

China Monetary Policy Report

Quarter Two, 2013

(August 2, 2013)

**Monetary Policy Analysis Group of
the People's Bank of China**

Executive Summary

In the first half of 2013 the performance of the economy was stable, with structural adjustments and upgrading making new headway, consumption growing steadily, and investment expanding rapidly. The agricultural sector was in good shape and the structural adjustment of the industrial sector was making progress. The overall price level and employment situation were generally stable. The GDP reached 24.8 trillion yuan, up 7.6 percent year on year and the consumer price index was up 2.4 percent year on year.

Since the beginning of the year, the PBC has followed the overall arrangements of the State Council and continued to implement a sound monetary policy. Given the increased uncertainty in international capital flows and the build-up of pressures in money and credit expansion, fine-tuning and preemptive adjustments were carried out in a forward-looking manner. A mix of instruments was used, including open market operations, central bank lending and discounts, the Standing Lending Facility (SLFs), Short-term Liquidity Operations (SLOs), and so forth, and the dynamic adjustment tool of differentiated reserve requirements continued to play a counter-cyclical role in guiding the stable and reasonable growth of money and credit. The coverage of agro-linked central bank lending was expanded nationwide to guide rural financial institutions to lend more to the agricultural sector, the rural areas, and farmers. The assessment of the impact of the credit policy guidance continued to promote improvements in the credit structure. As a further step in the market-based interest-rate reforms, controls over lending interest rates were removed as of July 20, 2013. The use of RMB in cross-border trade and investment activities was expanded. The reform of financial institutions was advanced and the foreign exchange administration reform was deepened.

The growth of money and credit declined from the previously high level. At end-June 2013, broad money M2 was up 14 percent year on year. Outstanding RMB loans were up 14.2 percent year on year, an increase of 5.08 trillion yuan from the beginning of 2013, 221.7 billion yuan more than the growth registered in the first six months of last year. During the period under review, all-system financing aggregate totaled 10.15 trillion yuan, an increase of 2.38 trillion yuan year on year. The deposit and lending rates of financial institutions fluctuated slightly. In June, the weighted average lending rate offered to non-financial enterprises and other sectors was 6.91 percent. At end-June, the central parity of the RMB against the US dollar was 6.1787 yuan per dollar, an appreciation of 1.73 percent from the end of 2012. RMB exchange-rate expectations were generally stable.

The Chinese economy is at a critical stage of structural adjustments, upgrading, and transformation. There are still many positive factors and favorable conditions to support sustainable and sound development, and there remains ample room for further

industrialization and urbanization. But balanced regional development has much room for improvement. Adjustment of the economic structure is making positive progress. A modern service industry, high-tech industry, and some emerging sectors are developing at a good momentum. In particular, enterprises and sectors that have worked actively to promote upgrading, transformation, and independent innovation have shown remarkable resilience and dynamism. However, there are many risks and challenges. Against the background of deceleration of potential GDP growth, the excess capacity in the traditional manufacturing industries, which matched the growth pattern during the high-growth period, is quite serious. The indebtedness and leverage ratio of some enterprises have risen rapidly. Some of the local financing platforms are using even more complicated financing channels. Natural resources and the environment are overly stretched. At the moment, the key is to take into full consideration and properly handle relations among maintaining stable economic growth, adjusting the economic structure, furthering the reform, and managing risks to promote sustainable and sound economic growth. The price situation is generally stable, but structural issues remain. Price movements are quite sensitive to the expansion of demand. Therefore, it is necessary to continue to guide and manage inflation expectation.

The PBC will follow the overall arrangements of the State Council, follow the principle of seeking macro-economic stability, enhancing vitality at the micro-level, and making progress and improving quality amidst stability, maintain policy stability and continuity, continue to implement a sound monetary policy, make policy measures more targeted and better coordinated, conduct fine-tuning and preemptive adjustments when necessary, strike a balance among preserving stable economic growth, adjusting the economic structure, promoting reform, and preventing risks, and create a stable financial environment and monetary conditions for economic structural adjustments, transformation, and upgrading. A variety of monetary policy tools will be used, including quantity-based and price instruments, and the macro-prudential policy framework will be improved to guide money, credit, and all-system financing aggregate to grow in a stable and reasonable manner. The allocation of financial resources will be further optimized and financial institutions will be encouraged to properly manage their stock of credit assets and to make good use of new loans, to consolidate resources to support small and micro-sized enterprises, and to step up credit support to the agricultural sector, rural areas, and farmers. Consumer financing will be further developed to support an upgrading of consumption so as to guide and support the transformation and adjustment of key sectors and industries. Private capital will be given access to the financial sector to provide differentiated and highly efficient financial services with broad coverage. The reform will be furthered to strengthen the role of market mechanisms, to improve the monetary policy transmission mechanism, to effectively prevent systemic financial risks, and to promote sustainable and sound economic growth.

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Part 1 Monetary and Credit Performance

In the first half of 2013 the performance of the economy was stable, credit aggregates grew relatively rapidly before slowing down slightly in May and June, and the credit structure was improved.

I. Money supply registered decelerated growth

At end-June 2013, outstanding M2 stood at 105.4 trillion yuan, up 14 percent year on year, a deceleration of 1.7 percentage points from the end of March and an acceleration of 0.2 percentage points from the end of last year. Outstanding M1 stood at 31.4 trillion yuan, up 9.1 percent year on year, a deceleration of 2.7 percentage points from the end of March and an acceleration of 2.6 percentage points from the end of last year. Currency in circulation M0 totaled 5.4 trillion yuan, up 9.9 percent year on year. Net cash injections totaled 50.9 billion yuan in the first half of the year, down 95.6 billion yuan year on year.

In June, the growth of money supply slowed down. By end-June, the M2 growth rate had decreased by 2.1 percentage points from the peak at the end of April due to decelerated deposit growth compared with last June. With the adoption of related financial regulatory policies, commercial banks, in line with the macro-prudential requirements, intensified efforts to adjust the asset-liability structure, slowed down the excessive pace of issuance of credit, and reduced transactions on the inter-bank market, thus derivative deposits declined. Because money supply during the same period of last year was relatively high, the growth of money was affected. In addition, outstanding fiscal deposits registered a much smaller decline compared with that during the same period of last year, contributing to the decline in the growth of deposits. In general, the slower growth rate of money supply is consistent with the anticipation of the macro-economic management and the requirements of a sound monetary policy, and it is close to the 13 percent growth target determined at the beginning of the year. It will provide a sound monetary environment for stable and healthy economic development, enable the financial sector to play a better role in the adjustment of the economic structure, the economic transformation, and upgrading.

At the end of June 2013, outstanding base money registered 25.8 trillion yuan, up 13 percent year on year and 543.2 billion yuan more than that at the beginning of the year. The money multiplier stood at 4.09, which was same as that at the end of March. The excess reserve ratio of financial institutions was 2.1 percent and that of rural credit cooperatives (RCCs) was 3.9 percent.

II. A larger year-on-year increase of deposits in financial institutions

At the end of June 2013, outstanding deposits of domestic and foreign currencies in all financial institutions (including foreign-funded financial institutions, the same hereinafter) reached 103.6 trillion yuan, up 14.1 percent year on year and on par with that at the end of last year. This was 9.2 trillion yuan more than that at the beginning of 2013, representing a year-on-year acceleration of 1 trillion yuan. Outstanding RMB deposits registered 100.9 trillion yuan, up 14.3 percent year on year and an acceleration of 0.9 percentage points from the end of last year. This was 9.1 trillion yuan more than that at the beginning of 2013, representing a year-on-year acceleration of 1.7 trillion yuan. Outstanding deposits in foreign currencies posted USD 441.5 billion, an increase of 9 percent year on year or an increase of USD 31.3 billion from the beginning of 2013. This was USD 98.8 billion less than that during the same period of the previous year. This is mainly due to the relatively large volume during the same period of last year and the stronger expectations since the beginning of 2013 that the Fed would taper the QE3.

Broken down by sectors, growth of household deposits was stable and growth of deposits of non-financial institutions recovered. At the end of June 2013, outstanding household deposits in financial institutions posted 44.8 trillion yuan, up 14.5 percent year on year, representing growth of 4.1 trillion yuan from the beginning of the year and a slight deceleration of 72.9 billion yuan year on year. Outstanding RMB deposits of non-financial enterprises registered 35 trillion yuan, up 12.4 percent year on year, an acceleration of 4.5 percentage points from the end of last year; this represented a rise of 2.3 trillion yuan compared with that at the beginning of the year, 1.2 trillion yuan more than the increase registered during the same period of last year. In particular, time deposits increased by 2.6 trillion yuan from the beginning of 2013, 1.1 trillion yuan more than the increase registered during the same period of last year, indicating that enterprises tend to reserve more funds when economic growth expectations are unstable. At the end of June 2013, outstanding fiscal deposits registered 3.4 trillion yuan, up 958.8 billion yuan from the beginning of the year, 427.4 billion yuan more than that during the same period of last year.

III. Outstanding loans of financial institutions grew steadily

At the end of June, outstanding loans in domestic and foreign currencies at all financial institutions registered 72.9 trillion yuan, up 15.1 percent year on year, a deceleration of 0.9 percentage points and 0.5 percentage points from the end of March and the end of last year respectively. This was an increase of 5.6 trillion yuan from the beginning of the year, 429.6 billion yuan more than the increase registered during the same period of last year.

