China Monetary Policy Report
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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the first half of 2008 the Chinese economy overcame the adverse impacts of the devastating natural disasters and the unfavorable international economic and financial situations and maintained a momentum of stable and relatively fast growth. Investment, consumption, and exports all grew in a balanced manner. Domestic demand, consumer demand in particular, played a greater role in driving economic growth. Household income, corporate profits, and fiscal revenue continued to increase. The national economy developed in the intended direction of macroeconomic management. In the first half of 2008 GDP posted 13.1 trillion yuan, up 10.4 percent year on year, and the CPI registered year-on-year growth of 7.9 percent.

In accordance with the overall arrangements of the Central Committee of the Communist Party of China (CCCPC) and the State Council, the People's Bank of China (PBC), actively took part in earthquake relief and post-disaster reconstruction. In addition, the PBC promoted social and economic development, and properly managed the priority, pace and intensity of financial macro-adjustment policies to maintain a balance at the aggregate level. The PBC flexibly used open market operation (OMO) instruments and the reserve requirement ratio to absorb excess liquidity. At the same time, lower reserve requirement ratios were applied to rural credit cooperatives located in 1,379 counties (county-level cities) throughout the country that are heavily involved in agro-linked lending to units with relatively smaller assets. More central bank lending was extended to the central and western regions, the major grain-producing areas, and the disaster-hit areas. Measures were taken to guide the appropriate supply of money and credit and to optimize the credit structure. Continued efforts were made to promote the reform of financial institutions, to strengthen the flexibility of the RMB exchange rate, to improve the foreign exchange administrative system, and to promote balanced economic and financial development.

In the first half of 2008 the financial sector performed in a sound manner, in the intended direction of the financial macro-adjustment policies. At end-June 2008, broad money M2 increased 17.4 percent year on year, an acceleration of 0.3 percentage points from the same period of the last year and down 0.7 percentage points from that at end-May. Loans grew in a stable way. At end-June, outstanding RMB and foreign currency loans of all financial institutions totaled 30.5 trillion yuan, representing an increase of 15.2 percent year on year. New RMB and foreign currency loans reached 2.7 trillion yuan in the first half of 2008, 98.3 billion yuan more than the growth recorded during the same period of the last year. Enterprise deposits increased relatively rapidly. At end-June, the deposits of enterprises had increased 21.2 percent year on year, and the overall payment capacity of enterprises had been enhanced. The flexibility of the RMB exchange rate was further strengthened. At end-June, the central parity of the RMB against the US dollar was 6.8591 yuan per

US dollar, representing an appreciation of 6.50 percent from the end of the last year. The central parity of the RMB against the euro and the Japanese yen was 10.8302 yuan per euro and 6.4468 yuan per 100 yen, representing depreciations of 1.51 percent and 0.63 percent respectively from the end of the last year.

At present, the global economic environment faces an even harsher situation, and policy-makers in many economies face the dilemma of both maintaining price stability and promoting economic growth. Institutional and structural imbalances still remain in the Chinese economy, and pressures for price hikes are relatively high. Furthermore, many uncertainties both at home and abroad present risks to economic and financial operations, and the macro adjustment faces a complicated situation. However, under the combined forces of industrialization, urbanization, internationalization, and industrial and consumption structure upgrading, China's economy still has strong internal resilience and vitality. In the second half of 2008 the economy will follow the pattern of the first half of the year, maintaining a momentum of overall stable and relatively fast growth.

The PBC will follow the overall arrangements of the CPC and the State Council for the next half of the year, placing maintaining stable and rapid economic growth and curbing excessive price hikes as top priorities of macroeconomic management, and placing the reining in of inflation high on its agenda. Efforts will be made to maintain the continuity and stability of monetary policy, increase the foresightedness, targeting, and flexibility of the adjustment policy, adopt fine-tuning measures when appropriate according to the changing situations both at home and abroad, and manage the priorities, pace, and intensity of macroeconomic adjustments, so as to balance the relationship between containing inflation and maintaining rapid economic growth and to promote sound and rapid growth of the economy. The PBC will guide the appropriate growth of money and credit aggregates, attempting to combine the fine-tuning of aggregates with structural optimization. The PBC will continue to strengthen liquidity management, using a mix of policy instruments to absorb the liquidity in the banking sector. Price-type instruments will be appropriately used to steadily promote the market-based interest-rate reform. Continued efforts will be made to perfect the RMB exchange rate formation mechanism in a self-initiated, controllable, and gradual manner, and to maintain it at an adaptive and equilibrium level. Policies will be adopted to encourage growth in some sectors while discouraging growth in other sectors, and to guide financial institutions to increase credit inputs into key sectors and weak links of the economy such as agriculture, rural areas, and farmers, small enterprises, and post-disaster reconstruction. The PBC will take comprehensive measures to deepen the reform of the foreign exchange administrative system and to promote an equilibrium in the balance of payments. At the same time, restructuring will be accelerated with a focus on expanding domestic demand.

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Part 1 Monetary and Credit Performance

In the first half of 2008 the Chinese economy overcame the difficulties brought about by the severe natural disasters and unfavorable international economic and financial environments and maintained steady and rapid growth. As a result of various macroeconomic management measures, money and credit performed in a sound manner, which was in line with the expectations of macroeconomic management.

I. Growth of money supply fell

At end-June, the outstanding balance of broad money M2 amounted to 44.3 trillion yuan, an increase of 17.4 percent year on year, up 0.3 percentage points from the same period of the last year but down 0.7 percentage points from the end of May. The outstanding balance of narrow money M1 reached 15.5 trillion yuan, an increase of 14.2 percent year on year, down 6.7 percentage points over the growth in the previous year. Cash in circulation M0 grew by 12.3 percent year on year to 3.0 trillion yuan, a deceleration of 2.3 percentage points from the same period of the last year. Net cash withdrawals in the first half of 2008 totaled 19.4 billion yuan, 0.2 billion yuan more than that recorded in the same period of the previous year.

Since the beginning of 2008, growth of M2 has been broadly stable. Broken down by the components of the money supply, the growth of demand deposits in M1 continued to decelerate, 741.6 billion yuan less than the increase recorded in the first half of 2007; among the various components of quasi-money in M2, savings deposits grew by a large margin, an acceleration of 1.4 trillion yuan from the previous year

II. Deposits of financial institutions tilted in the direction of time deposits

At end-June, outstanding deposits of all financial institutions (including foreign-funded financial institutions, as throughout this Report) denominated in both RMB and foreign currencies increased by 17.8 percent year on year to 45.0 trillion yuan, an acceleration of 2.5 percentage points from the same period of the last year and an increase of 4.9 trillion yuan from the beginning of 2008, 1.5 trillion yuan more than the increase recorded in the same period of 2007. In particular, outstanding RMB deposits rose by 18.9 percent year on year to 43.9 trillion yuan, an increase of 5.0 trillion yuan from the beginning of the year and an acceleration of 1.6 trillion yuan from the growth in the previous year; outstanding foreign currency deposits declined year on year by 1.8 percent to USD163.8 billion, a decrease of USD3 billion from the beginning of 2008.

Broken down by sectors and maturities, RMB deposits of households grew at a rapid pace, deposits of non-financial companies decreased slightly from the previous year, and fiscal deposits increased steadily. Meanwhile, due to the large fluctuations in the capital market since the beginning of 2008, a large amount of funds flowed back into banking system, resulting in a remarkable increase in time deposits of both households and enterprises. At end-June, outstanding household RMB deposits totaled 19.8 trillion yuan, representing growth of 14.6 percent year on year, an acceleration of 5.1 percentage points from the same period of 2007, an increase of 2.2 trillion yuan from the beginning of 2008, and an acceleration of 1.4 trillion yuan from the increase recorded in the same period of 2007. In particular, the growth of household time deposits increased by 1.5 trillion yuan year on year. Outstanding deposits of non-financial companies stood at 20.5 trillion yuan, representing growth of 20.1 percent year on year, an acceleration of 0.4 percentage points compared with the increase recorded in the same period of the last year, an increase of 1.6 trillion yuan from the beginning of the year, and a deceleration of 27 billion yuan year on year. In particular, the growth of corporate time deposits increased by 758 billion yuan from the increase in the prior year, indicating the continued strong payment capability of enterprises. Outstanding fiscal deposits amounted to 2.8 trillion yuan, representing an increase of 1.0 trillion yuan over the beginning of 2008 and an acceleration of 192.6 billion yuan from the previous year.

III. Loans of financial institutions grew steadily

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 30.5 trillion yuan at end-June, representing growth of 15.2 percent year on year, a deceleration of 1.1 percentage points from the same period of the last year but an increase of 2.7 trillion yuan over the beginning of the year, accelerating by 98.3 billion yuan compared with the growth in the same period of the last year. Outstanding RMB loans grew by 14.1 percent year on year to 28.6 trillion yuan, representing a deceleration of 2.4 percentage points from the same period of the last year and an increase of 2.5 trillion yuan over the beginning of the year, 89.9 billion yuan less than that recorded in the same period of the last year. Foreign currency loans maintained relatively rapid growth. At end-June, outstanding foreign currency loans rose by 48.6 percent year on year to USD275.3 billion, representing an increase of USD55.3 billion over the beginning of the year and an acceleration of USD38.8 billion compared with the growth in the same period of the last year. In addition, the growth of entrusted loans and trust loans totaled 360.8 billion yuan, 140.2 billion yuan more than the increase in the previous year, and the overall financing volume of enterprises continued to accelerate.

In terms of the sectoral distribution of RMB loans, the growth of loans to households, non-financial companies, and other sectors were all moderate. Loans to households increased year on year by 21.1 percent, down 4.6 percentage points from the previous year and an increase of 460.2 billion yuan over the beginning of the year, decelerating by 213.9 billion yuan compared with the growth in the same period of the last year. Among the loans to households, consumer loans increased by 258 billion yuan from the beginning of 2008, 122 billion yuan less than the growth in the previous year, and continuing the deceleration since the beginning of 2008, which can be attributed to the decline in housing sales, the cautious stance of financial institutions in terms of extending housing loans, and the wait-and-see attitude of individuals with regard to the real estate market. Household operational loans increased by 202.3 billion yuan from the beginning of 2008, a deceleration of 91.9 billion yuan year on year. Loans to non-financial companies and other sectors increased by 12.6 percent year on year, down 2.1 percentage points from the previous year, and grew by 2.0 trillion yuan from the beginning of the year. In particular, short-term loans, paper financing, and medium and long-term loans grew by 791 billion yuan, 5 billion yuan, and 1.2 trillion yuan respectively.

Broken down by financial institutions, lending by policy banks accelerated compared with that during the same period of the last year, whereas lending by other financial institutions decelerated year on year. In terms of loan distributions, new agricultural loans reached 770.4 billion yuan, accounting for 31.4 percent of the total new RMB loans in the first half of 2008. The bulk of RMB medium and long-term loans went to the infrastructure, real estate, and manufacturing sectors. In the first half of 2008, the total RMB medium and long-term loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) extended to the infrastructure sectors (including transportation, storage and postal services, electricity, gas, and water production and supply, water conservancy, and environmental and public facility management), the real estate sector, and the manufacturing sector totaled 882.6 billion yuan, accounting for 67.7 percent of the total new medium and long-term loans.

Table 1: RMB lending by financial institutions in the first half of 2008

Unit: 100 million yuan

	In the first half of 2008		In the first half of 2007	
	New loans	Year-on-year acceleration	New loans	Year-on-year acceleration
Policy banks	2853	589	2264	820
State-owned commercial banks	9005	−467	9472	287
Joint-stock commercial banks	5255	−362	5616	995
City commercial banks	1742	−283	2025	384
Rural financial institutions	4036	−525	4561	1089
Foreign financial institutions	585	−70	655	279

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

Source: The People's Bank of China.

Box 1: How to handle the financing problems of small- and medium-sized enterprises

There has been recent public attention to the problems of the operational difficulties and tight cash flow of some small- and medium-sized enterprises (SMEs). For SMEs, the financing difficulties are not a temporary phenomenon but rather a chronic problem. The current financing difficulties are not purely a problem of poor accessibility to financing, but rather reflect the tight capital supply due to the operational difficulties of SMEs, showcasing manifold problems in the economic restructuring that is underway in China and the world.

The long-existing financing difficulties of SMEs may be attributed to the underdeveloped direct financing and unsound financial institutional system in China on the one hand, and also may be related to the characteristics of the SMEs on the other hand. For a long time, SMEs in China mainly depended on bank loans to obtain capital and they had few direct financing tools. Their small size, unstable income streams, poor risk-proof ability, and lack of qualified mortgages to a large extent affected the banks' willingness to lend to them. Additionally, the SMEs were concentrated in the traditional manufacturing industries such as textiles and the printing and dyeing industry, most of which are high energy-consuming and highly polluting with unreasonable industrial structures, thus constraining the ability of the SMEs to attract financing.

Some new situations in the economy also had a great impact on the operations and financing of the SMEs. First, due to the sub-prime mortgage crisis in the U.S., the weakening external market, and the slowdown of exports, Jiangxi, Zhejiang, Guangdong, and other export-oriented coastal areas with a high concentration of SMEs were greatly affected. Dwindling corporate profits reduced their own revenue on the one hand, and also constrained their ability to access bank loans on the other hand. Second, under the combined influence of the price hikes of energy and raw materials, the increasing labor costs, the higher requirements for energy-conservation and environmental protection, the adjustment of the export rebate and processing-trade policy, and the RMB appreciation, pressures for economic restructuring were shifted to the labor-intensive SMEs. These problems could not be resolved simply by increasing bank lending; instead they required coordinated policies to support the structural adjustments and industrial upgrading. SMEs needed to change their extensive development mode to meet the requirements of the structural adjustments.

