 percentage points from end-2009. Real estate development loans grew in a generally moderate manner. At end-March, outstanding real estate development loans were up 19.6 percent year on year to 2.10 trillion yuan, representing an acceleration of 3.8 percentage points from end-2009 but a deceleration of 0.7 percentage points. Growth of mortgage loans accelerated. At end-March, outstanding mortgage loans were up 52.6 percent year on year to 5.33 trillion yuan, representing an acceleration of 10.1 percentage points from the end of 2009, with mortgage loans for new homes up 50.3 percent and mortgage loans for pre-owned homes up 91.6 percent. At end-March, outstanding real estate loans accounted for 20.1 percent of the total outstanding loans, an acceleration of 0.9 percentage points from end-2009.

To address the excessive housing price hike, on January 7, 2010 the State Council issued the *Notice on Promoting Steady and Healthy Development of the Real Estate Market* to improve and strengthen macro-management of the market and to stabilize market expectations. In general, positive changes have occurred on the real estate market. Yet, a trend of excessive housing prices and land price hikes reemerged in some cities, and speculative purchases again became brisk. The State Council attached great importance to this and on April 17, 2010 issued the *Notice on Containing Excessive Price Hikes in Some Cities,* requiring that local governments and relevant departments perform their duties in stabilizing housing prices and in ensuring a supply of welfare housing, containing irrational demand, increasing effective housing supply, accelerating the building of welfare homes, and strengthening market supervision.

(2) Water Production and Supply Industry

The serious drought in several southwestern provinces has affected local economic activities and people's daily life to a very large extent. The situation has also highlighted the vital importance of water resources and the necessity for the efficient use of water resources. As a result of population and economic growth, water shortages have become a bottleneck factor in China's development. Between 2000 and 2009, with per capita disposable fresh water resources at a mere 900 cubic meters, China became one of the water shortage countries. The water shortage has amounted to 40 billion cubic meters per year and 400 out of 655 cities are experiencing water shortages, including 110 cities with severe water shortages. About 230 million mu of farming land is affected by drought as a result of the water shortages.[4]

The production and supply of water, sewage treatment and recycling, and treatment and re-use of water are vitally important to people's daily lives and economic activities. In recent years, due to the rapid growth of the water production and supply industry, water supply capacity, water quality, and water supply technology and services have all improved. In 2009, there were over 4,000 public water factories and over 2,000 sewage processing factories in urban China. The water supply capacity and sewage treatment capacity in urban China is 266 million and 105 million cubic meters per day respectively; the total length of water supply pipes and drain pipes is 480,000 kilometers and 315,000 kilometers respectively; urban water supply and sewage drainage are 50 billion cubic meters and 36 billion cubic meters respectively.[5] There are two main problems in the water production and supply industry. The first problem is poor efficiency, as evidenced by the widespread losses in water production and supply factories. In February, about 48 percent of these enterprises incurred total losses of 1620 million yuan, and the entire industry showed sales profitability of -2.77 percent.[6] The second problem is low supply ability and poor utility efficiency. At the moment, per capita water supply ability in China is only two-thirds of the world average, GDP output per cubic meter of water is only one-third of the world average, and the coefficient of agricultural irrigation water utilization is only about 0.48, far below the average range between 0.7 and 0.8 in the developed countries.[7]

The flawed water pricing mechanism is an important reason behind these problems. As a result of the planned economy, the price of water is basically set by or under the guidance of the government, thus it neither covers compensation for resource consumption and environment pollution nor reflects the relationship of supply and demand or resource scarcity. In urban China, the low level of the price of water supplies, sewage treatment fees, and water resource charges and the limited scope of the charges have contributed to low water prices. The use of water in the agricultural sector is not based on a good pricing mechanism. The low price of water does not help conserve water or prevent water pollution, and without covering sewage treatment costs and water resource fees, the low price also means that the water production and supply sector has low or no profits. The production and supply of

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[4] National Development and Reform Commission, *Report on the State of Water Resources and Water Prices.*

[5] Water Department of the Ministry of Housing and Urban Construction, news release on the 2010 Urban Water Strategy Forum.

[6] Wind information service.