Growth of RMB loans slowed down slightly. At the end of June, outstanding RMB loans stood at 68.1 trillion yuan, up 14.2 percent year on year or a deceleration of 0.7

percentage points and 0.8 percentage points over the end of March and the end of last year respectively. This was an increase of 5.08 trillion yuan from the beginning of 2013, 221.7 billion yuan more than the increase registered during the same period of last year. The amount of loan disbursements was more balanced in each month of the second quarter, and average monthly new loans totaled 773.6 billion yuan, down 144.7 billion yuan from the first quarter.

The growth rate of medium- and long-term loans increased steadily, and the credit structure generally improved. First, the growth rate of medium- and long-term loans in the industrial sector recovered. At the end of June, medium- and long-term loans in the industrial sector increased by 7.4 percent year on year, an acceleration of 1.1 and 0.2 percentage points from the end of last year and the same period of last year respectively. Second, the growth of medium- and long-term loans in the service sector accelerated. By the end of June, medium- and long-term loans in the service sector had increased by 7.9 percent year on year, an acceleration of 5.7 and 6.6 percentage points from the end of last year and the same period of last year respectively. Broken down by institutions, lending by Chinese-funded large-sized national banks and small- and medium-sized local banks registered a larger increase than that during the same period of last year.

Table 1 RMB Loans of Financial Institutions in the First Half of 2013

Unit: 100 million yuan

| | First Half of 2013 | | First Half of 2012 | |
|--------------------------------------------------------------------|--------------------|--------------|--------------------|--------------|
| | New Loans | Acceleration | New Loans | Acceleration |
| Chinese-funded large-sized national banks ¹ | 23,286 | 1,141 | 22,145 | 1,902 |
| Chinese-funded small- and medium-sized national banks ² | 13,948 | 677 | 13,271 | -365 |
| Chinese-funded small- and medium-sized local banks ³ | 8,179 | 1,371 | 6,808 | 4,240 |
| Rural cooperative financial institutions ⁴ | 8,814 | 224 | 8,590 | 1,558 |
| Foreign-funded financial institutions | -90 | -379 | 289 | 5 |

Notes: 1.Chinese-funded large-sized banks operating nationwide refer to banks with assets denominated in domestic and foreign currencies equivalent to no less than 2 trillion yuan (according to the amount of total assets in both domestic and foreign currencies at end-2008). 2. Chinese-funded small- and medium-sized banks operating nationwide refer to banks operating across different provinces with assets of less than 2 trillion yuan denominated in domestic and foreign currencies.

3. Chinese-funded small- and medium-sized local banks refer to banks operating within a single province with total assets of less than 2 trillion yuan denominated in domestic and foreign currencies.
4. Rural cooperative financial institutions refer to rural commercial banks, rural cooperative banks, and rural credit cooperatives.

Source: People's Bank of China.

Foreign currency-denominated loans grew rapidly. At the end of June, outstanding foreign-currency loans of financial institutions reached USD 775.8 billion, up 33.2 percent year on year. This was an increase of USD 92.4 billion from the beginning of the year and USD 48.6 billion more than that registered during the same period of last year, mainly due to the relatively stable trade performance in the first half of 2013, the abundant foreign currency deposits in banks, and the loose quota of medium- and long-term external debts, and so forth. In terms of the loan structure, trade financing increased by USD 47.7 billion, USD 29.8 billion more than that registered during the same period of last year. Outward lending and medium- and long-term domestic loans increased by USD 27.1 billion yuan, USD 7.3 billion more than the increase registered during the same period of last year.

Box 1 The Mismatch between Financial and Economic Data

In the first several months of 2013, money, credit, and all-system financing grew relatively rapidly. However, the fact that the financial and economic data do not move tandem attracted attention. Although the two categories of data are related to each other to some extent, it is rare to have a perfect match between the two. From a historical perspective, the two sets of data have deviated from one another to varying degrees. The recent lack of synchrony is attributed to structural and cyclical factors.

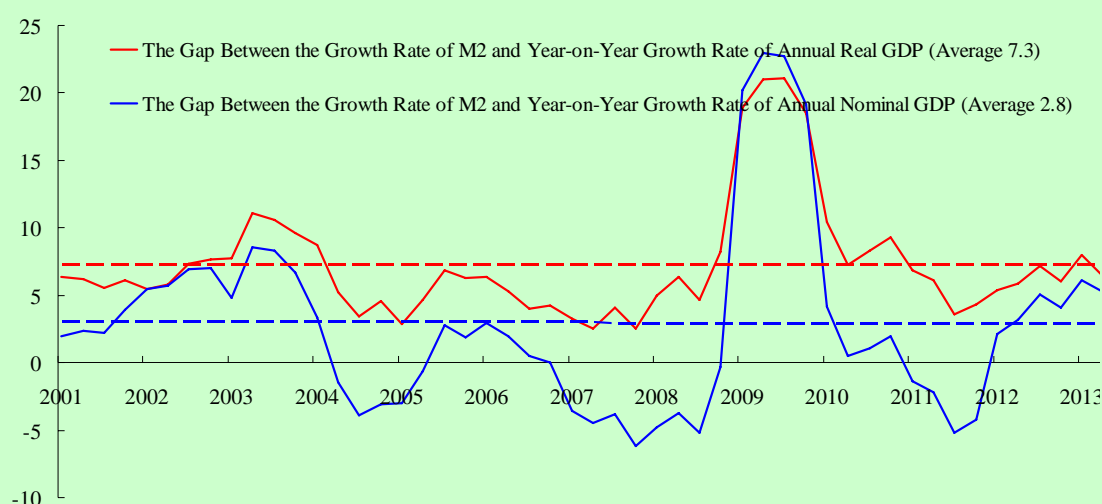
Looking at the structural factors, due to the overcapacity in traditional industries and the lack of new sources of economic growth, more funds were invested in the infrastructure and real estate sectors. In particular, land acquisitions and purchases require large amount of funds, but the related investments are not included in the GDP statistics prior to the launch of a project. Second, the adjustment of the industrial structure boosts financing demands by requiring extra funds. Although marginal output is diminishing in the inefficient traditional industries, the emerging industries have not produced noteworthy returns. Third, financing procedures may take longer time during the process of the financial deepening.

From a cyclical perspective, enterprises tend to hoard funds when the economic outlook and expectations are uncertain. China is still at the stage of economic expansion and transition, and economic entities always have a strong demand for funds. Enterprises tend to hoard money when they can borrow from banks, issue bonds, or have other financing opportunities; and these enterprises are more likely to hold money when the economic outlook and expectations are uncertain. With money in their bank accounts, they can use it for debt repayments, lend to other entities for higher returns, and invest in productive activities during an economic recovery.

However, this traditional philosophy of fund utilization may have some negative impacts when the potential growth rate is slowing down.

Historically, the fact that economic and financial data were not synchronized is not something new. For example, the M2 growth rate exceeded that of GDP by a large margin in 2003, 2005, and 2009. Comparatively, during economic boom and periods of higher inflation, the M2 growth rate deviated from the GDP growth rate only slightly, and was sometimes even lower than the nominal growth rate (for example in 2004, 2007 to 2008, and 2011); during economic slumps, the M2 growth rate exceeded the GDP growth rate by a notable margin due to the decreasing velocity of money caused by pessimistic expectations of enterprises and the lack of investment projects. According to preliminary estimations, compared with the fourth quarter of 2012, the decline in the velocity of money during the first quarter of 2013 was 2.1 percentage points larger than that in Q4 2013.

Unit: Percent



Source: People's Bank of China, National Bureau of Statistics.

Figure 1 Historical Trend in the Year-On-Year Growth Rate of M2 and GDP

Furthermore, the real economy covers a wide range of sectors, including the primary, secondary, and tertiary industries and other subdivisions. Based on the size of enterprises, there are large-, medium-, and small- and micro-sized enterprises. It is unwise to measure the amount of funds flowing into the real economy by the share of loans to the manufacturing industry or to certain types of enterprises in total lending because loans and other financing both constitute support of the financial system to the real economy.

It should be noted that since the financial structure is determined by the economic structure, the key to higher efficiency in fund utilization is an accelerated adjustment of the economic structure in order to have new sources of economic growth and

endogenous growth drivers. During recent years, relatively rapid growth of money and credit has played an important role in supporting the development of the real economy. However, those inefficient enterprises in sectors that suffer from overcapacity still take up a huge amount of financial resources, leading to inefficiencies in fund utilization and a lower contribution to economic growth. Thus, it is necessary to improve the allocation of financial resources, properly manage the stock of credit assets, and make good use of new loans to better support the development of the real economy. More importantly, efforts should be made to accelerate the adjustment of economic structure, transform the economic growth pattern, and expand fund utilization.

IV. All-system financing aggregate increased notably year on year

All-system financing aggregate measure the total funds flowing to the real economy (i.e., enterprises and individuals) from the financial system during a given period of time (month, quarter, or year), comprehensively monitor financing activities in the society, and serve as a reference for the adjustment of monetary policy. According to preliminary statistics, all-system financing aggregate reached 10.15 trillion yuan in the first half of 2013, an increase of 2.38 trillion yuan from the same period of last year and representing the highest increase in history. In particular, all-system financing aggregate totaled 1.04 trillion yuan in June, a decline of 148.5 billion yuan and 742.7 billion yuan from the last month and the same period of last year respectively.