In recent years, on the basis of the deepening reform, commercial banks have explored ways to grant differential treatment to various borrowers through market mechanisms and to enhance the financial services for the SMEs. First, credit support to the SMEs has been maintained. Many commercial banks regard SME lending as a strategic priority and as a source of growth of profits, thus actively developing business in this regard. Some joint-stock commercial banks that mainly provide financial services to SMEs saw that their new SME loans in the first half of 2008 already surpassed the increments in 2007. According to the recent PBC survey on lending to private industrial enterprises, in the first five months, new loans to private SMEs accounted for 16.2 percent of the total new loans, up 1.6 percentage points from the same period of 2007. The loan-coverage ratio of the SMEs increased steadily. Second, bills acceptance remained relatively rapid growth. In addition to loans and bills discount, acceptance bills are also an important channel for SMEs to obtain financial support, enhance their payment ability, and ensure normal business operations. In 2008 the outstanding balance and the accumulated amount of bankers' acceptances continued to grow rapidly. In the first half of 2008, outstanding bankers' acceptances grew by 384.6 billion yuan, and by 418.1 billion yuan in cumulative terms, representing a growth of 212.1 billion yuan and 185.8 billion yuan respectively year on year. Third, specialized financial services for SMEs have been underway. Some commercial banks further enhanced their service awareness in line with the strategic transformation, established different SME lending procedures and management systems according to the characteristics of SME lending, such as urgent and frequent need, small amount, and short maturity, simplified credit procedures for SMEs, and delegated authority of loan approvals to sub-branches so as to increase approval efficiency, innovated new ways of guarantee and products tailore-made for SMEs, improved incentive mechanisms, and established special risk-management systems. Some commercial banks established specialized SME departments. Tailore-made financial services for SMEs, such as capped mortgage loans, revolving credit lines, joint-guarantee loans, overdrafts from legal person's accounts, and mortgages with movable property, were gradually introduced. However, it is noteworthy that many Chinese banks still focused on mortgages, guarantees, short-term profits, and fiscal subsidies in terms of their loan management concept, which is not entirely suitable to the characteristics of the SMEs.

To resolve the financing difficulties of the SMEs, efforts should be made to deal with their short-term difficulties, and to take comprehensive measures to establish a long-term mechanism. First, efforts should be made to develop a system of small- and medium-sized financial institutions by establishing new financial institutions such as village and township banks, micro-credit companies, loan companies, and rural capital shops. Second, progress should be made to speed up financial innovation, to encourage financial institutions to innovate trade-financing tools and credit products for SMEs, and to further increase the credit coverage ratio of SMEs. Third, efforts should be made to establish a multi-layered SME financing system and to expand direct financing channels. Fourth, endeavors should be made to accelerate the establishment of a guarantee system and a credit information system, promoting the development of guarantee institutions in various forms and improving the local guarantee system for the SMEs. Furthermore, efforts should be made to improve the public's credit awareness. Fifth, fiscal support to small-sized enterprises should be strengthened to play a guiding role for fiscal funds. More importantly, SMEs should transform their extensive operation mode in a timely manner to adapt to the restructuring requirements and to strengthen their risk-proof abilities. In addition, efforts should also be made to further improve internal management, enhance management levels, improve accounting standards and credit awareness, advance technologies, increase competitiveness, and create favorable conditions to meet the financing requirements.

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

At end-June, the outstanding balance of base money amounted to 11.5 trillion yuan, 1.4 trillion yuan more than that at the beginning of 2008, and year-on-year growth of 40.0 percent, up 9.0 percentage points from the previous year Since the second half of 2006, the PBC has raised the reserve requirement ratio several times, resulting in an acceleration of base money growth as the required reserves are included in the base money. Excluding the liquidity frozen by the higher reserve requirement ratio, the growth rate of base money would be less than 5 percent. At end-June, the money multiplier (broad money/base money) was 3.84, down 0.73 from the same period in 2007. The excess reserve ratio of financial institutions stood at 1.95 percent, down 1.55 percentage points from the end of 2007, but it picked up from end-April and end-May. In particular, the excess reserve ratio of state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 1.59 percent, 1.83 percent, and 5.67 percent respectively. Affected by several factors such as the proper conduct of open market operations, better liquidity management of commercial banks, and the steadily improved payment and settlement system, the excess reserve ratio of financial institutions saw an overall decline.

Box 2: Excess Reserve Ratio

The reserve requirement ratio can be divided into the required reserve ratio and the excess reserve ratio. Excess reserves refer to the reserves deposited in the central bank by financial institutions on a voluntary basis with the aim of satisfying their payment and settlement needs as well as the transfer of funds, or to be used as assets. The proportion of excess reserves in deposits is called the excess reserve ratio. Before 1998, the PBC required that financial institutions maintain an excess reserve ratio of 5-7 percent, whereas after 1998, the PBC removed the restrictions on the excess reserve ratio and allowed financial institutions to decide on their own the amount of excess reserves to be deposited in the central bank based on their specific payment and settlement and transfer of funds needs, etc.

As a general trend, the excess reserve ratio of China’s financial institutions fell year by year (Figure 1). There are several reasons for the decline in the excess reserve ratio. First, after the PBC reformed the regulation regarding the reserve requirement ratio in March 1998, the required reserves could be used for payment and settlement during the business day. Second, with the excess reserve ratio gradually lowered and the share-holding reform of commercial banks steadily advanced, financial institutions attach more importance to increasing the returns on the use of funds, and tend to decrease the excess reserve ratio. Third, the financial market became broader and deeper, short-term financing instruments were enriched on the money market, and the holding of bond assets by financial institutions expanded remarkably, which created favorable conditions for financial institutions to improve their liquidity management. Fourth, with the progress and systematic development in the PBC's payments and clearing techniques, the efficiency of payments and settlement was greatly enhanced, providing technical support for financial institutions to further lower the excess reserve ratio. In general, the continued decline of the excess reserve ratio of financial institutions is a result of their own decisions.

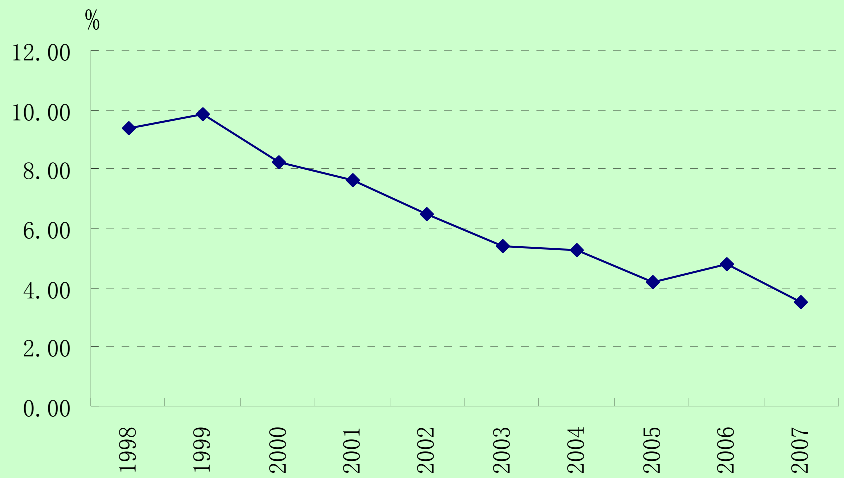


Figure 1: Movement of the excess reserve ratio of financial institutions since 1998

Over the past two years, affected by several factors including the fluctuating capital market, the flow of funds, and policy expectations, the excess reserve ratio of financial institutions saw large fluctuations. Since 2006, developments in the capital market have been a major factor triggering the drastic fluctuations in the excess reserve ratio. Especially during the issue of large-cap stocks, the fluctuating source of funds of financial institutions caused by sizable cross-bank and cross-border capital flows called for raising the excess reserve ratio; after the issue, the excess reserve ratio bounced back to its normal levels. In addition, the expectations of financial institutions regarding macro management policies and other unexpected market events may also increase movements of the excess reserve ratio.

In terms of institutions, the excess reserve ratio of different types of commercial banks varied in terms of settlement efficiency and liquidity management preferences. Generally, small and medium-sized commercial banks with a relatively weak financing capability and a lower efficiency in fund transfers within the system tend to hold a higher excess reserve ratio, whereas state-owned commercial banks hold a lower excess reserve ratio.

Liquidity management of financial institutions is a dynamic process, and the needs for reserves can be satisfied either through money market financing or by adjusting the asset structure. Financial institutions should maintain the excess reserve ratio at an appropriate level according to their asset and liability position, liquidity in the banking system, money market interest rate and expectations, etc, and should cope with the potential effects of liquidity fluctuations in the banking system with a forward-looking approach.

V. Lending rates of financial institutions increased with fluctuations

In the first half of 2008, the lending rates for loans of different maturities displayed an overall rising trend, but they declined in June. In the first four months, RMB lending rates of financial institutions edged up slowly due to the expectation of an interest rate hike; in May, driven by the significant increase in the short-term loans of rural credit cooperatives (RCCs) and the large upward-floating of the interest rates, lending rates obviously rose; in June, with the expectation of interest-rate increases weakening, lending rates saw an overall decline. The weighted average lending rate of 6 month to 1 year (including 1 year) RMB loans was 8.47 percent, up 0.54 percentage points from the fourth quarter of 2007, but down 1.25 percentage points from May. The share of loans with interest rates floating upward from the benchmark rate escalated. In June, the share of loans with interest rates floating upward registered 45.58 percent, up 1.34 percentage points over the fourth quarter of 2007 or 8.96 percentage points from March, whereas it was down 28.06 percentage points from May.

Table 2: Average lending rates of financial institutions in the first half of 2008

Unit: percent

Maturity	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Within 6 months	7.06	7.09	7.32	7.47	7.66	7.28
6 month-1year	8.33	8.40	8.72	9.15	9.72	8.47
1-3 year	7.98	7.99	8.69	9.72	11.99	8.41
3-5 year	7.68	7.82	7.98	8.08	7.77	8.04
5-10 year	7.66	7.63	7.72	7.74	7.70	7.78
Above 10 years	7.20	7.14	7.27	7.24	7.33	7.37

Source: The People's Bank of China.

Table 3: Share of loans with rates floating at various ranges in the first half of 2008

Unit：percent

	Floating downward	At benchmark	Floating upward					
	[0.9，1)	1	Sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2
January	25.93	29.77	44.30	16.13	14.76	6.06	6.50	0.85
February	26.51	30.04	43.45	15.46	14.22	5.92	6.91	0.94
March	25.46	37.92	36.62	18.77	13.84	2.79	1.11	0.12
April	14.87	21.72	63.42	12.89	15.95	24.40	9.19	0.99
May	10.49	15.87	73.64	8.80	17.49	22.65	7.04	17.66
June	21.60	32.81	45.58	16.40	14.24	6.13	7.66	1.15

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

Source: The People’s Bank of China.

The interest rate of inter-bank RMB demand deposits of financial institutions fell slightly, whereas that of inter-bank time deposits remained broadly stable. In June, the weighted average interest rate of inter-bank demand deposits was 1.35 percent, a decline from that recorded in March, which may be attributed to the weakened volatility of short-term interest rates on the money market; the weighted average interest rate of time deposits was 3 percent, up 0.07 percentage points from March. The interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) saw a decline. In June, the weighted average interest rate of negotiable deposits with maturities of above 5 years stood at 4.69 percent, down 1.06 percentage points from March, which may due to the backflow of funds to the banking system; and the weighted average interest rate of negotiable deposits with maturities of between 3 to 5 years remained stable.

The interest rates of domestic large-value foreign currency demand deposits went down, whereas those of foreign currency loans experienced an overall increase. In particular, the weighted average interest rate of 1-year large-value foreign currency deposits was 6.96 percent, up 1.98 percentage points from March; the interest rate of 1-year foreign currency loans recorded 6.34 percent, up 0.52 percentage points from March.

Table 4: Average interest rates of large-value dollar deposits and loans in the first

half of 2008

Unit: percent

		Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Large-value deposits	Demand	1.95	1.61	1.69	1.67	1.65	1.50
	within 3 months	3.77	3.36	3.36	3.84	4.00	3.36
	3—6 months	4.21	3.84	3.33	4.42	3.17	4.04
	6—12 months	3.81	3.35	3.43	5.89	4.37	4.53
	1 year	4.21	4.67	4.98	4.45	7.11	6.96
	above 1 year	5.43	—	5.62	7.53	3.34	8.30
Loans	within 3 months	6.04	6.02	6.55	6.63	6.29	6.24
	3—6 months	5.95	5.82	5.82	6.79	6.43	6.53
	6—12 months	5.68	5.71	6.28	6.55	6.27	6.46
	1 year	5.30	5.29	5.82	6.20	6.35	6.34
	above 1 year	4.42	3.94	4.98	5.07	4.70	5.54

Source: The People's Bank of China.

VI. The flexibility of the RMB exchange rate was further strengthened

The fundamental role of market supply and demand continued to function well, and in general the RMB exchange rate appreciated. At end-June, the central parity of the RMB against the US dollar was 6.8591 yuan per US dollar, appreciating by 4455 basis points or 6.50 percent over the end of the last year; the central parity of the RMB against the euro and the Japanese yen was 10.8302 yuan per euro and 6.4468 yuan per 100 Japanese yen respectively, a depreciation of 1.51 percent and 0.63 percent over end-2007. Between the exchange rate regime reform on July 21, 2005 and end-June 2008, the RMB cumulatively appreciated by 20.66 percent and 13.33 percent against the US dollar and the Japanese yen respectively, and cumulatively depreciated by 7.54 percent against the euro.

The flexibility of the RMB exchange rate was further strengthened, and the linkage of the RMB exchange rate with the major currencies was obvious. In the first half of 2008, the peak and bottom central parities of the RMB against the US dollar were 6.8591 yuan per US dollar and 7.2996 yuan per US dollar respectively. The largest appreciation of the RMB central parity against the US dollar in a single business day was 0.35 percent (246 basis points) and the largest depreciation in a single business day was 0.23 percent (162 basis points). Among the 120 trading days, the inter-bank foreign exchange market saw an RMB appreciation on 74 days, an RMB depreciation on 45 days, and a flat rate on one day, indicating that the RMB exchange rate floated in both directions. In the first half of 2008, the daily fluctuation of the central parity averaged 79 basis points, suggesting the enhanced flexibility of the RMB exchange rate compared with the average of 62 basis points recorded in 2007.