[7] Chen Lei, minister of water resources, "Strict Management of Water Resources to Guarantee Sustainable Development," *Guangming Daily*, March 22, 2010.

water is thus compromised.

In recent years, the government has attached importance to the water-pricing mechanism and has taken a series of policy measures to reform water prices by adjusting and straightening out the prices. Urban water prices are improving in terms of its composition. The urban water supply price or the price for end-users consists of the tap water price (the cost of building and maintaining the pipe network), sewage treatment fees, water resource fees (the contribution to the south-north water diversion fund is also included in the water resource fee in the benefiting regions), and a surcharge on urban public utilities, and the level of water prices has been higher. This plays a positive role in adjusting the supply and demand of water. Given the current situation in the production and utilization of water, the water-pricing mechanism needs to be further improved to build a water-conserving culture and improve water-utilization efficiency. First of all, reform of the water production and supply sector will be deepened. As this is a public utility sector, a market mechanism shall be introduced and a government oversight system shall be established and improved to promote development of the water production and supply sector and to satisfy the demands for water in people's daily lives and in economic activities. Second, the water-pricing mechanism will be improved. The urban water-supply price will be advanced to establish a water-pricing mechanism that fully reflects market supply and demand, water resource scarcity, and the cost of pollution, so that the water-pricing mechanism can adjust water supply and demand. There will be efforts to explore a reform of agricultural water to establish a price-management mechanism that promotes water conservation and reduces the farmers' burdens.

Part 5 Future Monetary Policy Stance

I. Macroeconomic outlook

Supported by a host of favorable factors, the Chinese economy is expected to continue to grow rapidly during the next stage. The PBC business survey and survey on bankers in the first quarter of 2010 both show strong confidence in robust macroeconomic performance into the next quarter, with the macroeconomic expectation index rising 2.6 percentage points quarter on quarter to 47.5 percent in the business survey and picking up 2.5 percentage points to 52.4 percent in the bankers' survey. Externally, despite the shocks of the sovereign debt crisis and other uncertainties in global financial markets, the global recovery in general remains on track, helping to improve the external environment. According to the PBC business survey in the first quarter, the export order index had climbed 0.8 percentage points from the last quarter to 50.0 percent. Domestically, domestic demand is expected to expand rapidly due to growing economic activities and confidence, enthusiasm for a quicker pace of development and greater investment across regions, and stronger growth drivers brought about by urbanization and upgrading of the consumption structure. Newly started projects in the first quarter increased by 5,882 year on year to 58,787, with the total planned investment rising 34.5 percent, continuing the rapid growth from 2009. Structural upgrading in urban consumption and expanding rural consumption supported by higher incomes combined with the economic upturn and improvements in corporate profits and employment will contribute to higher household income and a propensity for consumption that will boost consumption growth. The PBC urban depositors' survey in the first quarter shows that sentiment about future income recovered for three consecutive quarters while sentiment about employment rose for four consecutive quarters, indicating improving household sentiment regarding income and jobs.

Nevertheless, it should be noted that the economy faces a complex environment. At the global level, uncertainties about global economic performance persist and new sources of global growth have not emerged. In the domestic economy, the recovery of domestic demand needs to be established on a more balanced foundation, private investment and endogenous growth drivers need to be enhanced, and expanding consumption, improving income distribution, and optimizing the economic structure remain demanding challenges. Potential risks in public finance must not be overlooked. In this context, it is important to take action that will both support the current sound and relatively rapid development momentum and create favorable conditions for development over the long term. It is also important to accelerate the transformation of the economic development pattern.

Potential pressures for price hikes need to be closely watched. Though the price level is expected to remain stable for the time being as external demand is still in the process of recovery and domestic capacity is adequate, pressures are building up as a result of rising commodity prices, which are supported by the loose monetary conditions, the overall recovery across the globe, and the strengthening confidence as the domestic economy recovers at a rapid speed. The higher costs of labor, resources, and environmental protection may also drive up prices. All these point to heightened upward pressures for prices and greater potential threats to price stability. This is reflected in the results of the PBC urban depositors' survey in the first quarter, which suggests the price approval index dropped 2.3 percentage points from the last quarter and the price expectation index remains high at 65.6 percent.