Table 2 All-system Financing Aggregate

Unit: 100 million yuan

| | All-system Financing aggregates ¹ | Of which | | | | | | |
|--------------------|----------------------------------------------|------------------------|-----------------------------------------------------|-----------------|-------------|-----------------------------------|------------------|-----------------------------------------------------------------------------|
| | | RMB loans ³ | Foreign currency-denominated loans (RMB equivalent) | Entrusted loans | Trust loans | Undiscounted bankers' acceptances | Enterprise bonds | Financing by domestic non-financial institutions via domestic stock markets |
| 2010 | 140191 | 79451 | 4855 | 8748 | 3865 | 23346 | 11063 | 5786 |
| 2011 | 128286 | 74715 | 5712 | 12962 | 2034 | 10271 | 13658 | 4377 |
| 2012 | 157631 | 82038 | 9163 | 12838 | 12845 | 10499 | 22551 | 2508 |
| Q1, 2013 | 61652 | 27547 | 4453 | 5235 | 8244 | 6706 | 7571 | 617 |
| First half of 2013 | 101511 | 50768 | 5791 | 11118 | 12319 | 5164 | 12234 | 1248 |

Notes: 1. All-system financing aggregates refer to the total volume of financing provided by the financial system to the real economy during a certain period of time. It is a flow rather than a stock value.

2. Data for the current period are preliminary.

3. Data for RMB loans are the historical numbers released in the past.

Sources: People's Bank of China, National Development and Reform Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission, China Government Securities Depository Trust and Clearing Co., Ltd., National Association of Financial Market Institutional Investors, and so forth.

In terms of the structure, all-system financing aggregates in the first half of 2013 have the following features. First, the volume of new RMB loans was larger than that during the same period of last year, but the share fell. In the first half of 2013, new RMB loans totaled 221.7 billion yuan more than during the same period of last year, accounting for 50 percent of all-system financing aggregate and down 12.4 percentage points year on year. Second, foreign-currency denominated loans, corporate bonds, entrusted loans, and trust loans grew rapidly, accounting for a larger share of the all-system financing aggregates. The financing structure continued to diversify. In the first half of 2013, the shares of foreign-currency denominated loans, corporate bonds, entrusted loans, and trust loans were 5.7 percent, 12.1 percent, 11 percent, and 12.1 percent respectively, up 2.1 percentage points, 1.5 percentage points, 4.8 percentage points, and 7.8 percentage points year on year. The volume of undiscounted bankers' acceptances fluctuated, increasing 579.8 billion yuan in January, the highest monthly level, then decreasing to 262 billion yuan by June, down 573.3 billion yuan year on year. In the first half of 2013, new loans of micro-credit and credit companies amounted to 112.2 billion yuan, up 14.4 billion yuan year on year.

V. The deposit and lending rates of financial institutions fluctuated

slightly

In June, the weighted average lending rate offered to non-financial enterprises and other sectors was 6.91 percent, up 0.27 percentage points compared with the rate offered in March. In particular, the weighted average interest rate of loans registered 7.1 percent, down 0.12 percentage points from the rate in March; the weighted average bill financing rate posted 5.88 percent, up 1.26 percentage points from the rate in March; the weighted average home mortgage rate rose slightly to 6.29 percent, up 0.02 percentage points from March.

The share of loans with interest rates lower than or flat with the benchmark rate rose slightly, and the share of loans with interest rates higher than the benchmark rate decreased. In June, the shares of loans with interest rates lower than or flat with the benchmark rate were 12.55 percent and 24.52 percent respectively, up 1.11 and 0.73 percentage points from March, and the share of loans with interest rates higher than the benchmark rate was 62.93 percent, down 1.84 percentage points from March.

Table 3 Shares of Loans with Rates Floating at Various Ranges of the Benchmark Rate, January through June 2013

Unit: Percent

| Month | Lower than the benchmark | At the benchmark | Higher than the benchmark | | | | | |
|----------|--------------------------|------------------|---------------------------|------------|------------|------------|------------|----------|
| | [0.7, 1.0] | 1 | Subtotal | (1.0, 1.1] | (1.1, 1.3] | (1.3, 1.5] | (1.5, 2.0) | Over 2.0 |
| January | 10.62 | 25.08 | 64.30 | 19.84 | 25.23 | 7.87 | 8.28 | 3.07 |
| February | 11.69 | 25.05 | 63.26 | 19.57 | 23.96 | 7.88 | 8.83 | 3.02 |
| March | 11.44 | 23.79 | 64.77 | 19.55 | 24.71 | 8.15 | 9.28 | 3.09 |
| April | 10.56 | 23.53 | 65.91 | 18.96 | 25.52 | 8.96 | 9.23 | 3.24 |
| May | 11.89 | 22.45 | 65.66 | 19.65 | 25.92 | 8.84 | 8.46 | 2.79 |
| June | 12.55 | 24.52 | 62.93 | 19.47 | 24.95 | 7.95 | 8.04 | 2.52 |

Source: People's Bank of China.

The deposit and lending rates of foreign currencies fluctuated slightly due to the fluctuation of interest rates on the international financial market and changes in the supply and demand of foreign exchange in China. The rates rose slightly compared with the end of March. In June, the weighted average interest rates of large-value US dollar demand deposits and US dollar deposits with a maturity of less than 3 months were 0.12 percent and 1.07 percent respectively, up 0.01 and 0.15 percentage points from March. The weighted average interest rates of US dollar loans of less than 3 months and of 3 to 6 months (inclusive of 3 months) posted 2.23 percent and 2.34 percent respectively, up 0.26 percentage points and 0.18 percentage points from March.

Table 4 Average Interest Rates of Large-value Deposits and Loans Denominated in US Dollars, January through June 2013

Unit: %

| Month | Large-value deposits | Loans |
|-------|----------------------|-------|
|-------|----------------------|-------|

| | Demand Deposits | Within 3 months | 3-6 months (inclusive of 3 months) | 6-12 months (inclusive of 6 months) | 1 year | Over 1 year | Within 3 months | 3-6 months (inclusive of 3 months) | 6-12 months (inclusive of 6 months) | 1 year | Over 1 year |
|----------|-----------------|-----------------|------------------------------------|-------------------------------------|--------|-------------|-----------------|------------------------------------|-------------------------------------|--------|-------------|
| January | 0.11 | 0.90 | 1.35 | 1.75 | 1.90 | 2.45 | 1.74 | 2.04 | 1.87 | 2.00 | 3.25 |
| February | 0.12 | 0.84 | 1.42 | 1.75 | 2.04 | 2.12 | 2.18 | 1.91 | 1.82 | 2.14 | 4.08 |
| March | 0.11 | 0.92 | 1.57 | 1.91 | 2.44 | 1.54 | 1.97 | 2.16 | 2.07 | 2.35 | 3.03 |
| April | 0.10 | 0.82 | 1.36 | 2.04 | 2.36 | 1.27 | 1.99 | 2.13 | 2.22 | 2.30 | 3.26 |
| May | 0.12 | 0.80 | 1.39 | 1.89 | 2.31 | 1.20 | 2.00 | 2.11 | 2.34 | 2.38 | 3.02 |
| June | 0.12 | 1.07 | 1.69 | 1.86 | 2.50 | 1.14 | 2.23 | 2.34 | 2.40 | 2.78 | 3.33 |

Source: People's Bank of China.

VI. The flexibility of the RMB exchange rate increased significantly

Since the beginning of 2013, the RMB exchange rate moved in both directions and appreciated slightly. The flexibility of the exchange rate increased and expectations remained stable. At the end of June, the central parity of the RMB against the US dollar was 6.1787 yuan per dollar, representing an appreciation of 1.73 percent from the end of last year. From the beginning of the RMB exchange-rate regime reform in 2005 to the end of June 2013, the RMB appreciated 33.95 percent against the US dollar. The BIS estimated that in the first half of 2013 the nominal effective exchange rate of the RMB and the real effective exchange rate of the RMB appreciated 5.89 percent and 5.67 percent respectively. From the beginning of the RMB exchange-rate regime reform in 2005 to June 2013, the nominal effective exchange rate and the real effective exchange rate of the RMB appreciated 30.47 percent and 39.28 percent respectively.

Part 2 Monetary Policy Operations

From the beginning of 2013, in line with the overall arrangements of the State Council, the PBC continued to implement a sound monetary policy, making preemptive adjustments and fine-tunings in a forward-looking manner in response to heightened uncertainties in international capital flows and increased pressures from money and credit expansions.

I. Flexible open market operations

Supported by closer analysis and monitoring of liquidity supply and demand in the banking system, and taking into account the V-shaped curve that characterizes liquidity movements during the Spring Festival, the PBC flexibly carried out open market operations in both directions in the first quarter through a proper mix of short-term reverse repos and 28-day repos and focused on sterilization operations in the second quarter through 28-day repos and re-launching 3-month central bank bills to flexibly manage liquidity in the banking system. Since June, in view of the changing liquidity situation, the PBC moderated the intensity and frequency of its operations and employed open market operations, standing lending facilities(SLFs), and other tools to moderate short-term liquidity fluctuations caused by multiple factors. In the first half of 2013, the PBC conducted 1.34 trillion yuan of reverse repos and 765 billion yuan of repos, and issued 114 billion yuan of central bank bills.

The interest rates of open market operations remained stable. In response to the volatile external environment, the PBC intensified analysis and monitoring of market interest-rate developments, and kept the interest rates of open market operations at a stable level to guide market expectations. At end-June, the interest rates for 28-day repos and 3-month central bank bills recorded 2.75 percent and 2.9089 percent respectively.