Part 2 Monetary Policy Conduct

In the first half of 2008, according to the decisions and arrangements of the Central Committee of the Communist Party of China (CPC) and the State Council, the PBC placed both earthquake disaster relief and economic and social development on its agenda, and appropriately handled the priority, pace, and strength of financial macro management in line with the principle of differentiated treatments of different sectors. Comprehensive measures were taken to strengthen liquidity sterilization in the banking system, to guide the appropriate growth of money and credit and the optimization of the credit structure, to steadily promote financial institution reform, to further enhance the flexibility of the RMB exchange rate, to improve foreign exchange administrative reform, and to maintain a balance at the aggregate level.

I. Open market operations were conducted flexibly

In the first half of 2008, with close attention to developments in the economic and financial situations both at home and abroad, the PBC strengthened liquidity management and flexibly conducted open market operations. First, the portfolio of open market operation tools was arranged flexibly. Given the large fluctuations in the short-term demand for liquidity in the banking system, the PBC used both central bank bills and repos of special treasury bonds according to the status of liquidity in the banking system and the changing needs of financial institutions for fund allocations to drain lax liquidity in the banking system. In the first half of 2008, the issuance of central bank bills totaled 2.94 trillion yuan, and the amount of repos reached 2.35 trillion yuan. At end-June, outstanding central bank bills amounted to 4.24 trillion yuan, and outstanding repos reached 175.6 billion yuan. Second, efforts were made to strengthen the role of pre-emptive adjustments and to fine-tune open market operations. Based on scientific analysis and predictions of liquidity supply and demand, the PBC appropriately handled the strength and pace of open market operations, and flexibly arranged the maturities of operation tools to allow central bank bills and repos to have complementary maturities, which effectively alleviated the impact of seasonal factors on the market. Third, the interest rates of open market operations remained stable and properly guided market expectations. At end-June, the issuance rate for 3-month, 1-year, and 3-year central bank bills stood at 3.3978, 4.0583, and 4.56 percent respectively, flat with the rates recorded at the beginning of 2008. Fourth, treasury cash management was carried out when appropriate. In order to promote the coordination of fiscal and monetary policy and to enhance the efficiency of the use of treasury cash, the PBC and the Ministry of Finance deposited a total of 30 billion yuan in 3-month time deposits in commercial banks on three successive occasions, specifically on January 30, April 30, and July 30, thus ensuring the continuity of the business.

II. The sterilizing role of the reserve requirement ratio was further strengthened, and relevant preferential policies were adopted for some rural credit cooperatives and the disaster-hit areas

In the first half of 2008, in order to sterilize excess liquidity, the PBC announced it would raise the reserve requirement ratio of deposit-taking financial institutions by 0.5 percentage points on January 16, March 18, April 16, and May 12, effective on January 25, March 25, April 25, and May 20 respectively; and on June 7 it announced it would raise the reserve requirement ratio by 1 percentage point, with the ratio raised by 0.5 percentage points on June 15 and by another 0.5 percentage points on June 25. The reserve requirement ratio for local currency of financial institutions reached 17.5 percent. Meanwhile, a relatively low reserve requirement ratio was continued for the RCCs in 1,379 counties (cities) with a large share of agricultural lending to units with a relatively small asset scale to increase financial support to the rural economy. Currently, the required reserve ratio of these RCCs is 5.5 percentage points lower than its normal levels. In addition, in an effort to intensify support to the rebuilding of the quake-hit areas in the aftermath of the Wenchuan earthquake, the reserve requirement ratio of financial institutions incorporated in the worst quake-hit areas remained unchanged.

III. Window and credit policy guidance was strengthened

Efforts have been made to guide the commercial banks to strengthen credit control, appropriately balance the pace of credit extensions within the year, and prevent excessive fluctuations of loans. In line with the principle of differentiated treatments of different sectors, the PBC guided commercial banks in optimizing the credit structure, strictly limiting lending to low-quality enterprises in industries with high energy consumption, heavy pollution, or overcapacity, strengthening credit support to the rural economy, earthquake disaster relief, small and medium-sized enterprises, the services sector, self-initiated innovation, energy conservation and environmental protection, and improving financial services in the rural areas. Steps have also been taken to strengthen the role of central bank lending to support the agricultural sector, promoting the redemption of special bills for the reform of the RCCs, increasing central bank lending to the central and western areas, the grain-producing regions, and the disaster-hit areas, and allowing the RCCs to withdraw special deposits in advance. Rural financial institutions were also guided to extend loans according to the agricultural production cycle, and to enhance credit extensions for the production of grain, edible oil, meat, and other necessities. Preferential money and credit policies were adopted in the disaster-hit areas to satisfy their credit needs.

IV. Reform of financial institutions was promoted steadily

The share-holding reform of state-owned commercial banks was deepened. After completing the reform, the Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Bank of Communications continued to improve their corporate governance, business transformation, and profitability. In the first half of 2008, business in the reformed banks witnessed a momentum of good growth, with their net interest income, fees, and commissions increasing rapidly, and the four banks saw a great improvement in their performance compared with that in 2007. Basic work related to the reform of Agricultural Bank of China made great strides. After the reform plan of serving the rural economy was implemented on a pilot basis in 123 branches at the county level in 17 regions of 8 provinces (cities), a pilot reform of the financial services departments of the rural areas was also carried out in 11 branches at the secondary level in 6 provinces (regions) in May 2008. The PBC, together with other relevant departments, further deliberated a share-holding reform plan for the Agricultural Bank of China.

According to the reform guidelines and plans approved by the State Council, the commercial-based reform of the China Development Bank was advanced at a steady pace. At present, the China Development Bank has completed legal due diligence, and preparations for the share-holding reform are underway.

The reform of the RCCs also underwent important advances and produced good results. At end-June, the cumulative redemption of special bills in 1,771 counties (cities) amounted to 120.6 billion yuan, effectively reducing the historical burdens of the RCCs. With the remarkable capital improvements, the RCCs' financial services to the rural economy and rural households further improved. At end-June, according to the four-category loan classification system, the NPL ratio of the RCCs was 8.4 percent, 28 percentage points less than that recorded at the beginning of the reform. The outstanding loans of the RCCs accounted for 12 percent of the total credit of the financial institutions, up 1.6 percentage points from the beginning of the reform. Their agricultural loans accounted for 47 percent of their total loans, up 7 percentage points from the beginning of the reform. The reform of the property rights regime advanced smoothly. At end-June, 19 rural commercial banks, 131 rural cooperative banks, and 1,894 rural credit cooperatives with a unified legal entity at the county (city) level had been established nationwide. The PBC, together with the China Banking Regulatory Commission (CBRC), carefully fulfilled their obligations and conducted strict verification according to the relevant rules and procedures to actively encourage the RCCs to strengthen their internal management and to intensify their disciplinary mechanism. Policies to provide fund support to the RCCs played a positive role and provided an incentive to promote the reform of the RCCs. Under the guidance of the State Council, the first priority of the reform of the RCCs was to improve their services to the rural economy. At the current stage, long-term and stable upholding of the legal entity status of the RCCs at the county (municipal) level should be guaranteed in the process of reforming the property rights system or choosing corporate governance structures, which will be beneficial to the reform of the RCCs to better serve the rural economy, to the healthy and sustained development of the RCCs, and to the appropriate competition and development of the rural financial market. According to the existing rules and regulations, the PBC will continue to apply preferential central bank lending policies and a relatively low reserve requirement ratio to those RCCs with long-term and stable upholding of the legal entity status at the county (municipal) level and a large share of agricultural loans, and will place priority on supporting their access to the inter-bank borrowing market.

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

Efforts have been made to continue to improve the managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies, to further promote the fundamental role of market supply and demand in the RMB exchange rate formation mechanism, to strengthen the flexibility of the RMB exchange rate, and to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. Meanwhile, active steps have been taken to deepen the reform of the foreign exchange management system, properly guide expectations of the RMB exchange rate, and strengthen the monitoring, analysis, and management of cross-border fund flows so as to promote a BOP equilibrium. First, measures were adopted to adjust the liquidity of foreign exchange in the banking system in a market-based approach, to further improve the price transmission mechanism among financial institutions, enterprises, and households, and to guide different market participants to effectively diversify exchange rate risks with price instruments. Second, a network verification system was established for the surrender of foreign exchange from exports, and credit extensions to the trade sector were registered and managed so as to prevent the inflow of funds without authentic trading records. At present, the new system is performing in a sound manner and has achieved initial results. Third, foreign debt management through relevant indicators was improved, and short-term foreign debt indicators in financial institutions were cut by nearly 10 percent based on the 2007 figures. Fourth, coordination for monitoring abnormal capital movements by various departments was strengthened, and special examinations and investigations of foreign exchange were launched to crack down on illegal cross-border flows of funds. IT techniques were adopted to intensify and improve foreign exchange management of direct investment. Fifth, a pilot reform of foreign exchange management for trade in services was conducted in some regions to meet the business needs of enterprises. The Qualified Domestic Institutional Investors (QDII) system continued to advance, and the Qualified Foreign Institutional Investor (QFII) system was further improved.

Issues related to the remittance and exchange of funds from the reduction in the holding of A-shares by foreign shareholders were being researched.. Sixth, the number of foreign exchange market participants was increased, and a total of 10 banks were approved to become members of the inter-bank RMB foreign currency swap market, and a finance company was approved to become a member of the inter-bank foreign exchange spot market, better satisfying the needs of market participants to hedge foreign exchange risks.

Part 3 Financial Market Analysis

In the first half of 2008 the financial market continued to perform in a sound and steady manner, featuring brisk activities on the money market and on the bond market, relatively large fluctuations on the capital market, a slight increase in the interest rate on the money market, an upward shift of the yield curve of bonds, good performance of bond issuances, stable operation of the foreign exchange market, more innovation in financial products, and improved institutional building of the financial market.

Financing by the domestic non-financial institution sector (including households, enterprises, and the government sector) increased steadily in the first half of 2008, with growth of 5.1 percent year on year. In terms of the financing structure, loan financing continued to play a dominant role; the share of enterprise bond financing and equity financing increased noticeably, indicating a strengthened role of direct financing in allocating social funds; due to the continued implementation of a sound fiscal policy, decreased issuances, and the large redemption of government securities, the amount of net financing in this category declined substantially.

Table 5:Financing by domestic non-financial sectors in the first half of 2008

	Volume of financing (RMB 100 million yuan)		As a percentage of total financing (%)	
	First half of 2008	First half of 2007	First half of 2008	First half of 2007
Financing by domestic non-financial sectors	31081	29569	100	100
Bank loans	27341	26358	88.0	89.1
Equities(1)	2391	1267	7.7	4.3
Government Securities	246	1594	0.8	5.4
Enterprise bonds	1103	350	3.5	1.2

Note: (1) Equity financing does not include financing by financial institutions on the stock market.

Source: The People's Bank of China.

I. An overview of financial market operations

1. Trading on the money market was active, with stable and upward interest rates and diversified fund lenders

Transactions on the inter-bank repo market and borrowing market were active, with average daily transactions climbing to new highs. In the first half of 2008, the turnover of bond repos registered 25.7 trillion yuan, with the daily turnover averaging 209.2 billion yuan and with year-on-year growth of 39.3 percent. The turnover of inter-bank borrowing registered 7.4 trillion yuan, with the daily turnover averaging 60.4 billion yuan and with year-on-year growth of 1.5 times. Most of the transactions on the repo and borrowing markets were overnight products; the proportions of overnight products were 54.5 percent and 68.2 percent respectively. The turnover of government bond repos on the stock exchanges increased 25.8 percent to 963.1 billion yuan.

Inter-bank borrowing showed three distinct features: first, lenders were diversified. Although state-owned commercial banks reduced their net lending noticeably, other commercial banks increased their net lending; second, mainly due to the large volatility on the capital market, the funding demands of securities companies and fund management companies moderated; third, foreign financial institutions showed a strong demand on the money market due to their rapid asset expansion.

Table 6: Fund flows among financial institutions in the first half of 2008

Unit: 100 million yuan

	Repo		Inter-bank borrowing	
	First half of 2008	First half of 2007	First half of 2008	First half of 2007
State-owned commercial banks	-45761	-55144	17672	2333
Other commercial banks	5000	1700	-21822	-8040
Other financial institutions	24094	38207	704	4261
Of which：Securities and fund management companies	4986	5773	2832	3210
Insurance companies	11575	9897	—	—
Foreign financial institutions	16667	15237	3446	1446

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

Source: The People's Bank of China.

Supply on the money market was relatively abundant, and the market interest rate displayed a mainly stable and slightly upward trend. In June, the weighted average interest rates of inter-bank borrowing and pledged bond repos were 3.07 percent and 3.08 percent respectively, up 0.75 percentage points and 0.27 percentage points respectively from January. At end-June, the overnight, one-week, and two-week Shibor were 2.7949 percent, 3.2936 percent, and 3.3525 percent, up 51, 69, and 37 basis points from that at the end of 2007.

Since the full-scale launching of interest rate swap transactions at end-February, the turnover of forward interest rate agreements has increased rapidly, though the amount is still small in terms of absolute volume, while the turnover of the forward bond interest rate swap moderated. The Shibor gradually played a role in the pricing of interest rate derivative products. In the first of 2008, there were 434 interest rate swaps based on the Shibor, with a turnover of 40.65 billion yuan, accounting for 19 percent of all interest rate swaps. There were 68 forward interest rate swap transactions, with a notational principal amount of 4.86 billion yuan, and all the forward interest rate agreements were based on the 3-month Shibor.