I. Policy stance for the next stage

The year 2010 will be a critical juncture for China to succeed in its efforts to address the impact of the global financial crisis and to make achievements in supporting sound and rapid economic development and accelerating the transformation of the development pattern. Going forward, the PBC will continue to follow the scientific outlook on development and implement the relatively easy monetary policy in line with the overall arrangements of the State Council. It will properly manage the intensity, pace, and focus of policies and make policies better targeted and more flexible while also maintaining policy consistency and stability. It will strike a balance between supporting sound and relatively rapid development and restructuring the economy and managing inflationary expectations, strengthen the sustainability of financial support to economic development, and ensure that the financial system performs in a sound manner.

First, the PBC will strengthen liquidity management and guide money and credit to grow at a proper pace. In line with economic and financial developments and changes in foreign exchange flows, the PBC will deploy a wide range of monetary policy tools and carefully arrange the mix and term of the policy tools and manage the intensity of monetary policy operations to enhance liquidity management, making sure that liquidity in the banking system remains at a reasonable level and money and credit grow properly. It will guide financial institutions to properly pace provision of loans in line with the requirements for macroeconomic management and the needs of economic developmrient to eliminate sharp monthly credit fluctuations.

Second, the PBC will step up financial support to promote a shift in the development pattern and economic restructung. It will continue to implement differentiated credit policies and to improve the credit structure. Specifically, the PBC will enhance credit policies to support weak links in the economy, employment, energy conservation, and environmental protection, emerging industries of strategic importance, and industrial relocation; address the financing difficulties facing the agricultural sector and small enterprises; ensure that loans to key projects are granted; and rein in lending to high energy-consuming and polluting industries and industries with overcapacity. It will implement differentiated mortgage policies to promote the healthy and stable development of the real estate market. It will improve risk warnings to financial institutions and enhance management of risks of loans extended by local financing corporations. Moreover, the PBC will explore the establishment of a macro-prudential management framework and, taking advantage of the framework's counter-cyclical adjustment function across business cycles, will raise capital restrictions and liquidity requirements for systemically important banks so as to maintain the soundness of the financial system, prevent systemic risks, and improve the sustainability of financial support to economic development.

Third, the PBC will steadily advance the market-based interest rate reform and improve the RMB exchange rate regime. It will press ahead with the establishment of a benchmark interest rate system on the money market to improve pricing ability and the adjustment role of interest rates. It will improve the managed floating exchange rate regime based on market supply and demand and adjusted with reference to a basket of currencies in accordance with the relevant principles, and will keep the RMB exchange rate basically stable at an adaptive and equilibrium level. The PBC will promote the development of the foreign exchange market and introduce more tools for managing exchange rate risks. It will steadily advance the pilot program for RMB settlement of cross-border trade transactions to facilitate trade and investment and will support the going-global initiative. It will deepen the reform of the foreign exchange administration system to promote balanced capital flows. It will also regulate cross-border capital flows and step up monitoring and management of irregular and abnormal fund flows.

Fourth, the PBC will promote the sound development of the financial market. The PBC will deepen the reform of financial enterprises and accelerate the introduction of modern financial enterprise systems. It will provide more direct financing channels for enterprises, speed up the development of the bond market, and introduce more financial derivatives. While promoting innovations in debt-financing instruments for non-financial enterprises, the PBC will encourage SMEs to issue short-term financing bills and medium-term collective bonds, will explore the possibility of issuing SME convertible debt-financing instruments, and will study the issuance of asset-backed bills by enterprises.

Moreover, it will be necessary to strengthen the coordination and cooperation among fiscal, industrial, and monetary policy. Efforts will be needed to support proper and stable growth of domestic demand, develop new consumption models and new sources of consumption growth, and encourage and guide private investment to develop in a healthy way. It will be important to advance the economic restructuring so that economic growth will be driven collectively by consumption, investment, and exports rather than mainly driven by investment and exports, led by the primary, secondary, and tertiary industries together instead of being led by the secondary industries alone; and will shift to economic growth that is based on technological advances, improvements in the labor force, and managerial innovation from economic growth that is based on consumption of additional materials and resources.