The PBC properly conducted state treasury cash management operations. In the first half of 2013, a total of 120 billion yuan of state treasury funds was deposited in commercial banks in three separate 6-month deposit operations.

In response to the changes in liquidity supply and demand in the banking system during the past two years, the volume of central bank bill issuances dropped and became smaller than the amount of matured bills. This contributed to shrinking outstanding central bank bill aggregates, which had an impact on the buoyancy of central bank bill trading in the secondary market and the effectiveness of its role as a pricing benchmark. In this context, the PBC decided to roll over part of the matured 3-year central bank bills held by large financial institutions with adequate liquidity at market determined prices. Central bank bills after the rollover are allowed to be traded in the inter-bank market and are an eligible instrument for open market operations.

The PBC also provided necessary short-term liquidity support to a number of financial institutions as they participated in these rollover operations. Overall, this combination of operations that freeze long-term liquidity and that provide short-term liquidity has a neutral effect on liquidity. It responds to both the need for an appropriate liquidity level and for money market stability in the context of a sound monetary policy, and it represents an innovation in the conduct of monetary policy in China. Against the background of the volatile global financial market and the changing liquidity supply and demand, the rollover of part of the matured central bank bills helps the PBC to implement its monetary policy with stronger initiative and flexibility. It is also important for promoting a steady interest-rate reform and for supporting bond market development. The PBC will continue to conduct such rollover operations on a discretionary basis in combination with other policy instruments in order to implement a sound monetary policy and to create favorable monetary conditions for the stable functioning of financial markets and economic development.

II. Strengthening macro-prudential regulation by improving case-on-case adjustments of the differentiated reserve requirement as a counter-cyclical tool

The PBC continued to apply a case-on-case adjustment of the differentiated reserve requirement as a way to strengthen macro-prudential regulation. Based on domestic and global economic and financial developments, the soundness of financial institutions, and implementation of the credit policy, the PBC calibrated the parameters of the differentiated reserve requirement to guide stable and reasonable credit growth, to improve the resilience of financial institutions, and to encourage financial institutions to increase credit support to the weak links in the economy, such as small- and micro-sized enterprises and the agricultural sector, rural areas, and farmers.

Box 2 Policy efforts to improve financial macro-management since the 2008 crisis

The 2008 global financial crisis left countries with twin challenges: to address the shocks from the crisis and to safeguard steady growth by flexibly deploying macro-economic policies on the one hand and, with hindsight, to rethink and improve the financial macro-management framework on the other.

In dealing with the first challenge, the major economies have taken full advantage of interest-rate adjustments – a traditional policy tool – and when interest rates approached the zero band, they have introduced unconventional monetary policies, including quantitative easing by adjusting the size and structure of the central bank balance sheets and, in some cases, making adjustments for a stronger role of forward guidance, i.e., clear communications of the central bank’s views on policy prospects

when making policy announcements. The rationale for providing forward guidance, as Professor Michael Woodford at Columbia University has noted, is that public expectations could have a significant impact on economic developments when the interest rate touches the lower band and the nominal interest rate stays unchanged for an extended period of time. In this context, guidance from the central bank is very important. In practice, the Federal Reserve has explicitly linked its monetary policy to the unemployment and inflation levels, and has guided public expectations by declaring preconditions for an exit from its unconventional policies. Also, the Bank of Japan announced a clear inflation target.

As for improving the framework for financial macro-management, there has been progress in theoretical studies as well as in the practice of financial reform. Most notably, people have come to understand that monetary stability does not amount to financial stability. For a long time, from the 1980s until the recent financial crisis, a *single target* (the CPI) and a *single instrument* (the interest rate) have been the widely accepted mainstream monetary policy framework. The most typical representation of this framework is inflation targeting (IT), an arrangement that reduces the dynamic inconsistency problem and makes policies more transparent and rule-based, thus stabilizing market expectations. The weakness of IT, however, is also evident: an error in measuring the inflation level could lead to systemic policy deviation, and the lack of policy tools other than the short-term interest rate makes it difficult to manage volatility in asset prices and market disturbances in the context of a stable CPI, a situation widely seen in recent years. This calls for the introduction of new policy tools as a complement to existing tools. Former governor of the Bank of England, Mervyn King, has pointed out that, while still a necessary arrangement, inflation targeting alone is not enough to address the policy challenges and macro-prudential measures that are needed to contain the excessive expansion of banks. Research reports from the Brazilian central bank argue that it is necessary to introduce macro-prudential policies for financial stability considerations, given that inflation targeting faces challenges from exchange rates that cannot float freely, an imperfect credit market, and a low policy priority for financial stability.

In retrospect, monetary policy in earlier times focused on stimulating growth and discretionary policy choices, and then later turned to price targeting and interest rates as the only policy tools, thus requiring policy rules and expectation management. As the evolution of financial macro-management since the financial crisis shows, the major central banks began to favor quantitative tools and the role of commitments and expectations in addition to traditional interest-rate tools. They also introduced the concept of a macro-prudential policy framework in financial reforms, reflecting their belief that currency stability and financial stability need to be reconciled and the existing policy toolkit needed to be expanded. The idea of macro-prudential regulation provides an opportunity to rethink the purpose, tools, and transmission mechanisms for financial macro-management, and the interactions between monetary policy and financial regulation.

Strengthening macro-prudential policies has been at the core of the reform of global financial management for years, and considerable progress has been made. On policy tools, the basic framework of the Basel III was approved by the G20 in late 2010, which represents progress in enhancing macro-prudential regulation and improving counter-cyclical adjustments. For example, in addition to the minimum capital requirement, the framework introduces a capital requirement for macro-prudential reasons, including capital reserve buffers, counter-cyclical capital buffers, and capital surcharges for systemically important financial institutions. To address the vulnerabilities financial institutions experienced in managing liquidity during the crisis, the framework also set higher requirements for the liquidity and leverage ratio. The new leverage ratio requirement includes off-balance sheet risks to prevent excessive leveraging.

In global practices of financial regulatory reform, the Federal Reserve was given greater regulatory power over systemically important financial institutions, including a new mandate to regulate large complex financial institutions. The Bank of England was mandated to conduct macro-prudential regulation and was given the regulatory power that had been in the hands of the Financial Service Agency. In Europe, the European Systemic Risk Board (ESRB) was set up to coordinate implementation of macro-prudential measures in the euro area. The European Commission proposed the establishment of a European banking union. The European Parliament adopted an act for a Single Supervisory Mechanism for the European banking sector in May 2013, which gives the ECB regulatory power over large banks and a greater voice in the regulation of other banks. The ECB has a mandate to deploy all macro-prudential measures prescribed by law, including counter-cyclical capital buffers, capital surcharges for systemically important financial institutions, and liquidity requirements.

Theoretical studies and practices in financial macro-management since the financial crisis have focused on improving the traditional framework of a *single target* and a *single instrument*. Price movements can be structural, the credit market is not perfect, and the information available can be incomplete. In this sense, a single target, as well as reliance on quantity or price-based adjustments, is insufficient. It is important to assess overall price levels in a broader sense and to develop a better understanding of the link between monetary policy and financial stability, and improve the policy toolkit and the organizational structure accordingly. In China, the monetary authority uses both quantity- and price-based tools and macro-prudential policies, which reflects China's circumstances and is in line with the new global thinking that builds on a reexamination of the traditional framework after the financial crisis. Quantity and price are closely linked. Quantity management and price-based management are sometimes equivalent and sometimes complementary. Depending on domestic and global economic and financial developments, a flexible choice and combination of policy tools, including open market operations, reserve requirements, and interest

rates, will be important to strengthen macro-prudential management and to make financial macro-management more effective. As financial innovation and the financial market become more sophisticated, China will need to allow price-based management and its transmission channels to play a greater role while promoting a shift in financial macro-management from quantity to price-based adjustments.

III. New steps in advancing the market-based interest-rate reform

On July 20, 2013, with the approval of the State Council, the PBC decided to remove all controls on lending rates offered by financial institutions. First, the floor for lending rates, which was 70 percent of the benchmark lending rate, was removed and financial institutions are allowed to use their discretion in determining lending rates in line with commercial principles. Second, restrictions on discount rates were lifted, allowing the discount rates to be determined by financial institutions instead of adding a premium to the central bank discount rate. Third, the ceiling for the RCC lending rates was removed. Fourth, the floating band for personal mortgage loans continues to be applied in order to support strict implementation of the differentiated housing credit policy and to promote the healthy development of the real estate market.

Liberalization of lending rates allows financial institutions greater room in negotiating rates with their clients. This encourages financial institutions to adopt differentiated pricing strategies and reduces funding costs for enterprises. It encourages financial institutions to improve their independent pricing capacity, transform their business models, improve financial services, and increase financial support to enterprises and households. Greater negotiating room also helps improve the allocation of financial resources, enhance the supportive role of the financial sector to the real economy, and promote adjustments and upgrading of the economic structure.