Table 7: Transactions of interest rate derivatives

	Bond forward		Interest rate swap		Interest rate forward	
	Transactions	Amount(100 million yuan)	Transactions	Notional principal amount (100 million yuan)	Transactions	Notional principal amount (100 million yuan)
2005	108	177.99	—	—	—	—
2006	398	664.46	103	355.7	—	—
2007	1238	2518.09	1978	2186.9	14	10.5
Q1, 2008	441	1512.72	591	837.16	24	14.1
Q2, 2008	313	1208.32	944	1265.93	44	34.5
Total	2498	6081.58	3616	4645.69	82	59.1

Source: China Foreign Exchange Trading System.

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

Due to factors such as funds flowing back to the banking system, spot bond trading was active on the inter-bank market. The turnover in the first half of 2008 totaled 16.2 trillion yuan, with the average daily turnover hitting a historic high of 131.9 billion yuan, representing year-on-year growth of 1.7 times. The turnover of government bond spot trading on the stock exchanges registered 76.3 billion yuan, 10.4 billion yuan more than that in the same period of the last year. On the inter-bank spot bond market, except for other commercial banks that sold 909.3 billion yuan on a net basis, other financial institutions were net purchasers, with the net purchases of state-owned commercial banks and other financial institutions standing at 318.6 billion yuan and 460 billion yuan respectively.

Both the inter-bank bond index and the stock exchange bond index fell after climbing, displaying an overall upward trend. The inter-bank bond index climbed by 3.2 percent from 114.76 points at end-2007 to 118.43 points at end-May 2008; the stock exchange T-bond index increased by 2.4 percent from 110.87 points at end-2007 to 113.52

points at end-May 2008. In June, the inter-bank bond index and the stock bond index declined noticeably. At end-June, the inter-bank bond index and the stock exchange bond index were 116.84 points and 113.41 points respectively, down 1.37 percent and 0.14 percent from that at beginning-June.

The yield curve of the inter-bank government securities market displayed a declining-then-climbing trend. Since the beginning of 2008, the yield curve of government securities displayed an overall downward trend. In May, with the gradual tightening of the market and the heightened expectations of a tighter monetary policy, the prices of government securities declined and the yield curve of government securities shifted upward slightly. In June, affected by the increasing uncertainties both at home and abroad, investors became more cautious, and the yield curve of government securities moved up substantially.

The issuance of bonds increased steadily. In the first half of 2008, a total of 1.15 trillion yuan of bonds (excluding central bank bills) was issued, an increase of 45.5 billion yuan, or 4.1 percent year on year. Among the total, the issuance of enterprise bonds increased rapidly. In terms of their maturity structure, the proportion of issuance of bonds with a maturity of less than 5 years was 63.1 percent, down 1.1 percentage points year on year, among which the proportion of issuance of bonds with a maturity of less than 1 year was 6 percentage points lower than that during the same period of the last year. At end-June, outstanding bonds deposited with the China Government Securities Depository Trust & Clearing Co. Ltd. totaled 13.7 trillion yuan, an increase of 11.4 percent and 31.8 percent from that at end-2007 and the same period of the last year respectively, with 12.5 trillion yuan on the inter-bank market and 0.3 trillion yuan on the stock exchange market.

Table 8: Issuances of major bonds in the first half of 2008

Government securities	Issuances (100 million yuan)	Year-on-year growth(%)
Government securities	3902	-6.8
Policy financial bonds	4434	1.3
Bank subordinated bonds and hybrid capital bonds	162	-44.1
Bank common bonds	0	—
Enterprise bonds (1)	2867	50.2
Asset-backed securities	165	—

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

Source: The People's Bank of China.

The issuing rate of bonds displayed a sliding-then-climbing trend. In the first quarter, with a weakened expectation of interest rate hikes and funds flowing out of the capital market, the issuing rate of bonds declined somewhat. Since April, mainly affected by the market liquidity and a heightened expectation of interest rate hikes, the financing costs increased with the issuing rates of bonds edging up. The issuing rate of 10-year book-entry government bonds issued in June 2008 was 4.41 percent, up 0.34 percentage points from that of government bonds with the same maturity issued in March 2008. The issuing rate of 3-year fixed rate bonds issued by the China Agricultural Development Bank in July 2008 was 4.82 percent, up 0.17 percentage points and 0.22 percentage points respectively from that of bonds with the same maturity issued in January 2008 and in March 2008. The issuing rate of 10-year fixed rate corporate bonds issued by the State Grid in July 2008 was 5.71 percent, up 0.36 percentage points from that of bonds with the same maturity by the State Grid issued in January 2008.

The Shibor has played a greater role in the pricing of bonds. In the first half of 2008, a total of 11 fixed-rate enterprise bonds was issued based on the Shibor rates, totaling 29.59 billion yuan in volume. A total of 82 short-term financing bills based on the Shibor rates was issued, amounting to 71.1 billion yuan in volume and accounting for 41 percent of the total issuance. A total of 13 medium-term bills based on the Shibor rates was issued, amounting to 31.1 billion yuan in volume and accounting for 42 percent of the total issuance. A total of 2 floating-rate bonds based on the three-month Shibor rate was issued, amounting to 10.5 billion yuan.

3. Acceptance of commercial bills increased

In the first half of 2008, a total of 3.4 trillion yuan of commercial bills was issued by the corporate sector, up 14.2 percent year on year. Discounted bills totaled 5.8 trillion yuan, up 12.3 percent year on year. Rediscounted bills totaled 6.24 billion yuan, at par with that during the same period of the last year. At end-June, outstanding commercial bills amounted to 2.9 trillion yuan, up 15.3 percent year on year. Outstanding discounted bills totaled 1.3 trillion yuan, down 26.3 percent year on year. Outstanding rediscounted bills totaled 5.11 billion yuan, a little more than that in the same period of the last year.

Since the beginning of 2008, the acceptance of commercial bills has increased relatively rapidly and has provided credit support for enterprises. In the first half of 2008, outstanding bankers' acceptances increased 458.9 billion yuan, totaling 3.3 trillion yuan, 146.4 billion yuan and 441.1 billion yuan more than those in the same period of the last year respectively. However, the amount of outstanding paper financing decreased measurably. At end-June, outstanding paper financing declined by about 700 billion yuan from the peak period, while the amount of paper financing increased 5 billion yuan, a deceleration of 18.7 billion from the amount during the same period of the last year. Since the beginning of 2008, the average monthly balance of paper financing has decreased by about 30 percent, and the continuous decline in paper financing changed the situation whereby short-term loans used to be replaced by means of paper financing. In order to improve financial services for county and rural areas and to alleviate the financing difficulties of small and medium-sized enterprises, the People's Bank of China will use bill rediscounting to adjust the credit structure and to guide the allocation of credit funds, so as to promote the stable growth of paper financing and to guide financial institutions to increase their lending to county and rural areas and to small and medium-sized enterprises.

Box 3: An overview of China's private lending market

Private lending is a logical outcome when social and economic development reach a certain stage, enterprises and individuals continue to accumulate wealth, industrial capital is transformed into financial capital, and the formal finance sector cannot meet social demands. A private lending market has been in existence in all countries for a long time. The existence and development of private lending is not only associated with the stage of social and economic development, but also has its own intrinsic comparative advantages which cannot be paralleled by the formal financial institutions.

In recent years, with China's rapid economic development, private capital has become increasingly abundant. In the meantime, the private sector and small and medium-sized enterprises have developed rapidly, and all kinds of market participants have had a strong demand for capital. While financial institutions have continued to expand credit, the private lending market has become more and more active. Compared with the formal financial sector, the private lending market, based on connections due to geographical proximities, interpersonal relationships, and kinship, has its own competitive advantages. First, the private lending market has advantages in terms of acquiring some "soft" information such as irregular financial information, and its costs of collecting and processing information are low. Second, convenient and flexible procedures can provide customized lending services to different borrowers with a lower transaction cost. Third, the private lending market has a special risk management mechanism and flexible modes of loan collection.

China's private lending market exhibits the following features: first, the financing scale increases year by year. According to a survey, the average outstanding balance of the sampled enterprises' borrowings from the private lending market increased from 543,000 yuan at end-2006 to 741,000 yuan at end-March 2008, an increase of 36 percent; the average outstanding balance of the surveyed natural persons' borrowings from the private lending market increased from 11,000 yuan to 16,000 yuan, an increase of 45 percent. Second, with increasing inflationary pressures and bank interest rate hikes, the interest rate on the private lending market edged up gradually, but the growth of the interest rate hike was lower than that of financial institutions. The lending rates of private lending markets across different regions refer to the lending rates of financial institutions. However, due to differing regional economic development, capital demand and supply, types of borrowers and uses of lending, the interest rates in different regions vary greatly, and are largely based on market demand and supply. Third, most private lending has a short-term maturity, and is used to supplement the inadequate working capital of enterprises and the operating capital of the self-employed and farmers. Fourth, the activities of private lending are associated with economic aggregates, the development stage of the private sector, and the regional financial ecologies across the different regions. In big cities such as Beijing, Shanghai, and Tianjin with good financial ecologies and abundant formal financial institutions, the private lending markets are relatively inactive, whereas in the less-developed western regions, the scale of private lending is relatively small and the interest rates are lower than the national average. In regions where the private sector is more developed, the scale of private lending is among the highest across the country, and most of the interest rates on the private lending market are higher than the national average. Fifth, the source of funds mainly comes from individuals, and the channels and ways of financing are diversified. Except for direct lending between individuals and enterprises, fund-raising by enterprises (stock offerings), private equity funds, rotating savings and credit associations (ROSCA) or "*taihui*" (a similar institution), fund intermediaries and underground banks, and other institutions and organizations, such as small lending companies, pawn shops, guarantee companies, and spontaneous financial and industrial cooperatives, are also heavily involved in private lending, and the degree of organization has improved to some extent.

As a useful and necessary complement to formal financing, private lending, to some extent, alleviates the financing difficulties of small and medium-sized enterprises and of the rural economy, enhances the capacity of the economy to self-adjust and adapt, and fills the fund shortfall that the formal financial sector does not want, or fails to provide. A standardized and orderly private lending market will help break the long-time monopoly of formal financial institutions such as commercial banks and will cultivate and develop a multi-layered credit market. However, because the private lending market remains outside the formal financial sector, there may arise some problems such as hidden transactions, inadequate supervision, uncertain legal statuses, not easily identified risks, illegal financing, and money laundering, and other criminal offenses, and laws and regulations should be formulated to guide and standardize the operation of the private lending market. Recently, very high annualized interest rates in private lending emerged in some areas, arousing broad concern. According to the survey, these kinds of private lending are mainly used to increase the short-term positions of enterprises, or are used as “bridge funds” to repay bank loans. Their maturities are very short, usually between ten days and one month and not exceeding three months. Although the interest rates are very high, the interest payments are still affordable for the enterprises. In particular, the “bridge funds” used to repay bank loans may hide the difficulties of enterprises and bring potential risks to the banks, so they merit the attention of the commercial banks.

Overall, while the formal financial sector further develops, in light of the features, functions, and potential risks of the private lending market, a better legal environment should be created that is conducive to the coexistence of the private lending market and the formal financial sector, to improve the multi-layered financing system, and to effectively forestall relevant risks. Measures should be taken to expedite legislation regarding money lenders that do not take in deposits, and to promulgate the *Regulations on Money Lenders* at an appropriate time, so as to legalize and standardize private lending. Differentiated treatment and categorized management should be applied to the private lending market. Administrative measures should be downplayed, and laws and market discipline should be strengthened. A monitoring system should be established to provide all-round information for economic decision-making and macro regulation. In the meantime, outreach activities should be strengthened so as to alert the general public to the potential risks and to improve their awareness of the financial risks and their capacity to identify risks.

4. The stock market fluctuated greatly

In the first half of the year, the total turnover of the Shanghai Stock Exchange and the

Shenzhen Stock Exchange registered 16.9 trillion yuan, a decrease of 6.8 trillion yuan year on year, and the daily turnover averaged 141.2 billion yuan, down 30.4 percent year on year. At end-June, market capitalization amounted to 6 trillion yuan, down 35.9 percent and 22 percent respectively from that at end-2007 and end-March 2008.

At end-June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 2736 points and 793 points respectively, down 48.1 percent and 46.1 percent respectively from beginning-2008, and the stock market fluctuated heavily. With the stock market tumbling amid large fluctuations, the risk of a rapid stock price hike like that occurred in the last year was eased somewhat. At end-June, the average P/E ratios of A-shares on the Shanghai and Shenzhen Stock Exchanges declined from 59 and 72 to 21 and 24 respectively.

Stock market financing was basically stable. According to preliminary statistics, in the first half of 2008 a total of 239.1 billion yuan was raised by Chinese enterprises through IPOs, secondary offerings, rights issues, and issuance of convertible bonds on equity markets both at home and abroad, 13.56 billion yuan, or 5.4 percent, less than that in the same period of the last year. Among the total, 209.5 billion yuan was raised on the A-share market, 15.3 billion yuan more than that in the same period of the last year.

5. The demand for insurance products increased noticeably, and the growth of total assets in the insurance industry moderated

In the first half of the year, the total premium income in the insurance industry amounted to 561.8 billion yuan, up 51.1 percent year on year or an acceleration of 30.4 percentage points, and demand for insurance products increased noticeably. Property insurance premium income increased 19.9 percent, and life insurance premium income increased 64.2 percent. Claim and benefit payments in the insurance industry amounted to 154.4 billion yuan, 38.7 billion yuan more than that during the same period of the last year, representing growth of 33.4 percent. The growth of payments in property insurance and life insurance amounted to 17.9 billion yuan and 18.2 billion yuan, up 40.2 percent and 28.9 percent respectively year on year.

The growth of the total assets of the insurance industry moderated. At end-June, the total assets amounted to 3 trillion yuan, an increase of 19.3 percent year on year and a deceleration of 26.9 percentage points. In terms of structure, investment-type assets grew 29.3 percent year on year, a deceleration of 24 percentage points.