IV. Strengthened window guidance and credit policy guidance

The PBC continued to employ monetary policy tools, macro-prudential tools, and credit policies to guide structural improvements, and enhanced coordination with industrial policies in an effort to support the economic restructuring and upgrading and to strengthen the financial sector's capacity to serve the real economy. The PBC encouraged financial institutions to channel more new credit to key areas and to weak links in the economy, including small- and micro-sized enterprises, the agricultural sector, rural areas, and farmers, and to meet the funding needs of key national projects, while improving the structure of the credit stock. Following a differentiated approach, financial institutions increased credit support to advanced manufacturing, strategic emerging industries, labor-intensive industries, and the Going Global initiatives, as well as to the upgrading of the service sector and traditional industries. The use of credit has become more efficient.

The PBC urged financial institutions to improve financial services that are closely related to the people's livelihood and to improve financial support to programs designed to promote balanced regional economic development. Lending to heavily energy-consuming and polluting industries as well as to industries with excess capacity was subject to strict controls, while lending was provided to enterprises to make targeted mergers and acquisitions aimed to integrate excessive capacity. Moreover, implementation of the differentiated housing credit policies was continued to contain speculative home purchases and to support affordable housing projects, shantytown renovations, construction of small- and medium-sized residential units, and first-time home purchases.

Credit support to small- and micro-sized enterprises and to the agricultural sector, rural areas, and farmers maintained a strong growth momentum. At end-June, outstanding RMB loans to small- and micro-sized enterprises extended by major financial institutions, rural cooperative financial institutions, and foreign-funded banks grew 12.7 percent year on year, outpacing RMB loans to large and medium enterprises by 2.3 percentage points and 1.9 percentage points respectively.

In the first six months of 2013, lending in both RMB and foreign currencies by major financial institutions, rural cooperative financial institutions, village and township banks, as well as finance companies to villages, rural households, and the agricultural sector increased 1.48 trillion yuan, 450.5 billion yuan, and 290 billion yuan, representing a year-on-year rise of 116.8 billion, 86 billion, and 31.1 billion yuan respectively.

V. Liquidity provision through the use of the standing lending facility and central bank discounts

Following the introduction of standing lending facilities (SLFs) prior to the Spring Festival in 2013 to address the liquidity gap in some banks as a result of massive cash supplies, the PBC conducted SLF operations in June in response to the money market volatility driven by a number of factors. These operations aim to provide liquidity support against eligible collaterals, including top-rated bonds and quality credit assets, to financial institutions whose lending practices are in compliance with industrial policies and macro-prudential rules, focus on supporting the real economy, and remain sound in terms of the aggregate and pace of credit supply. The PBC also took measures where necessary to provide liquidity support to financial institutions struggling with liquidity management challenges so as to safeguard financial stability. The outstanding SLF totaled 416 billion yuan as of end-June.

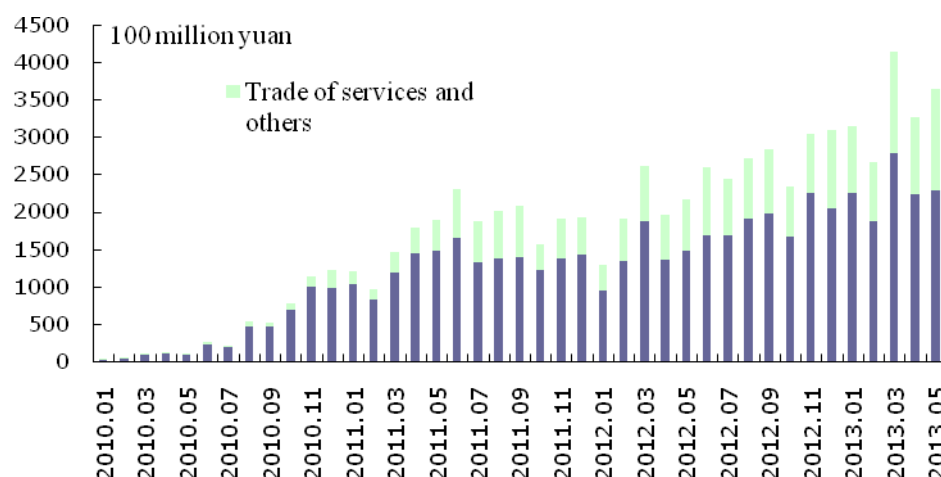
The PBC also enhanced management of liquidity in local legal-person financial institutions, providing liquidity support via central bank lending and discounts to those institutions that met macro-prudential requirements. On June 27 it approved an additional 12 billion yuan in the central bank discount quota to support qualified

financial institutions to increase lending to small- and micro-sized enterprises and to the agricultural sector, rural areas, and farmers. Outstanding central bank lending and discounts recorded 464.1 billion yuan as of end-June.

VI. Steady growth in cross-border use of RMB

The role of the RMB in the settlement of cross-border trade and investment grew steadily. According to preliminary statistics, in the first half of 2013 cross-border trade settled in RMB reached 2.05 trillion yuan, up 64 percent year on year. This included 1.37 trillion yuan of settlements of trade in goods and 683.78 billion yuan of settlements of trade in services and other items under the current account. Actual RMB receipts and payments in cross-border trade registered 885.2 billion yuan and 1.16 trillion yuan respectively, bringing the receipt-payment ratio to 1:1.3. Bank settlements of cross-border RMB direct investments reached 183.49 billion yuan, including 21.96 billion yuan of outward direct investments and 161.53 billion yuan of foreign direct investments.

Figure 2 RMB settlements of cross-border trade.



Source: People's Bank of China.

VII. Further improvements in the RMB exchange rate regime

The PBC further improved the RMB exchange rate regime in line with the principle of making it a self-initiated, controllable, and gradual process. Focusing on the role of market supply and demand and adjustments with reference to a basket of currencies, the PBC enhanced the flexibility of the RMB exchange rate and kept it basically stable at an adaptive and equilibrium level. In the first half of 2013, the central parity of the RMB against the US dollar peaked at 6.1598 yuan per dollar and reached a trough of 6.2898 yuan per dollar. It appreciated on 59 out of the 113 trading days in the first six months of the year, and it depreciated on the remaining 54 trading days, with the largest intraday appreciation at 0.20 percent (or 126 points) and the sharpest intraday depreciation at 0.15 percent (or 91 points).

The RMB exchange rate moved in both directions against the euro, the Japanese yen, and other major international currencies. At end-June, the central parity of the RMB against the euro registered 8.0536 yuan per euro, an appreciation of 3.28 percent from end-2012, and the central parity of the RMB against the Japanese yen stood at 6.2607 yuan per 100 Japanese yen, an appreciation of 16.68 percent from end-2012. Beginning from the reform of the RMB exchange rate regime in 2005 to end-June 2013, on a cumulative basis the RMB appreciated 24.34 percent against the euro and 16.69 percent against the Japanese yen.

Direct trading between the RMB and foreign currencies in the inter-bank foreign exchange market remained brisk and market liquidity grew markedly, bringing down exchange costs. In the first half of 2013, direct trading between the RMB and the Japanese yen grew 750 percent year on year to 710.53 billion yuan, and trading between the RMB and the Australian dollar grew 2130 percent year on year to 47.2 billion yuan.

Table 5 Trading volume of the RMB against other currencies in the inter-bank foreign exchange spot market in the first half of 2013

Unit: 100 million yuan

| Currency | USD | Euro | Japanese Yen | HKD | GBP | Australian Dollar | Canadian Dollar | Malaysian Ringgit | Russian Ruble | Thai Baht |
|----------------|----------|--------|--------------|-------|------|-------------------|-----------------|-------------------|---------------|-----------|
| Trading volume | 108654.4 | 1121.1 | 7105.3 | 536.5 | 25.9 | 472.0 | 3.5 | 6.9 | 18.9 | 4.0 |

Source: China Foreign Exchange Trade System.

Bilateral local currency swap operations between the PBC and overseas monetary authorities totaled 472 billion yuan in the first half of 2013, of which 9.32 billion yuan was used by overseas monetary authorities, thus playing a strong role in promoting bilateral trade and investments.

VII. Advancing financial institution reforms

The rural financial services arm of the Agricultural Bank of China (ABC) significantly improved its support for the agricultural sector, rural areas, and farmers as it accelerated the supply of credit and financial innovation. Outstanding lending by the pilot rural financial service divisions at the ABC branches in 12 provinces recorded 920.64 billion yuan at end-June, representing a rise of 9.1 percent from end-2012, which outpaced the overall lending growth in these local ABC branches. Local ABC branches that ran these pilot rural financial service divisions focused their reforms on accelerating rural industrial chain financing and agro-linked personal financing, strengthening R&D on rural self-service terminals and financial services

and products for urbanization, advancing innovation in electronic financial service channels, and exploring new financial service models to meet the need for better rural financial services. As of end-June, these branches had issued 80,736,000 rural bankcards, established 309,000 service stations, and installed 669,000 electronic banking devices, covering over 80 percent of the towns and more than 60 percent of the villages in their jurisdictions.

Important achievements were made in advancing the pilot reforms of the rural credit cooperatives (RCC). The RCCs' operations and financial position continued to improve. Based on the five-category loan classification, outstanding NPLs at the RCCs at end-June dropped 8.8 billion yuan from end-2012 to 345.2 billion yuan, while the NPL ratio declined to 4 percent, down by 0.5 percentage points from end-2012. The capital adequacy ratio was 11.5 percent. Agro-linked lending by RCCs grew markedly. At end-June, total RCC lending registered 8.7 trillion yuan, or 12.8 percent of total lending, an increase of 0.3 percentage points from end-2012. In particular, outstanding agro-linked loans reached 5.9 trillion yuan, up 500 billion yuan, or 10 percent, from end-2012, and loans to rural households recorded 2.9 trillion yuan, a rise of 300 billion yuan, or 11 percent, from end-2012. Steady progress was made in promoting RCC property rights reform. As of end-June, a total of 1,771 RCCs with legal-person status at the county (city) level, 383 rural commercial banks, and 134 rural cooperative banks had been established.