Table 9:Use of insurance funds at end-June 2008

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-June, 2008	End-June, 2007	End-June, 2008	End-June, 2007
Total assets	30236	25347	100	100
Of which: Bank deposits	6978	7537	23.1	29.7
Investment	20086	15539	66.4	61.3

Source: The China Insurance Regulatory Commission.

6. The foreign exchange market developed in a sound manner, and foreign exchange derivatives became an important risk management instrument for enterprises

The number of participants on the foreign exchange market further increased. The inter-bank spot foreign exchange market operated smoothly and the dominant role of OTC transactions was strengthened. In the first half of 2008, the turnover of eight currency pairs totaled USD 29.9 billion, with transactions in the USD/HKD and EUR/USD currency pairs accounting for 76.7 percent of the total trading volume.

Foreign exchange derivatives traded briskly and became an important risk management instrument for enterprises. In the first half of 2008, the turnover of the RMB foreign exchange swap market totaled USD 216.5 billion, an increase of 58.3 percent year on year, and trading activities concentrated on products within three months (including overnight products). The turnover of the RMB foreign exchange forward market totaled USD12.5 billion, an increase of 12.8 percent year on year. The forward foreign exchange surrendered to banks by enterprises totaled about USD 95.47 billion, accounting for 14.3 percent of exports at the same time, up 12.2 percentage points from that in 2004. The forward foreign exchange sold to enterprises by banks totaled USD 52.53 billion, accounting for 9.3 percent of imports at the same time, up 8.5 percentage points from that in 2004. In the second quarter of 2008, according to a survey conducted by the People's Bank of China on the means of risk hedging and risk management of major enterprises, enterprises mainly used forward foreign exchange surrender, foreign exchange swaps, offshore NDF, trade financing, changing modes of trade settlements, RMB settlements, and other means to hedge risks. Among the total 1,121 enterprises surveyed, the proportion of enterprises using foreign exchange forwards and swaps to prevent risks took the lion's share, totaling 451 enterprises, accounting for 40.2 percent of the total. Foreign exchange forward operations have become an important risk management instrument for enterprises to prevent foreign exchange risks, promoting the enterprises' adaptability to the floating exchange rate regime and playing an active role in advancing China's foreign trade development and economic restructuring.

II. Financial market institutional building

1. RMB interest rate swap transactions were launched comprehensively

Drawing on the experiences of the pilot RMB interest rate swap business, in January 2008 the PBC released the *Notice on Conducting RMB Interest Rate Swaps*, so as to fully launch the interest rate swap business. The *Notice* included all participants on the inter-bank bond market, lifted the limitations on only swaps between fixed-rates and floating-rates, and helped market participants better use interest rate swaps to hedge risks.

2. Institutional building of the inter-bank bond market was strengthened

First, the self-regulating mechanism of the inter-bank bond market was strengthened. In April 2008 the PBC released the *Administrative Rules on Debt Financing Instruments for Non-financial Enterprises on the Inter-bank Bond Market*, which established the role of the National Association of Financial Market Institutional Investors (NAFMII) in organizing market participants to develop and manage direct financing products, and emphasized that the NAFMII should vigorously strengthen market self-regulation of non-financial enterprises in terms of registering, issuing, trading, and information disclosure of debt financing instruments, signaling a major transformation in the regulation of the inter-bank bond market. Second, insurance products were introduced into the inter-bank bond market. In April 2008 the PBC released the *Notice on Opening Depository Accounts in the Name of Products by Insurance Institutions* (the PBC Document [2008] No. 122), which allowed insurance institutions to open independent depository bond accounts in the name of products, helped insurance institutions standardize internal management and trading, and cultivated and developed new participants in the inter-bank bond market.

3. Institutional building of the securities market made progress

On the basis of vigorously striking against illegal securities activities and improving the institutional building of the Growth Enterprise Market (GEM), in the second quarter of 2008 the PBC strengthened the institutional building of the securities market in the following respects. The first was to standardize the listed companies' transfer of original shares released from trading restrictions. On April 20, the China Securities Regulatory Commission (CSRC) released the *Guidance Opinions on the Transfer of Stock Shares with Terminated Sales Limits of Listed Companies* (hereinafter referred to as the *Guidance Opinions*), which regulated the transfer of stock shares with terminated sales limits of listed companies exceeding a specified amount. The promulgation of the *Guidance Opinions,* by improving the institutional arrangements, helped solve the market efficiency problems when shareholders sold a large amount of stocks on the secondary market at one time after the listing of non-tradable shares, prevented price distortions resulting from stock shares transfers, and stabilized investors' expectations for the transfer of stock shares with a terminated sales limit. The second was to perfect the supervisory system on a comprehensive basis so as to promote the sound and sustainable development of the securities companies. On April 23 the State Council released the *Rules on Supervision over Securities Companies* and the *Rules on Risk Disposal of Securities Companies*. The aforesaid rules defined regulations on supervision over and risk disposal for securities companies, and established a comprehensive supervisory system for securities companies. The third was to regulate the significant restructuring of listed companies, and to protect the legitimate rights and interests of listed companies and investors. On April 18, the CSRC released the *Administrative Rules on Significant Asset Restructuring of Listed Companies* and the *Application Documents on Significant Asset Restructuring of Listed Companies*. The fourth was to improve supervisory transparency and to promote administration according to the laws and regulations. The *Measures for Disclosure of Securities and Futures Regulatory Information (Trial)* were released on April 29 and came into force on May 1.

4. The level of operational management of securities and insurances companies was raised

In March 2008 the China Insurance Regulatory Commission (CIRC) released the *Notice on Strengthening Self-Assessment of the Internal Control of Life Insurance Companies*, further regulating the scoring rules and requirements for self-assessment of internal control in life insurance companies. The *Notice* helped rationalize the internal operations and internal control of insurance companies. In April 2008 the CSRC released the *Provisional Rules for the Chief Risk Officer of Futures Companies*, which stipulated that futures companies should establish a risk-based supervisory framework based on a chief risk officer system, and promoted the compliance, risk management, and a credit-awareness culture of the futures market.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

Since the beginning of 2008 the global economy has experienced a broad-based slowdown, rising inflationary pressures, and drastic turbulence in the financial markets. Many economies are caught in a dilemma between maintaining growth and curbing inflation. The risk of recession still overshadows the U.S. economy, and downside risks have become larger. The euro area and Japan have continued to grow, but the prospects are not optimistic. The emerging market economies and developing countries (regions) maintained a momentum of rapid growth, but more underlying problems have emerged. Inflation has continued to mount throughout the world, including in the major developed economies and the emerging market economies. International financial markets have fluctuated substantially; the major stock indexes tumbled; the U.S. dollar continued its slump against the euro and the Japanese yen; major T-bond yields fluctuated at a high level. In July 2008 the IMF adjusted its April forecast of global economic growth from 3.7 percent to 4.1 percent, but this forecast was still 0.9 percentage points lower than actual growth in 2007. Among the major economies, the IMF forecast that the U.S., the euro area, and Japan would grow by 1.3 percent, 1.7 percent, and 1.5 percent respectively, compared to its April forecast of 0.5 percent, 1.4 percent, and 1.4 percent respectively, or 0.9, 0.9, and 0.6 percentage points lower than actual growth in 2007.

1. Economic development of the major economies

The U.S. economy was still overshadowed by recession, with inflationary risks on the rise. In Q2, the seasonally adjusted annualized GDP growth registered 1.9 percent,[1] much lower than the 4.8 percent growth in the same period of the last year. The employment situation continued to deteriorate, as unemployment rates in April, May, and June stood at 5.0 percent, 5.5 percent (a 3-year record high), and 5.5 percent respectively, averaging 5.3 percent, or 0.4 percentage points and 0.8 percentage points higher than that in Q1 and in the same period of the previous year respectively. The trade deficit in goods and services declined slightly to USD351.4 billion in the first half of the year, representing a decrease of USD7 billion year on year. The rescue plan significantly expanded the fiscal deficit. Fiscal revenue dwindled due to the economic stimulus measures and the compensation paid by the Federal Deposit Insurance Corporation to the depositors of the failed banks, but fiscal expenditures continued to rise. The fiscal deficit in the previous ten months of the 2008 fiscal year starting from

[1] It is noteworthy that GDP growth in Q1 2008 was revised from 1.0 percent to 0.9 percent, and GDP growth in Q4 2007 was adjusted downward from 0.6 percent to –0.2 percent, the first negative figure since Q3 2001.

October 1, 2007 mounted to USD371.4 billion, USD214 billion higher year on year. Inflationary pressures continued to build up, with the year-on-year CPI in the three months of Q2 reaching 3.9 percent, 4.2 percent, and 5.0 percent (a 17-year new high) respectively, averaging 4.4 percent, which was 0.3 percentage points higher than that in Q1.

The risks of a recession in the euro area rose, and the high inflation increased the downside risks. The GDP registered year-on-year growth of 2.1 percent and 1.5 percent in the first two quarters respectively, with the second quarter growth declining by 0.9 percentage points from the same period of the last year. Employment remained stable, with the unemployment rates in the three months of Q2 posting 7.2 percent, 7.3 percent, and 7.3 percent respectively, slightly higher than those in Q1. The trade deficit grew to 13.2 billion euros in the first five months, compared to a surplus of 2.1 billion euros in the same period of the previous year. Inflationary pressures heightened, with the Harmonized Index of Consumer Prices (HICP) registering 3.3 percent, 3.7 percent, and 4.0 percent (a record high since the creation of the euro area) in April, May, and June respectively, averaging 3.7 percent, much higher than the target of 2 percent set by the European Central Bank.

Although the Japanese economy continued to grow, the trade and inflation situations indicated unfavorable prospects. In the first two quarters, GDP grew 1.2 percent and 1.0 percent year on year respectively, and the growth in Q2 was 0.8 percentage points lower than that in the previous year. The employment situation worsened slightly, with the unemployment rate posting 4.0 percent, 4.0 percent, and 4.1 percent respectively in the three months of Q2, averaging 4.0 percent, which was 0.2 percentage points higher than that in Q1. The trade situation was not optimistic. Due to the U.S. economic recession and weakening demand in the emerging market economies, the accumulated trade surplus in the first half of the year posted 2.9 trillion Japanese yen, 2.2 trillion yen lower year on year. Exports in June experienced their first decline in the past five years. Prices grew rapidly, with the CPI in the three months standing at 0.8 percent, 1.3 percent, and 2.0 percent (the highest in the past ten years) respectively, averaging 1.4 percent, which was 0.4 percentage points higher than that in Q1, compared to –0.1 percent in the same period of the previous year.

The major emerging market economies and developing countries (regions) maintained a momentum of rapid growth, but more problems emerged, coupled with more destabilizing factors in their economic and financial performance, such as an increasing number of negative growth factors, economic and financial turbulence in some economies, exchange rate volatility, and serious inflation. Though as a whole, the Asian emerging market economies maintained robust growth and Latin America grew in a stable manner, some emerging market economies such as Singapore and South Korea slowed down noticeably in Q2 due to the slowing external demand of the advanced economies such as the U.S. Influenced by the sub-prime crisis, international capital began to flow out of the emerging market economies in Asia, resulting in sliding equity markets across Asia. The recent economic and financial turbulence in Vietnam and the signs of deteriorating economic conditions in India indicated that the risks underlying the continued rapid economic growth of the emerging market economies in the past few years has gradually begun to wind down. Under the combined influence of the worsening balance of payments equilibrium and capital outflows, the exchange rates of the emerging market economies fluctuated substantially and some Asian currencies depreciated. In order to prevent excessive depreciation, central banks across Asia strengthened intervention efforts, which slowed down the growth of foreign reserves. It should be noted that since 2008 inflation in the emerging market economies and developing countries (regions) climbed across the board due to rising energy and food prices, capital inflows, and strong domestic demand, with Hong Kong, South Korea, and Thailand posting unprecedented consecutive inflation records for the past ten years, Indonesia, Philippines, Vietnam, Sri Lanka, Russia, and South Africa experiencing double-digit figures, and Singapore witnessing a 26-year new high. In addition, soaring oil prices from the beginning of the year made it more difficult for the emerging market economies to continue price controls and provide oil subsidies. Among other countries, Malaysia and Vietnam were forced to lift controls on prices of refined oil products and to reduce energy subsidies, which in practice pushed up domestic inflation. In an attempt to rein in the rising inflation, Brazil, South Africa, the Philippines, Indonesia, Russia, India, Thailand, and other emerging market economies hiked interest rates and made fiscal arrangements to help low-income people.

2. Global financial market development

Since the beginning of 2008, the international financial market has become more volatile due to the influence of the U.S. sub-prime mortgage crisis and the growing risks of stagflation in the real economy.

Exchange rates between the major currencies fluctuated considerably. At the beginning of the year, the depreciation of the U.S. dollar against the euro and the yen accelerated, but in the latter half of March the depreciation trend changed slightly. On June 30, the euro/dollar and dollar/yen rates closed at 1.5755 dollar per euro and 106.09 yen per dollar respectively, representing, in cumulative terms since the beginning of 2008, a depreciation of 7.99 percent and 4.94 percent of the dollar against the euro and the Japanese yen respectively.

The US dollar Libor fell before rising. Influenced by the U.S. sub-prime mortgage crisis and anticipation that the Fed would not cut interest rates at its next meeting, the 1-year dollar Libor dropped substantially, hitting its lowest level (2.18 percent) since

June 2004 on March 17, 2008, and then increased slightly to 3.31 percent on June 30, still representing a decrease of 0.91 percentage points from the beginning of the year. In the first half of the year, due to market expectations of a further rate hike, the Euribor climbed gradually, with the 1-year Euribor reaching 5.39 percent on June 30, or 0.65 percentage points higher than that at the beginning of the year.