IX. Deepening reform of foreign exchange administration

Management of foreign exchange inflows was enhanced. To address the intensifying net foreign exchange inflow pressures since the beginning of the year, the State Administration of Foreign Exchange issued the *Notice on Strengthening Management of Foreign Exchange Inflows* (SAFE Document [2013] 20) in early May and enhanced management of the banks' overall foreign exchange purchases and sales position, stepped up reviews of importers' and exporters' foreign exchange receipts and payments for trade in goods, and intensified foreign exchange inspections. As these measures took effect, beginning in May both the surplus in foreign exchange purchases and sales and in cross-border receipts and payments narrowed significantly. Moreover, actions were taken against foreign exchange-related violations and irregularities. As of end-June, joint operations with the public security authorities resulted in the cracking of 10 underground banking cases, 21 illegal foreign exchange selling and purchasing cases, and one online foreign exchange speculation case, involving a total of 790 million yuan.

Efforts were made to further facilitate trade and investment, including introducing policies that substantially simplify procedures for management of foreign exchange from current account activities in special customs regulatory areas, launching a pilot program that allows participating institutions in Beijing and 4 other areas to provide, through banks, centralized foreign exchange receipts, payments, purchases, and sales for small value cross-border e-commerce transactions, and approving a 15 percent

increase in the 2013 quota for financial institutions on short-term external debts and financing guarantees for overseas investments, with a priority on the central and western regions and small- and medium-sized enterprises.

Steady steps were taken to promote RMB convertibility under the capital account. External debt management was simplified as approval procedures were removed or delegated, and a registration-centered framework for external debt management was established. Steady progress was made in implementing the Qualified Foreign Institutional Investor (QFII), the Qualified Domestic Institutional Investor (QDII), and the RMB Qualified Foreign Institutional Investor (RQFII) schemes. In the first six months of 2013, a total of USD 60.2 billion of the foreign investment quota for 52 investors was approved under the QFII scheme, USD 6.28 billion of the outbound investment quota for 13 investors was approved, and USD 6 billion of the outbound investment quota for 7 investors was canceled under the QDII scheme. A total of 37.9 billion yuan of the investment quota for 37 investors was approved under the RQFII scheme. Measures were taken to promote the introduction of a capital account information system to enhance the foundation for deepening the reforms of foreign exchange management of the capital account and to prevent risks from cross-border capital flows. The pilot program that allows Chinese-funded enterprises to borrow at home with overseas guarantees within a prescribed quota was expanded.

Part 3 Financial Market Analysis

In the first half of 2013, China's financial market performed in a stable manner. The growth in the volume of transactions on the money market moderated and interest rates at the end of the quarter declined following a significant increase; the volume of bond issuances continued to grow; transactions on the equity market increased year on year; the growth of insurance assets moderated; and the foreign exchange market traded briskly.

I. Financial market analysis

1. The growth of trading volume on the money market moderated, and interest rates at the end of the quarter declined following a significant increase

The growth of bond repo transactions moderated, while the turnover of inter-bank borrowings declined. In the first half of 2013, the turnover of bond repos on the inter-bank market totaled 79.5 trillion yuan, with an average daily turnover of 651.9 billion yuan, up 13.3 percent year on year and representing a deceleration of 12.2 percentage points from the first quarter. The turnover of inter-bank borrowings reached 20.6 trillion yuan, with an average daily turnover of 168.7 billion yuan, a decline of 13.3 percent year on year. Overnight products still dominated bond repo and inter-bank borrowing transactions, accounting for 80.9 percent and 85.3 percent of their respective turnovers in the first half of 2013. The total turnover of government

securities repos on the stock exchanges soared 55.9 percent to reach 23.1 trillion yuan.

In terms of financing among financial institutions, the flow of funds showed the following characteristics: first, although domestically-funded large banks remained the net fund providers, the amount of their net lending declined significantly year on year. In particular, their trading of bond-pledged repos and inter-bank borrowing dropped rapidly in June, resulting in a decrease of 4 trillion yuan of net lending year on year. Second, borrowings by small- and medium-sized banks declined substantially. Third, the demand for financing of securities firms and fund management companies continued to increase.

Table 6 Fund Flows among Financial Institutions in the First Half of 2013

Unit:100 million yuan

| | Repos | | Inter-bank Borrowing | |
|----------------------------------------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| | In the first half of 2013 | In the first half of 2012 | In the first half of 2013 | In the first half of 2012 |
| Domestically-funded large banks ^① | -231,822 | -283,691 | -25,048 | -40,005 |
| Domestically-funded small- and medium-sized banks ^② | 71,558 | 134,390 | -16,551 | 6,789 |
| Securities and fund management companies | 73,112 | 61,475 | 22,751 | 17,681 |
| Insurance companies | 29,045 | 25,709 | — | — |
| Foreign-funded financial institutions | 8,307 | 7,287 | 4,159 | 2,167 |
| Other financial institutions and vehicles ^③ | 49,800 | 54,831 | 14,690 | 13,368 |

Notes: 1. Domestically-funded large banks include the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, the China Construction Bank, the China Development Bank, the Bank of Communications, and the Postal Savings Bank of China.

2. Domestically-funded small- and medium-sized banks include the China Merchants Bank and 16 other medium-sized banks, small-sized city commercial banks, rural commercial banks, rural cooperative banks, and village and township banks.

3. Other financial institutions and vehicles include urban credit cooperatives, rural credit cooperatives, finance companies, trust and investment companies, financial leasing companies, asset-management companies, social security funds, investment companies, corporate annuities, and other investment vehicles, among which some financial institutions and vehicles did not participate in the inter-bank lending market.

4. A negative sign indicates net lending and a positive sign indicates net borrowing.

Source: China Foreign Exchange Trade System.

In June, the weighted average interest rate of bond-pledged repos and inter-bank borrowing posted 6.82 percent and 6.58 percent respectively, up 420 and 397 basis points from the end of last year. At end-June, the overnight and 7-day Shibor stood at 4.94 percent and 6.16 percent respectively, up 108 and 158 basis points from the beginning of the year; the 3-month and 1-year Shibor registered 5.44 percent and 4.41

percent respectively, up 154 and 1 basis point from the beginning of the year. There were a variety of reasons for the short-term volatilities in the money market interest rates in June, such as the impact on the foreign exchange market of expectations of the U.S. Fed's tapering of the QE, seasonal factors including demands for cash during the holidays, payments of deposit reserve arrears by financial institutions, and tax payments by enterprises, missteps by financial institutions in liquidity risk and asset/liability management, sentiment factors including market expectation changes caused by external calls of shorting China, as well as the impacts of the release of a series of regulatory policies during a condensed period of time. Since late June, as the central bank took a series of measures to stabilize market interest rates, and the impacts of transient and sentiment factors were gradually eliminated, the money market resumed its stable operations. As a result, in July the weighted average interest rate of bond-pledged repos and inter-bank borrowing dropped to 3.61 percent and 3.60 percent respectively.

Box 3 New Rules of the Basel Committee on Banking Supervision of Liquidity Management

1. New rules and progress in liquidity management by the international community

The latest international financial crisis exposed major defects in liquidity risk management by banking institutions and drove home the importance of liquidity for the proper functioning of financial markets and the banking sector. To strengthen liquidity risk management, in December 2010 the Basel Committee on Banking Supervision (BCBS) published the *International Framework for Liquidity Risk Measurement, Standards, and Monitoring*, and developed two quantitative supervisory indicators, i.e., the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), to improve the banking sector's ability to absorb shocks arising from financial stress. These two indicators are separate but complementary. Since 2010, the BCBS has been carrying out quantitative measurements and calibrations of the LCR and the NSFR on an ongoing basis, and in January 2013 it issued the *Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*, which help to determine the final version of the LCR supervisory standard, whereas the NSFR indicator is still in the midst of calibration.

The LCR is defined as the ratio of the stock of high-quality liquidity assets to total net cash outflows over the next 30 calendar days, which reflects the liquidity risk profile under a stress scenario. It should not be lower than 100%. High-quality liquid assets include cash, central bank reserves, and high-quality bonds to the extent that these reserves can be drawn down at little or no loss in value in times of stress. There are two categories of assets that can be included in the stock of high-quality assets, i.e., "Level 1" assets and "Level 2" assets. In particular, Level 2 assets can only comprise up to 40 percent of the stock, and a minimum 15 percent haircut is applied to the current market value of each Level 2 asset held in the stock. The term total net cash outflows is defined as the total expected cash outflows minus the total expected cash

inflows in the specified stress scenario for the subsequent 30 calendar days, and the amount of inflows that can offset the outflows is capped at 75 percent of the total expected cash outflows as calculated in the standard. The objective of the LCR is to promote the short-term resilience of the liquidity risk profile of banks and to improve the banking sector's ability to absorb shocks arising from financial and economic stress. According to the BCBS, the LCR will be introduced as planned in January 2015, but the minimum requirement will begin at 60 percent, rising in equal annual steps of 10 percentage points to reach 100 percent in January 2019. According to the estimation of the BCBS based on data in late 2011, the average LCR for the global banking sector stood at 127 percent.