Major bond yields climbed amid fluctuations. Following a huge slide at the beginning of 2008, the major bond indices rebounded rapidly at end-March but retreated slightly in June. On June 30, the 10-year T-bond yield in the U.S. closed at 3.978 percent, a decrease of 0.053 percentage points from the beginning of the year; while its equivalents in the euro area and Japan closed at 4.623 percent and 1.595 percent respectively, representing an increase of 0.288 and 0.093 percentage points respectively.

The major stock indices fluctuated drastically. Affected by the sub-prime crisis, the major stock indices plummeted at the beginning of the year, with some indices experiencing their largest slump since the September 11 event, and thereafter the fluctuation took hold. On June 30, the Dow Jones Industrial Average was down 14.44 percent from the beginning of 2008, closing at 11350.01 points; the Nasdaq was down 13.55 percent to 2292.98 points; the STOXX50 was down 23.79 percent to 3352.81 points, and the Nikkei 225 Index was down 11.93 percent to 13481.38 points.

3. Housing market development in the major economies

The U.S. housing market remained sluggish. The trend of tumbling housing prices has not yet been reversed. In Q1, the national housing price index went down 3.07 percent, a 17-year record high; the decline was even larger in April and May, hitting 4.6 percent and 4.8 percent respectively. In June, the start of new home construction, sales of new homes, and new homes yet to be sold reached 1,066,000, 530,000, and 426,000 units respectively, down 26.9 percent, 33.2 percent, and 21.5 percent year on year.

The European housing market slid markedly. Housing prices in Britain spiraled downward, with the Halifax housing price index plunging by 1.5 percent, 2.4 percent, and 2.0 percent in April, May, and June respectively month on month following the 2.5 percent month-on-month decline in March (the largest drop since 1992). Since Q4 2007, the housing market in France has ended a boom decade and has begun to contract, with new home sales falling in two consecutive quarters and new home construction plummeting by 21.6 percent cumulatively in March, April, and May from the cumulative figure in the previous three months. Moreover, Ireland, Denmark, Spain, and other European countries also experienced substantial price plunges.

The downward risks in the Japanese housing market increased. The price gap between the urban and local areas widened. Affected by the economic slowdown, the increase in prices of construction materials, and the hike in housing loan interest rates, the start of new home construction experienced a less sharp year-on-year decline, with the price dropping 5.7 percent, 5.0 percent, 15.6 percent, 8.7 percent, and 6.5 percent respectively in the previous five months. The number of confirmed construction applications, as a concurrent indicator of new home construction, fell 15.0 percent in May year on year, larger than the 5.9 percent decline in April.

4. The monetary policy of the major economies

From the beginning of 2008, the Federal Open Market Committee (FOMC) cut the target Fed fund rate on four occasions by 225 basis points cumulatively to 2 percent, and lowered the discount rate on five occasions by 250 basis points to 2.25 percent. In order to strengthen market liquidity, the Fed continued to innovate and improve monetary policy instruments by extending loan maturities, broadening mortgage product choices, increasing counter-parties and reducing lending costs, and adopted measures to strengthen the efficacy of existing liquidity support. The ECB kept the base interest rate unchanged in the first half of the year, but announced an increase of 25 basis points on July 3, which meant that the minimum bid rate on the main refinancing operations, the marginal interest rate on deposit facilities, and the margin interest rate on lending facilities were 4.25 percent, 3.25 percent, and 5.25 percent respectively. The Bank of Japan (BOJ) maintained the uncollateralized overnight call rate at 0.5 percent. The Bank of England (BOE) lowered the official interest rate by 25 basis points on February 7 and April 10 respectively to 5 percent.

5. World economic outlook

Major risks threatening the world economic outlook include a slowdown in the world economy, rising global inflationary pressures, financial market volatility, and the persistent threats from trade protectionism.

The risk of a global economic slowdown looms larger. The growth of the developed economies will continue to decelerate as a result of the sub-prime crisis. The negative wealth effects triggered by the unfolding housing market adjustments are likely to worsen the already sluggish domestic consumption in the U.S.; trade account improvement that relies on the depreciation of the dollar lacks sustainability; and the U.S. economy is likely to experience a protracted downturn. Affected by the slackening U.S. economy, rising energy prices, the US dollar exchange rate adjustment, and other factors, the other developed economies cannot boast an optimistic growth outlook. Though the emerging market economies will maintain a momentum of relatively rapid growth, there will be more potential risks.

Rising global inflationary pressures will make it more difficult for the central banks of the major economies to choose between preventing recession and curbing inflation. Price hikes of crude oil, food, and other commodities, influenced by the tightening geopolitical situation and the depreciation and speculation in the major settlement currencies, constitute a major force pushing up global inflation. Energy and food price increases make the livelihoods of people in the emerging market economies and the developing countries (regions) more difficult, and exert greater pressures on their respective governments to provide fiscal subsidies, hence likely triggering a series of economic and social problems.

Attention should be paid to the turmoil in the financial market. Fannie Mae and Freddie Mac, the two largest mortgage finance companies in the U.S., have been struggling since July, giving rise to fresh concerns that the sub-prime mortgage crisis might escalate into a housing loan crisis and threaten the normal operations of the U.S. housing financial system. Its potential impact on the global financial market remains to be seen. In addition, monetary policy adjustments in the developed economies might reverse the direction of capital that has been flowing into the emerging market economies.

At the same time, anti-globalization sentiments, including trade protectionism in various forms, will persist and will unfavorably affect the sustainable and healthy growth of the world economy and the orderly adjustment of global imbalances.

In general, an increasing number of uncertain and destabilizing factors in the international environment pose greater challenges and difficulties for China to maintain stable and rapid economic growth and to effectively rein in inflation. The negative impacts of the weakening external demand on exports, growth, and employment will become even more obvious, and the international financial turmoil will adversely affect financial stability in China. Macroeconomic regulation will confront a complex situation, and greater attention should be paid to the development of the international economic and financial situations.

II. Analysis of China’s macroeconomic performance

In the first half of 2008 the Chinese economy maintained a momentum of stable and rapid development, despite the impact of the natural disasters and the adverse factors in the international economic and financial environments. Investment, consumption, and exports grew in a balanced manner; domestic demand, consumer demand in particular, became a stronger driving force for economic growth; household income, corporate profits, and fiscal revenue increased continuously; and the national economy developed in the desired direction. In the first half of the year, GDP grew 10.4 percent year on year to 13.1 trillion yuan, a deceleration of 1.8 percentage points from the previous year; the consumer price index was up 7.9 percent, an acceleration of 4.7 percentage points; the trade surplus posted USD99 billion, a decline of 13.2 billion from that during the same period of the last year.

1. Consumption grew rapidly, the investment structure improved, and the trade surplus dropped from the last year

Urban and rural household income continued to rise, and domestic consumer demand remained strong. In the first half of the year, the per capita disposable income of urban residents registered 8065 yuan, a year-on-year growth of 14.4 percent or 6.3 percent in real terms; the per capita cash income of farmers was 2528 yuan, a year-on-year growth of 19.8 percent or 10.3 percent in real terms. The steady increase in income in both urban and rural areas supported the continued growth of consumption. In the first half of 2008, the gross volume of retail sales reached 5.1 trillion yuan, representing nominal growth of 21.4 percent or real growth of 12.9 percent, 0.2 percentage points higher than that in the same period of the last year. Among the total, retail sales in urban China grew 22.1 percent to 3.5 trillion yuan, and retail sales in counties, townships, and villages grew 20.0 percent to 1.6 trillion yuan. The growth gap between the urban and rural areas was 2.1 percentage points, 0.4 percentage points wider than that during the same period of the last year.

Fixed-asset investments grew steadily with an improved investment structure. In the first half of the year, fixed-asset investments totaled 6.8 trillion yuan, representing year-on-year growth of 26.3 percent and an acceleration of 0.4 percentage points. Urban fixed-asset investments reached 5.8 trillion yuan, up 26.8 percent year on year, whereas rural fixed-asset investments posted 996.6 billion yuan, up 23.2 percent, an acceleration of 0.1 and 1.7 percentage points respectively from the same period of the last year. In terms of their geographical distribution, fixed-asset investments in eastern, central, and western China grew 22.4 percent, 35.3 percent, and 28.6 percent respectively, with central and western China growing much faster than eastern China. In terms of their sectoral distribution, fixed-asset investment growth in the three industries registered 69.5 percent, 26.6 percent, and 26.2 percent respectively, with primary industry representing an acceleration of 32.0 percentage points, much higher than that of the secondary and tertiary industries, whose growth was relatively stable.

Import growth outpaced that of exports, resulting in a smaller surplus than that during the same period of the last year. In the first half of the year, imports and exports totaled USD1.2 trillion, up 25.7 percent year on year. Exports grew 21.9 percent, representing a deceleration of 5.7 percentage points from the same period of the last year, to USD666.6 billion, whereas imports increased 30.6 percent, representing an acceleration of 12.4 percentage points, to USD567.57 billion, resulting in a surplus of USD99 billion, USD13.2 billion less than that during the same period of the last year. The accelerating import growth was related to the rising prices of commodities and the improved purchasing power due to the RMB appreciation, among other factors. In the first half of the year, the value of crude oil imports grew 126.9 percent year on year, but the growth in terms of volume registered only 30.6 percent. The major reasons for the declining export growth included the slowing external demand as a result of the economic slowdown in the major economies, the rising cost of raw materials and labor in the export-oriented companies, the adjustment of the export rebate policies, and the RMB appreciation. The export growth deceleration was accompanied by an improved export mix, evidenced by the hefty year-on-year decline in the export volume of steel, billet, coke, and other high energy-consuming and highly polluting products and resource products.

2. Agricultural production was stable and the structure of industrial production was optimized

Growth in the three industries moderated. In the first half of the year, the added value of primary industry was up 3.58 percent to 1180 billion yuan, a deceleration of 0.5 percentage points from the previous year; the added value of secondary industry was up 11.3 percent to 6741.9 billion yuan, a deceleration of 2.4 percentage points; the added value of tertiary industry was up 10.5 percent to 5140 billion yuan, a deceleration of 1.6 percentage points.

Agricultural production maintained a momentum of stable growth, and there was a bumper summer harvest. Summer crop production totaled 120.41 million tons, an increase of 3.04 million tons, or 2.6 percent year on year, representing growth for the fifth consecutive year. In the first half of the year, the producer prices of agricultural products (the price at which farmers sell their products) rose 22.9 percent, an acceleration of 14.1 percentage points from the same period of the last year, higher than the 20.7 percent growth in the prices of agricultural capital goods, a positive factor for the income gains of farmers.

Industrial production growth moderated, but corporate profits continued to grow. In the first half of the year, the added value of statistically large enterprises rose 16.3

percent year on year, a deceleration of 2.2 percentage points from the previous year, and the industrial structure continued to improve; production and sales of industrial products were closely linked, and the sales ratio of industrial enterprises was 97.7 percent, 0.2 percentage points higher than that during the same period of the last year; in the first five months, the profits of statistically large enterprises totaled 1.1 trillion yuan, a growth of 20.9 percent year on year, representing an deceleration of 21.2 percentage points compared to the increase registered in the same period of the last year, but the growth of industrial enterprises was 38.4 percent after deducting the losses incurred by oil refineries, nuclear material processing companies, power and thermal producers and providers, an acceleration of 7.6 percentage points over the same period of the previous year.

3. Huge pressures continued to push up the CPI

The CPI retreated from a high level, but inflationary pressures remained huge. In the first half of the year, the CPI grew 7.9 percent year on year, representing an acceleration of 4.7 percentage points over the same period of the last year. If the CPI basket were to be broken down by food and non-food items, the soaring food prices would be the major factor shoring up the CPI since the prices of food items rose 20.4 percent in the first half of the year, driving CPI growth by 6.7 percentage points; the prices of non-food items rose 1.7 percent, pushing up the CPI by 1.2 percentage points. Broken down by consumer products and services, the price increase of consumer products was higher than the price increase of services, with the consumer product prices rising 9.9 percent, pushing up the CPI by 7.5 percentage points, and service prices increasing 1.8 percent, shoring up the CPI by 0.4 percentage points. In terms of quarterly CPI growth, the CPI grew 8.0 percent in Q1 but slid to 7.8 percent in Q2. The CPI retreat was mainly due to the seasonable price decline of agricultural produce and the weakening impact of base period factors (also known as tail factors). Food prices fell seasonally when many agricultural products were available on the market, registering growth of 22.1 percent, 19.9 percent, and 17.3 percent in April, May, and June respectively, pushing up the CPI by 7.2, 6.5, and 5.7 percentage points respectively. After April, the base period factors decreased, pushing up the CPI by 5.3, 4.9, and 4.5 percentage points in April, May, and June respectively. Despite the continued CPI decline in year-on-year terms in Q2, the CPI posted month-on-month growth of –0.2 percent in June, still far higher than that in the same period of the previous years, indicating persistently higher pressures on inflation.

There was a hike in import and export prices, with import price growth outpacing export price growth by a large margin. In the three months of Q2, import prices grew 21.8 percent, 20.9 percent, and 20.1 percent year on year respectively, averaging 20.9 percent and representing an acceleration of 14.2 percentage points from the same period of the last year; export prices were up 10.1 percent, 10.4 percent, and 11.1

percent, averaging 10.5 percent and representing an acceleration of 4.7 percentage points from the previous year. The price hike in international bulk commodities and the increasing reliance on imports of crude oil, iron ore, and other resources were the major reasons behind the soaring prices of imports. And end-June, the price of crude oil futures closed above 140 dollars on the New York Commodity Exchange, and the Brent crude oil spot reached 139.4 dollars per barrel, a historical high. In Q2, the prices of soybeans, wheat, corn, and rice futures increased by 76 percent, 62 percent, 69 percent, and 93 percent respectively on the Chicago Commodities Futures Exchange, with the soybean price closing at USD 15.98 per bushel at end-June, a new historical high record; copper and aluminum traded 6.5 percent and 10.5 percent higher in Q2 on the London Metal Exchange, with several record price levels. China is the world's second largest oil consumer and 50 percent of its oil consumption depends on imports. In the first half of the year, the average crude oil import price rose 66.9 percent year on year, an acceleration of 72.2 percentage points over the same period of the last year. Over half of the demand for iron ore must be met by imports. In the first half of the year, the average import price of iron ore grew 77.4 percent, 55.8 percentage points higher compared to that one year earlier. As China became further integrated into the global economy, the higher bulk commodity prices in the world market intensified pressures of imported inflation.