The NSFR is defined as the amount of available stable funding to the amount of required stable funding. This ratio reflects the banks' medium- and long term liquidity condition and must be greater than 100 percent. "Stable funding" is defined as the portion of those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress. The required amount of stable funding of a specific institution is the long-term funds required for various types of held assets. The objective of the standard is to avoid an over-reliance on short-term wholesale funding by commercial banks in times of market exuberance and ample liquidity, to encourage banks to make a full assessment of liquidity risks of both on- and off-balance sheet assets, to guide banks to adjust the asset structure to reduce a maturity mismatch, to increase long-term funding sources, and to improve the banks' ability to prevent medium- and long-term risks. The NSFR measure was scheduled to be implemented in 2018. However, since the calibration work is still in process, the effective date is likely to be delayed.

2. Liquidity risk management of Chinese financial institutions: the current situation, problems, and directions for improvement

At present, China's commercial banks have put in place an initial liquidity risk management system and have compiled a number of indicators for monitoring liquidity risks, including the liquidity ratio and the excess reserve ratio. Relevant departments are currently developing a concrete plan for implementing the LCR. In recent years, with the changes in the business environment, business models, and funding sources, commercial banks face more challenges in liquidity risk management and some problems in liquidity risk management have emerged. In June 2013, short-term money market interest rates moved up and fluctuated wildly due to changes in the foreign exchange market, the demand for cash during the holiday, payment of the reserve requirement, payment of taxes, the funding requirement resulting from implementation of the regulatory policies, as well as missteps by some commercial banks in liquidity risk and asset/liability management. First, the balance among some operating indicators, such as the liquidity and profit indicators, needs to be improved. For the purpose of increasing the efficiency of fund use and meeting their profit targets, commercial banks have strong incentives to expand lending to increase profits, and it is easy for them to neglect the liquidity risks when weighing

liquidity, safety, and profitability. Second, the structure of credit asset allocations and the pace of credit extensions need to be improved. Commercial banks still have the habit of “early delivery of loans and an early reaping of yields.” Furthermore, when commercial banks expect potential policy changes, they tend to rush to expand loans to seize market share, especially during critical periods such as performance evaluations and information disclosures. Consequently, they are vulnerable to liquidity volatilities in the market. Third, the diversification and stability of liability management need to be strengthened. Inter-bank business is an important avenue for commercial banks to manage liquidity, increase capital efficiency, and enhance profitability, and it is also an important channel for the commercial banks to carry out differentiated operations, thus it is of great significance for promoting financial market development and financial product innovation. However, since there was relatively abundant liquidity in the market and short-term interest rates remained low, some commercial banks took advantage of the inter-bank business to circumvent regulations, relied heavily on short-term wholesale inter-bank funding, and rapidly extended long-term loans with the short-term funding from the inter-bank transactions. As a result, when market liquidity became volatile, the commercial banks were vulnerable to the liquidity fluctuations.

Commercial banks should further strengthen liquidity and asset/liability management and make their operating behavior consistent with the requirements for a sound monetary policy and for the economic structural adjustments. First, active efforts should be made to improve liquidity management, follow developments in international liquidity management analytical framework and monitoring tools, and be well prepared for internal assessments, system building, stress tests, and so forth. Second, commercial banks should strengthen analysis of the impacts of policy adjustments and changes in financial markets on the liquidity situation and make the relevant liquidity arrangements. Third, commercial banks should further improve the degree of precision and professionalism in liquidity management and maintain reasonable excess reserves to meet the various kinds of funding demands and to ensure normal payments and settlements. Fourth, commercial banks should follow the macro-prudential requirements, properly manage the total amount and maturity structure of assets/liabilities and the pace of credit extensions, increase the diversification and stability of liabilities, reduce the rush to attract deposits prior to performance evaluations, and prevent the risks of maturity mismatches in the inter-bank business. Fifth, commercial banks should make good use of the stock of money and credit to support the development of the real sector and adjust and optimize the credit structure by revitalizing the credit stock and optimizing incremental loans.

Transactions of RMB interest-rate swaps increased. In the first half of the year, a total of 12,540 deals were completed, with an aggregate notional principal of 1.53 trillion yuan, up 30.7 percent year on year. In terms of the maturity structure, RMB interest-rate swaps with maturities within one year traded most briskly, and their

aggregate notional principal amounted to 1.18 trillion yuan, accounting for 77.2 percent of the total. In terms of the reference rate, the floating rates of the RMB interest-rate swaps were based on the 7-day fixing repo rate and the Shibor, and their notional principal accounted for 61.5 percent and 37.0 percent of the total respectively. In the first half of 2013, the volume of transactions of bond forwards posted 101 million yuan.

Table 7 Transactions of Interest-Rate Derivatives, 2010~Q2 2013

| | Interest-rate swaps | | Bond forwards | | Forward-rate agreements | |
|---------|---------------------|-------------------------------------------------|---------------------|---------------------------|-------------------------|-------------------------------------------------|
| | Transactions (lots) | Amount of notional principal (100 million yuan) | Transactions (lots) | Amount (100 million yuan) | Transactions (lots) | Amount of notional principal (100 million yuan) |
| 2010 | 11,643 | 15,003.4 | 967 | 3,183.4 | 20 | 33.5 |
| 2011 | 20,202 | 26,759.6 | 436 | 1,030.1 | 3 | 3.0 |
| 2012 | 20,945 | 29,021.4 | 56 | 166.1 | 3 | 2.0 |
| 2013 Q1 | 5,533 | 7,375.8 | 1 | 1.0 | — | — |
| 2013 Q2 | 7,007 | 7,959.98 | — | — | — | — |

Source: China Foreign Exchange Trade System.

2. Bond transactions saw a year-on-year decline whereas bond issuances continued to increase

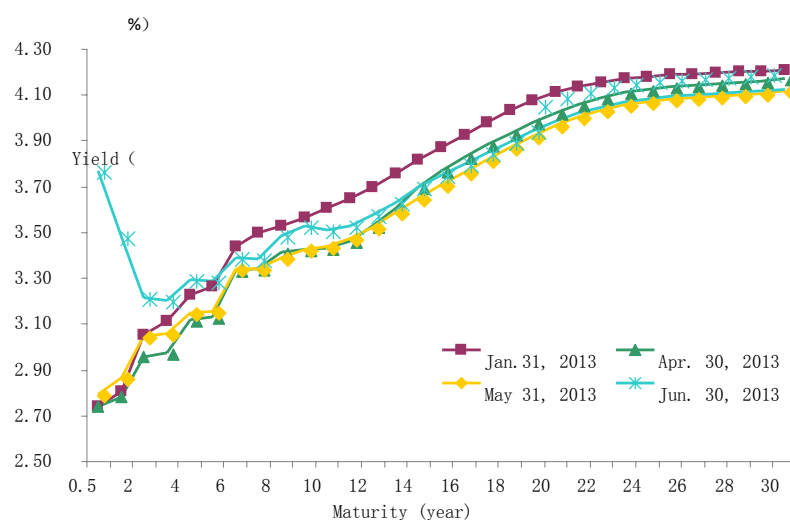
The turnover of spot bond transactions on the inter-bank market declined from the same period of last year. In the first half of 2013, the turnover of spot bond trading totaled 32.4 trillion yuan, with an average daily turnover of 265.2 billion yuan and down 3.8 percent year on year, mainly due to a reduction of 8.1 trillion yuan in the second quarter. In terms of trading entities, domestically-funded large banks and foreign-funded financial institutions were net purchasers on the spot bond market, with net purchases of 237.4 billion yuan and 128.9 billion yuan respectively; domestically-funded small- and medium-sized banks were net bond sellers, with a net amount of 425.2 billion yuan. A total of 40.9 billion yuan of government securities was traded on the stock exchanges in the first half of 2013, 6.9 billion yuan less than that during the same period of last year.

Bond price indices moved up slightly. The China Bond Composite Index (net price) rose 0.38 percent from 100.69 points at the beginning of the year to 101.07 points at end-June, and the China Bond Composite Index (full price) rose 0.85 percent from 111.63 points at the beginning of the year to 112.58 points at end-June. The exchange-traded government securities index rose 1.67 percent from 135.84 points at the beginning of the year to 138.10 points at end-June.

In the first half of the year, the yield curve of government securities moved downward. At end-June, except for government securities with a maturity of less than 5 years, the

yields of other maturities were lower than those at the beginning of the year. Affected by interest-rate volatility on the money market in June, to some extent the yields of government securities with a maturity of less than 2 years were inversely placed, but they have normalized gradually since July.

Figure 3 Yield Curves of Government Securities on the Inter-bank Bond Market



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

Bond issuances continued to grow. In the first half of 2013, a total of 4.3 trillion yuan of bonds was issued, 759.6 billion yuan more than that during the same period of last year. In particular, the issuance of corporate debenture bonds posted 2.1 trillion yuan, 617.8 billion yuan more than that during the same period of the last year, mainly due to increased issuances of debt-financing instruments by non-financial institutions. At end-June, the total volume of outstanding bonds posted 28.4 trillion yuan, an increase of 18.5 percent year on year.