Soaring producer prices and the accelerating price hike of production factors such as labor put more pressure on cost-driven inflation. High prices of crude oil and iron ore and surging domestic demand for coal and steel resulted in soaring prices of capital goods such as crude oil, coal, and steel, then driving up producer prices. In Q2, the purchase price of raw materials, fuel, and power and the producer price of industrial products gained 12.4 percent and 8.4 percent year on year, representing an acceleration of 2.6 and 1.5 percentage points respectively over Q1. The producer price of agricultural products grew 22.9 percent year on year, with the producer prices of grain and animal husbandry products increasing 11.9 percent and 39.8 percent respectively year and year. The price of agricultural capital goods grew 23.7 percent year on year, 6.2 percentage points higher than that in Q1. Labor compensation rose rapidly. In the first half of the year, the average salary of urban employees was 12.964 yuan, up 18.0 percent year on year. Among this total, the average salary in state-owned entities in urban areas was 13,800 yuan, up 17.0 percent; the average salary in collectively-owned entities in urban areas was 7,789 yuan, up 18.9 percent; the average salary in other types of entities in urban areas was 12,610 yuan, up 19.2 percent. According to a sample survey, the average per capita salary income of farmers was 880 yuan, up 17.9 percent.

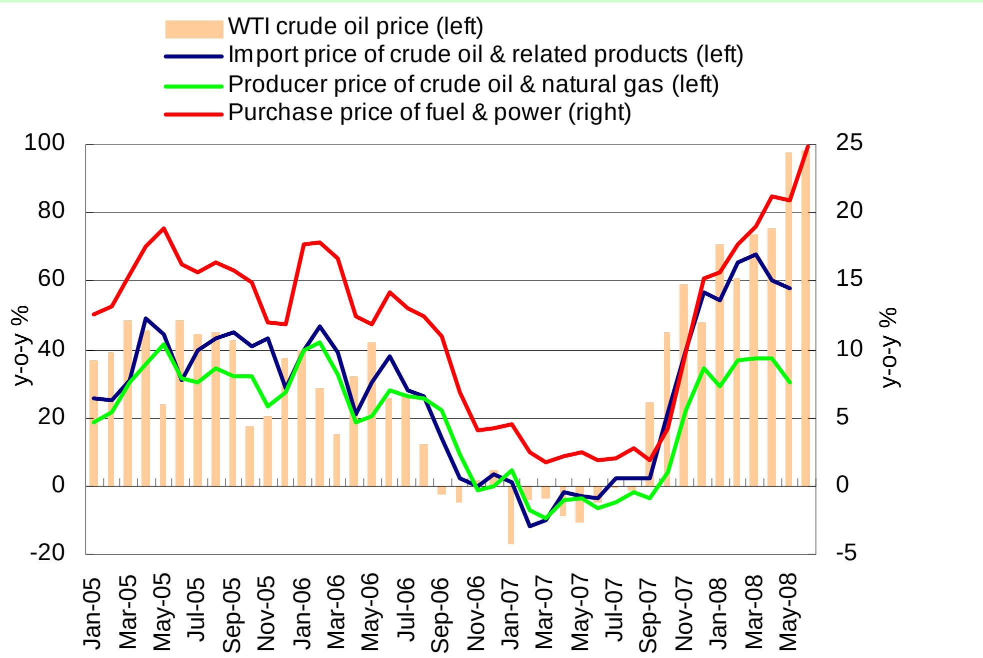
The GDP deflator continued to rise. The GDP in the first half of the year posted 13.1 trillion yuan, representing real growth of 10.4 percent. The GDP deflator (as a ratio of nominal GDP versus real GDP and an indicator of general price movements) was 8.6 percent, up 4.4 percentage points year on year or 0.4 percentage points higher than that in Q1. Because the GDP deflator has been on the rise since the second quarter of 2007, it is necessary to pay adequate attention to its movement.

The pricing reform of resource goods including refined oil products and power continued, which was conducive to promoting energy savings, pollution reduction, and a change in the economic growth mode. In January 2008, the *State Council Circular on Promoting the Economical and Intensive Use of Land* was issued to collect additional income from the land price hikes from the holders of idle land; the resource tax system was further reformed to move from a unit tax to an ad valorem tax in a bid to broaden tax items for the energy sector. The *Administrative Measures for the Paid Use of Plastic Bags in Commodity Retail Places* came into effect on June 1, which required commodity retail places to charge consumers for the use of plastic bags. On June 20, petrol and diesel oil prices were raised by 1000 yuan per ton, and aviation fuel was raised by 1500 yuan per ton. Later on July 1, the average electricity tariff increased 2.5 cents per kilowatt. The price adjustments received positive feedback from markets both at home and abroad. From a long-term perspective, only when resource prices are rationalized can the role of prices in increasing supply and curbing irrational demand be played out, can the economic structure be optimized and the development mode altered, and can inflationary pressures be fundamentally eased. In the future, efforts should be made to balance the relationship between curbing inflation and reforming resource prices, to fine-tune resource prices when appropriate so as to eliminate price distortions, and to push ahead with the pricing reform of resource goods.

Box 4: Oil price hikes and their impact on price levels

Oil price hikes have gathered momentum since 2007 and broke several new records. The WTI crude oil futures price rose from 55 dollars per barrel at the beginning of 2007 to 140 dollars per barrel in June 2008. Though the prices of oil recently pulled back, they still remained at a high level. Supply shortages, a weak dollar, and market speculation are the major reasons for the soaring oil prices. First, the gap between supply and demand has widened. The U.S. Energy Information Administration estimates that the average daily consumption of crude oil in 2005, 2006, and 2007 stood at 83.65 million, 84.62 million, and 85.38 million barrels respectively, whereas the average daily production during the same period of time was 84.63 million, 84.59 million, and 84.55 million barrels respectively. Supply growth was slower than demand growth. Second, a weaker dollar drove crude oil prices to grow even faster. According to BIS statistics, taking the year 2000 as 100, the real effective exchange rate of the dollar was 82.58 in June 2008, 5.88 percentage points lower than that before the sub-prime crisis in August 2007, representing a depreciation of 6.6 percent and pushing up oil prices in relative terms. Third, market speculation also played a role. Due to the excess liquidity and the sub-prime crisis, the major financial markets such as the U.S. and Europe became more volatile; international financial capital speculation on crude oil futures was another important reason for the price hikes.

Soaring oil prices fueled domestic inflationary pressures. Because of the rapid economic growth and the slowing industrial restructuring, the demand for oil and dependence on imported oil continued to grow rapidly. Imported crude oil registered 90.54 million tons in the first half of the year, 8.98 million tons more than that in the same period of the last year, and dependence on imported oil reached 49.0 percent, representing a year-on-year increase of 2.4 percentage points. Soaring oil prices in the international market and increasing imports of crude oil pushed up import prices and fed domestic inflationary pressures. In June, import prices of crude oil and related oil products rose by 77.1 percent, purchase prices of domestic fuel and power went up by 24.9 percent, and producer prices of crude oil and natural gas went up by 35.1 percent. Higher international oil prices highlighted the issue of pricing oil products in the domestic market. Though a market-based pricing mechanism featuring "crude oil price plus cost" was put into place, price adjustments of refined oil products in reality often lagged and tracked the international oil price in a passive manner; as a result, the price of refined oil products failed to reflect the demand and supply relationship in the domestic market and the costs of the refining companies.



Source: CEIC

Figure 2: Soaring oil prices in the international market fueled domestic inflationary pressures

Rationalizing the prices of refined oil products and improving the resources pricing mechanism are conducive to easing inflationary pressures at their source. The prices of resource products were kept low for many years, reflecting only the development costs such as excavation and transportation but not reflecting the scarcity of resources and the costs of environmental degradation. Low resource prices were a major cause of the internal and external imbalances because a large amount of resources was consumed at a low price, artificially dragging down the production costs of domestic products, and stimulating investment expansion and rapid export growth, and hence driving up domestic aggregate demand and shoring up inflationary pressures. In order to rationalize the prices of refined oil products and adjust the demand and supply relationship, the National Development and Reform Commission raised the prices of petrol and diesel oil by 1000 yuan per ton and aviation fuel by 1500 yuan per ton on June 20. In the short run, this adjustment will increase inflationary pressures. According to an input-output model, the CPI is about 0.04 percent higher for every 1 percent increase in the prices of oil products; and the aforesaid oil and electricity price hike will push up the CPI by 0.7 percentage points. But in the long run, the improvement in the pricing mechanism of resource products and the rationalization of the prices of refined oil products can reduce the risks of short supplies resulting from distorted prices, guarantee adequate supplies, and also help contain irrational demand and promote optimization in the economic structure and the shift of the economic development mode, so as to ease inflationary pressures at their source.

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

In the first half of the year, total fiscal revenues (excluding debt income) reached 3480.8 billion yuan, up 33.3 percent year on year and representing an acceleration of 2.7 percentage points from the same period of the last year; fiscal expenditures totaled 2288.2 billion yuan, up 27.7 percent year on year and representing an acceleration of 5 percentage points. As a result, revenue exceeded expenditure by 1192.6 billion yuan, representing an increase of 372.8 billion yuan from the same period of the last year.

Tax revenue maintained rapid growth, with the domestic value added tax and corporate income tax rising particularly fast. In the first half of the year, the domestic added value tax and corporate income tax grew 22.6 percent and 41.5 percent respectively year on year, up 1.7 and 1.5 percentage points over the same period of the last year. In terms of fiscal expenditures, expenditures for education, science and technology, medical and health care, social security, and environmental protection increased but general public spending was reduced. In contrast to merely 16.5 percent growth in general public expenditures in the first half of the year, expenditures for education, science and technology, medical and health care, social security, and environmental protection grew 23.2 percent, 39.6 percent, 36.1 percent, 41.8 percent, and 99.8 percent respectively year on year.

5. Balance of payments

The balance of payments account continued to maintain a large surplus, and the official foreign exchange reserves increased rapidly. In the first half of the year, the actual utilization of foreign direct investment totaled USD52.4 billion, up 45.6 percent year on year and representing an acceleration of 33.4 percentage points from the previous year. At end-June 2008, the official foreign reserves posted USD1808.8 billion, representing growth of USD280.6 billion from the end of 2007, or USD14.3 billion more than the gain in the corresponding period of the last year.

The external debt grew modestly. At end-March 2008, the outstanding external debt totaled USD392.59 billion, representing growth of 5.1 percent from end-2007 and an acceleration of 0.8 percentage points. Among this total, the outstanding registered external debt increased 3.4 percent from end-2007 to USD248.7 billion; and the short-term external debt increased 7.6 percent from end-2007 to USD236.7 billion, accounting for 60.3 percent of the total external debt, 1.4 percentage points more than that at end-2007.

6. Industrial analysis

Most industrial sectors witnessed steady gains in profits, and industrial restructuring exhibited positive changes. In the first five months, 34 out of 39 major industries saw profit growth in year-on-year terms. Altogether 12 industries registered higher growth compared to that in the same period of the last year, while 27 industries registered slower year-on-year growth. Most of the profit gains were concentrated in the upstream mining industry, with new profit gains in the oil extraction, coal mining, and ferrous metal mining industries accounting for 63.5 percent of the total gains in industrial profits. Positives signs emerged in the industrial restructuring whereby the momentum of excessively rapid growth of highly energy-consuming industries waned and the high-tech industry and the equipment manufacturing industry continued to grow at a fast pace. In the first half of the year, the total industrial added value of six highly energy-consuming industries grew 14.5 percent year on year, representing a deceleration of 5.6 percentage points; the industrial added value of high value-added high-tech industries increased 17.6 percent, 0.5 percentage points faster than the growth during the same period of the previous year; the industrial added value of machinery manufacturing gained 21.6 percent, 5.3 percentage points more than that of the statistically large enterprises. Coal, electricity, oil, and transportation registered rapid growth. In the first half of the year, the output of coal, crude oil, and electricity posted 1.26 billion tons, 94.33 million tons, and 1,680.3 billion kilowatt hours respectively, up 14.8 percent, 1.7 percent, and 12.9 percent respectively year on year. Freight transportation increased 11.9 percent year on year to 11.7 billion tons. Power and coal were in short supply. At end-June, the coal shortage idled 12.81 million kilowatts of the production capacity of the power grid.

(1) The real estate sector

In the first half of the year, investment in real estate development increased rapidly, and new construction projects and completed construction projects rose year on year, thus boosting market supply. But sales prices grew at a decelerated pace across the country, with prices dipping in some cities, so more potential buyers adopted a wait-and-see attitude, resulting in negative growth in both sold areas and sales revenue. Growth of outstanding commercial real estate loans declined month by month in year-on-year terms, and new loans decelerated.

Investment in real estate development grew rapidly, with investment in the development of small- and medium-sized housing units edging up. In the first half of the year, completed investment in real estate development registered 1.3 trillion yuan, up 33.5 percent year on year, an acceleration of 5 percentage points over the same period of the last year and 6.7 percentage points higher than the growth of fixed-asset investment during the same period. Broken down, investment in residential housing grew 36.6 percent year on year, accounting for 72 percent of the total investment. Investment in units with floor plans of less than 90 square meters was up 85.1 percent year on year, accounting for 19 percent of the total and an acceleration of 5.3 percentage points over the same period of the last year.

The acreage of start of new construction, construction in progress, and completed construction grew faster than that in the same period of the previous year, but the acreage of sold commercial housing dropped year on year. In the first half of the year, the acreage of start of new construction, construction in progress, and completed construction registered 540 million, 2.13 billion, and 170 million square meters respectively, up 19.1 percent, 24.1 percent, and 13.8 percent respectively, representing an acceleration of 0.7, 2.2, and 2.7 percentage points from the same period of the last year. The acreage of total sold housing stood at 260 million square meters, and sales revenue from commercial housing reached 1 trillion yuan, down 7.2 percent and 3.0 percent respectively year on year. Sold acreage of commercial housing dropped 47.1 percent, 22.7 percent, and 20.3 percent in Beijing, Sichuan, and Guangdong respectively.

Home sales prices continued to grow at a decelerated pace but remained high. Growth in sales prices in 70 large- and medium-sized cities continued to drop from the beginning of 2008, with the growth in June posting 8.2 percent, 3.1 percentage points lower than that in January. Approximately 16 cities, such as Shenzhen, Chengdu, Nanjing, Wuhan, Guangzhou, Fuzhou, Nanchang, and Chongqing, experienced negative month-on-month growth in June. In June, the sales prices of new homes and pre-owned homes surged 9.2 percent and 7.5 percent respectively year on year, representing a decline of 1 and 1.3 percentage points over the previous month. The new home index in 14 cities and the pre-owned home index in 18 cities posted negative month-on-month growth. New home sales prices in Shenzhen climbed 0.5 percent after a 6-month-long negative growth.

The growth of outstanding commercial real estate loans declined in year-on-year terms, and new loans decelerated. At end-June 2008, outstanding commercial real estate loans stood at 5.2 trillion yuan, up 22.5 percent year on year, representing a deceleration of 2 percentage points over that in the same period of the last year, the seventh successive monthly deceleration but still higher than the growth in total lending. Outstanding real estate development loans registered 1.95 trillion yuan, representing a year-on-year increase of 17.7 percent and a deceleration of 8 percentage points over the same period of the last year; the outstanding home purchase loans posted 3.3 trillion yuan, an increase of 25.6 percent year on year and an acceleration of 1.8 percentage points. New real estate loans in the first half of the year were 170.66 billion yuan less than that in the same period of the last year, reaching 398.84 billion yuan. Among this total, development loans and home purchase loans increased by 183.43 billion and 215.4 billion yuan respectively, 68.43 billion and 102.23 billion yuan less than that during the same period of the previous year.

(2) The coal industry

Coal dominates the energy consumption structure in China, accounting for about 70 percent of the total consumption of primary energy. In the first half of the year, the production and sales volume of coal increased substantially with the tight market supply. Affected by the tight supply, the soaring oil prices in the international market, and the price hikes in alternative energy, coal prices in the domestic market remained high, putting more cost pressures on the downstream industries.

The rapid growth of the coal supply heightened the conflict between resources exploitation and environmental protection. After growing at a rate exceeding or close to 10 percent for 8 successive years, national coal production registered 1.26 billion tons in the first half of the year, up 14.8 percent year on year. Coal resources and economic prosperity are distributed in opposite geographical patterns. In recent years, coal production has been increasingly concentrated in Shanxi, Shaanxi, Inner Mongolia, Ningxia, and other environmentally vulnerable regions with water shortages, heightening the conflict between resource exploitation and environmental protection. Priority consideration should be given to the economic sustainability of the coal-producing regions when building coal production bases. Inter-provincial coal transport accounts for nearly one-third of the total coal consumption. In recent years, the capacity of direct rail transport did not increase in tandem with the rapid growth in the capacity of installed power generation in Hunan and Hubei provinces; Yunnan and Guangxi provinces were building large-scale power plants, but their coal production capacity lagged. As a result, the structural problems in railway transportation exacerbated the coal crunch in some regions.

The demand of the downstream industries was strong, resulting in barely balanced supply and demand. In the first half of the year, sales volume totaled 1.2 billion tons, up 10.7 percent year on year. Inventories were below normal levels. At end-June, the length of time for coal to remain in port inventories and power plant inventories measured by the number of days was 1.7 days and 4 days lower than that in normal conditions respectively. The advent of the peak time of coal consumption in the summer and the implementation of measures aimed to guarantee power security during the Beijing Olympics would further drive up the domestic demand for coal.

Soaring coal prices exert more cost pressures on the downstream industries. In the first half of the year, the price indices of crude coal, soft coal, and anthracite went up by 21.7 percent, 21.4 percent, and 23.0 percent respectively. Given that over 70 percent of power generation relies on coal, a coal price hike will increase the costs of coal-fired power plants. In the first half of the year, the gross profits of the five largest power generation company groups declined by over 100 percent, four of which suffered losses. Only the China Huaneng Group made marginal profits.

The coal pricing mechanism should be reformed in order to shift the economic development pattern and to promote energy savings, pollution reduction, and balanced regional development. Though the government tentatively intervened in the surging electricity and coal prices for a short time, the trend that market demand and supply determine coal prices will not be changed, nor will the government's policy stance to reform the energy and resources pricing mechanism be reversed. Conducting a price reform of resource products such as coal, reforming the resource taxation system, improving the paid use of mineral resources and the compensation mechanism for environmental damage, improving the pricing mechanism for resources, incorporating resource costs, environmental costs, security costs, labor costs, and sustainable development costs into the cost computation system, and putting in place a scientific coal security system will play an important role in improving coal efficiency, shifting the economic development pattern, easing the energy crunch, and promoting balanced regional economic development.

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

I. Outlook for the Chinese economy

Since the beginning of 2008, the Chinese economy has been developing in the direction intended by macroeconomic management; unfavorable factors in the performance of the international economy and the serious natural disasters have not changed the economic fundamentals. Despite the increasing external and internal uncertainties, under the combined forces of industrialization, urbanization, globalization, and the structural upgrading of industrial production and consumption, economic development has remained vibrant and resilient. In the latter half of the year, the economy is projected to continue the growth path of the past half-year, and in general is expected to maintain a momentum of relatively rapid development.

Domestic demand will maintain relatively fast growth. Despite decelerating growth in external demand and its potential impact on domestic investment and consumption, such as the overcapacity of some export-oriented companies and the declining investment, in general the factors that support relatively rapid growth of investment and consumption will remain unchanged. Industrial upgrading, balanced regional development, improved housing guarantees, intensified efforts for energy saving and pollution reduction and post-earthquake reconstruction will all generate investment demand, coupled with the great enthusiasm for development, will likely promote relatively rapid growth of investment. At the same time, due to the accelerating economic restructuring and gradual increase in household income, consumption will contribute more to economic growth. The second quarter business survey conducted by the PBC showed that the market sentiment index hit its second highest level since the survey began, the domestic orders index was merely 0.1 percentage points lower than its highest ever level in the same period, and 93 percent of the enterprises expected domestic orders would keep their production capacity “completely full” or “relatively full.” The second quarter banking survey showed that the demand for loans index remained at a high level of 68.8 percent, the highest since the survey began in 2004. These results indicate relatively strong market demand and the large role of domestic demand in driving economic growth. The second quarter urban depositors’ survey showed that the income of urban residents was stable. In the future, various policies will be adopted to increase consumption and improve the people’s living conditions. These measures, along with a gradually improved consumption environment, will contribute to consumption growth. But the potential impact of a price hike on consumer behavior should be closely watched, and comprehensive measures are needed to maintain stable growth of consumer demand.

The trade surplus will remain large. The fallout from the U.S. sub-prime crisis is still unfolding, there are great uncertainties in the world economy, and external demand growth has moderated; policies such as the export tax rebate and the processing trade policy adjustment, as well as the improved RMB flexibility, also had effects in maintaining an equilibrium in the balance of payments. The PBC banking survey showed that in the second quarter of 2008 the export order index rebounded after a decline for three consecutive quarters, thus improving the export outlook, but it was still lower than where it stood during the same period in 2006 and 2007. Going forward, given the projected modest growth in the world economy, especially in the emerging market economies, the easing effects of trade diversification after a slowdown in certain regions dragged trade growth, and deep-rooted structural factors such as the high domestic savings rate, China’s trade surplus will remain at a relatively high level.

Inflation should be closely watched. At present, slowing growth of demand at home and abroad, modestly tight domestic monetary conditions, and seasonal adjustments in the prices of agricultural products are all conducive to curbing excessive price hikes. But factors that push up price levels still remain because of uncertainties in the global economy and in commodity prices and will increase uncertainties in the movement of domestic prices as a result of the higher correlation between global inflation, especially the prices of oil and other primary products, and domestic PPI and CPI movements against the backdrop of the greater opening-up of the Chinese economy. The massive industrialization and urbanization processes are likely to put primary products in relatively short supply, sustain high prices, and pass them on to domestic prices through trade. The gap between domestic prices and international prices of some important commodities is large, and price distortions of resources and energy still remain. Moreover, labor costs and costs of other factors of production are rising rapidly. In sum, the risk of inflation cannot be ignored.

At present, the national economy maintains a momentum of stable and relatively fast development. But it should also be noted that as the international environment is becoming more complex, the macroeconomic policies of many economies are caught in a dilemma between maintaining price stability and promoting economic growth. Institutional and structural problems in the Chinese economy, increasing pressures for price hikes, and uncertainties in the internal and external environments will increase risks to economic and financial performance. Macroeconomic management still faces a complex situation.

II. Monetary policy stance in the next stage

The PBC will follow the overall arrangements of the CPC and the State Council for the next half of the year, maintaining stable and rapid economic growth and curbing excessive price hikes as top priorities in macroeconomic management, and placing reining in of inflation high on its agenda. Efforts will be made to maintain the continuity and stability of monetary policy, increase the foresightedness, targeting, and flexibility of the adjustment policy, adopt fine-tuning measures when appropriate according to the changing situations both at home and abroad, manage the priorities, pace, and intensity of the macroeconomic adjustment, encourage growth of some sectors while discouraging growth of others, and strengthen financial support to priority areas and weak aspects of the economy so as to balance the relationship between containing inflation and maintaining rapid economic growth and to promote sound and rapid growth of the economy..

The PBC will guide an appropriate supply of money and credit aggregates. Building on the macro-adjustment results, on the basis of maintaining the continuity and stability of the regulatory policies at the aggregate level, the PBC will strive to improve the foresightedness, targeting, and flexibility of the financial macro-adjustments by tackling an increasing number of uncertain and destabilizing factors in the international environment and adopting fine-tuning measures when appropriate after taking into account the acute problems in the performance of the domestic economy.

The PBC will continue to strengthen liquidity management. The BOP runs twin surpluses in both the current account and the capital account, and excess liquidity in the banking system persists. A combination of policy instruments should be used to absorb liquidity, and the combination of tools and the manner in which they are applied will satisfy the needs for macro-adjustment to ensure the efficiency of all policy measures.

The PBC will use appropriate pricing tools. Measures will be taken to carry forward the interest rate reform, promote the development of the money-market benchmark rate system, and guide financial institutions to improve their interest rate pricing ability and improve the market-based discount rate formation mechanism. The RMB exchange rate formation mechanism will be improved in a self-initiated, controllable, and gradual manner so as to keep the RMB exchange rate basically stable at a adaptive and equilibrium level.

The PBC will strengthen window guidance and credit guidance to intensify efforts to adjust the credit structure. Efforts will be made to optimize the credit structure, to encourage growth in some sectors while discouraging growth in others, to limit lending to high energy-consuming and highly polluting industries, to industries with an overcapacity, and to low-quality enterprises, and to strengthen credit support to key areas and weak aspects. First, efforts should be made to intensify credit support to agriculture, rural areas, and farmers. A lower reserve requirement ratio and other policies to guide capital in postal savings institutions to flow back into the rural areas will be adopted to broaden the sources of credit funds used for agro-linked purposes.

Second, efforts should be made to intensify financial support to small enterprises that have sufficient market demand for their products, make profits, and create many jobs. Comprehensive measures will be taken to support the development of small enterprises, including encouraging financial institutions to invent new credit products and trade financing methods for small enterprises, establishing a multi-layered financial system for small enterprises, broadening direct financing channels for small enterprises, guiding social funds to flow into the financial market for small enterprises, promoting the creation of a credit system and guarantee system, and improving the financing environment for small enterprises. Third, efforts should be made to intensify credit support for post-earthquake reconstruction. Efforts should also be made to encourage banking financial institutions, on the premise of careful regulation and operational soundness, to increase credit to the stricken areas, adjust the credit structure and timing when appropriate in line with the actual needs in the affected areas, intensify credit support to priority infrastructure construction projects, housing construction projects, consumption, and to areas that can create jobs, and help the development of agriculture, rural areas, and farmers and the growth of small enterprises.

The PBC will adopt comprehensive measures to maintain an equilibrium in the balance of payments. Efforts will be made to promote the development of the foreign exchange market, improve the ability of financial institutions in terms of pricing and risk management, and encourage financial institutions to design better-targeted exchange rate risk management products for enterprises. The foreign exchange system administrative reform will be deepened to guide capital flows in a balanced manner, to speed up “going global,” and to improve the outward investment system featuring multiple players and multiple layers so as to bring about an equilibrium in the balance of payments. Measures with regard to networked investigations into foreign exchange receipts and settlement from export activities will be better implemented to monitor abnormal foreign exchange movements and prevent massive outflows of foreign capital.

Finally, the PBC will accelerate economic restructuring, with priority given to expanding domestic demand. Given the acute conflict between economic development and resources and energy conservation as well as the slowing of external demand, emphasis should be placed on shifting the economic development mode, promoting economic restructuring, and expanding domestic demand. In the next stage, efforts will be made to continue to improve fiscal and taxation policies with a view to creating a more favorable fiscal environment for expanding consumer demand and promoting the development of the services sector, to speed up institutional reforms, including social security, and to eliminate institutional factors that constrain the restructuring efforts. The reform of the pricing mechanism for resources and energy should be carried forward when appropriate to improve environmental protection standards and to promote the shift in the economic development pattern.