Table 8 Issuance of Major Bonds in the First Half of 2013

| Type of bonds | Issuance (100 million yuan) | Year-on-year growth (100 million yuan) |
|-------------------------------------------------------------------------------------------|-----------------------------|----------------------------------------|
| Government securities ¹ | 8,710 | 1,890 |
| Central bank bills | 1,140 | 1,140 |
| Financial bonds ² | 11,899 | -1,613 |
| Of which: Financial bonds issued by the China Development Bank and policy financial bonds | 9,629 | -1,787 |
| Corporate debenture bonds ³ | 20,795 | 6,178 |
| Of which: Debt-financing instruments of non-financial enterprises | 15,708 | 5,576 |
| Enterprise bonds | 3,122 | -217 |
| Corporate bonds | 1,625 | 578 |

| | | |
|-------|--------|-------|
| Total | 42,545 | 7,596 |
|-------|--------|-------|

Notes: 1. Including municipal bonds issued by the Ministry of Finance on behalf of local governments.

2. Including financial bonds issued by the China Development Bank, policy financial bonds, ordinary bonds issued by commercial banks, subordinated bonds issued by commercial banks, hybrid bonds issued by commercial banks, bonds issued by securities firms, and so forth.

3. Including debt-financing instruments issued by non-financial enterprises, enterprise bonds, corporate bonds, convertible bonds, bonds with detachable warrants, and privately placed SME bonds.

Sources: People's Bank of China, National Development and Reform Commission, China Securities Regulatory Commission, China Government Securities Depository Trust and Clearing Co., Ltd.

The issuance rates of government securities of all maturities were generally stable. The interest rate of 5-year government bonds issued in June was 3.09 percent, up 14 basis points from those of the same maturity issued in November 2012; the interest rate of 7-year government bonds was 3.29 percent, up 4 basis points from those of the same maturity issued in November 2012; the interest rate of 10-year government bonds was 3.36 percent, down 19 basis points from those of the same maturity issued in December 2012. The Shibor played a larger role in bond pricing. In the first half of the year, the issuance volume of floating-rate bonds based on the Shibor was 117 billion yuan, accounting for 51 percent of the issuance volume of all floating-rate bonds; the 229 fixed-rate enterprise bonds issued on the primary bond market were all based on the Shibor, with a gross issuance volume of 310.75 billion yuan. In addition, a total of 205.3 billion yuan of short-term financing bills based on the Shibor was issued, accounting for 48 percent of the total issuance of short-term fixed-rate financing bills.

3. The volume of bill financing increased slightly and interest rates on the bill market fluctuated by a large margin

The growth of bill acceptances moderated. In the first half of the year, commercial bills issued by enterprises totaled 10.7 trillion yuan, representing year-on-year growth of 21.8 percent; outstanding commercial bills at end-June posted 9.2 trillion yuan, representing year-on-year growth of 12.8 percent. At end-June, the outstanding balance of accepted drafts had increased by 0.8 trillion yuan from the beginning of the year, representing a deceleration of 0.7 trillion yuan from the same period of last year. In terms of financing entities, outstanding bankers' acceptances were mainly issued by enterprises in the manufacturing, wholesale, and retail industries, and small- and medium-sized enterprises issued more than two-thirds of the total.

The amount of bill financing increased slightly, and bill financing rates fluctuated by a large margin. In the first half of 2013, the cumulative amount of commercial bills discounted by financial institutions posted 22.4 trillion yuan, representing year-on-year growth of 58.8 percent; at end-June the outstanding balance of discounted commercial bills increased 2.3 percent year on year to 2.3 trillion yuan. The balance of bill financing at end-June increased by 285.7 billion yuan from the

beginning of the year, with a deceleration of 478.5 billion yuan year on year and accounting for 3.4 percent of all categories of loans, down 0.4 percentage points from the corresponding period during last year. In April and May, interest rates on the bill market were generally stable. In early June, bill financing of some financial institutions increased rapidly. In addition, due to a variety of seasonal and transient factors, interest rates on the money market fluctuated widely and those on the bill market followed suit. Since late June, as the central bank took a series of measures to stabilize market interest rates and the impacts of the temporary and emotional factors gradually tapered, interest rates on the money market declined and gradually returned to a reasonable range, and interest rates on the bill market followed this decline.

4. Stock indices declined sharply and turnover on the stock market increased year on year

Stock indices saw a sharp decline while the Growth Enterprise Board Index rose. At end-June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 1,979 and 7,695 points respectively, shedding 290 and 1422 points from end-2012. The Growth Enterprise Board (GEB) Index (Chinext Price Index) of the Shenzhen Stock Exchange closed at 1,012 points, gaining 298 points from end-2012. The weighted average P/E ratio on the A-share market of the Shanghai Stock Exchange declined from 12.3 times at end-2012 to 10.2 times at end-June 2013, while that of the Shenzhen Stock Exchange rose from 22.2 times to 23.5 times during the same period

The volume of trading on the stock markets increased. In the first half of 2013, the turnover on the Shanghai and Shenzhen stock exchanges totaled 21.1 trillion yuan, representing an increase of 20.9 percent year on year, and the average daily turnover posted 187.1 billion yuan, 37.6 billion yuan more than that during the same period of last year. The volume of transactions on the Growth Enterprise Board amounted to 1.9 trillion yuan, up 63.2 percent year on year. At end-June 2013, the market capitalization of the Shanghai and Shenzhen stock exchanges posted 16.9 trillion yuan, down 2.4 percent year on year, and the market capitalization of the Growth Enterprise Board amounted to 534.6 billion yuan, up 74.7 percent year on year.

Financing on the stock markets declined slightly. In the first half of 2013, a total of 194.6 billion yuan was raised by enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, additional offerings, rights offerings, and warrants' exercises, representing a decrease of 4.8 billion yuan year on year. Among this total, 152.4 billion yuan was raised on the A-share market, 22.3 billion yuan less than that was raised during the same period of last year.

5. The growth of the total assets of the insurance industry moderated

In the first half of 2013, the total premium income of the insurance industry amounted to 951.2 billion yuan, representing year-on-year growth of 11.5 percent, and total claim and benefit payments amounted to 296.3 billion yuan, representing year-on-year

growth of 30.9 percent. Specifically, total claim payments in the property insurance sector increased 22.5 percent, whereas those in the life insurance sector increased 40.8 percent.

The growth of total assets of the insurance industry moderated. At end-June, total assets of the insurance industry posted 7.9 trillion yuan, an increase of 16.4 percent year on year. In particular, bank deposits increased 3.7 percent, a large deceleration from the end of March; and investment-linked assets maintained steady growth, or up 26.0 percent year on year.

Table 9 Use of Insurance Funds, End-June 2013

| | Outstanding balance (100 million yuan) | | As a share of total assets | |
|-------------------------|----------------------------------------|---------------|----------------------------|---------------|
| | End-June 2013 | End-June 2012 | End-June 2013 | End-June 2012 |
| Total assets | 78,840 | 67,760 | 100.0 | 100.0 |
| Of which: Bank deposits | 23,405 | 22,578 | 29.7 | 33.3 |
| Investments | 49,424 | 39,226 | 62.7 | 57.9 |

Source: China Insurance Regulatory Commission.

6. Swap transactions on the foreign exchange market increased rapidly

In the first half of 2013, the turnover of spot RMB/foreign exchange transactions totaled USD 1.9 trillion, representing an increase of 10.5 percent year on year. The turnover of RMB/foreign exchange swap transactions totaled USD 1.5 trillion, representing a year-on-year increase of 33.1 percent; among this total, overnight RMB/USD swap transactions amounted to 819.14 billion, accounting for 54.2 percent; the turnover of the RMB/foreign exchange forward market totaled USD 7.23 billion, representing a decline of 88.8 percent year on year. The turnover of foreign currency pair transactions amounted to USD 33.95 billion, a decrease of 20.7 percent year on year. In particular, the Euro/USD accounted for the lion's share, or 47.2 percent, up 19.2 percentage points from the same period of last year.

The number of participants on the foreign exchange market expanded further. At end-June, there were 382 members on the foreign exchange spot market, 84 members on the foreign exchange forward market, 83 members on the foreign exchange swap market, 79 members on the currency swap market, 33 members on the foreign exchange options market, 31 market makers on the spot market, and 27 market makers on the forward and swap market.

7. The price of gold declined amid fluctuations

In the first half of 2013, the turnover of gold, silver, and platinum on the Shanghai Gold Exchange all saw an increase, while the turnover of gold and silver hit historical highs during the same period. The total trading volume of gold was 5,412 tons, an increase of 66.6 percent year on year, and its turnover posted 1613.7 billion yuan, an increase of 47.9 percent year on year. The trading volume of silver was 179,627 tons, and its turnover posted 909.8 billion yuan, an increase of 58.0 percent year on year. The total volume of platinum was 43 tons, and its turnover posted 13.4 billion yuan, an increase of 29.1 percent year on year.

In the first half of 2013, the price of gold on the international market fell sharply, reaching a trough of USD 1,180.1 per ounce. On June 30, the afternoon fixing price on the London Gold Market closed at USD 1,192 per ounce, down USD 472 per ounce from the end of last year, or 28.37 percent lower. The highest gold price on the Shanghai Gold Exchange (AU9999) was 340.8 yuan per gram, and the lowest price was 239.3 yuan per gram. At end-June, the price on the domestic market closed at 243.5 yuan per gram, down 91 yuan per gram from the end of last year, or 27.2 percent lower.

II. Institutional Building in the Financial Market

The reform of the new stock issuance system was furthered, and the national SME equity transfer system was improved. On June 6, the CSRC solicited public comments on the *Opinions on Further Promoting the Reform of the New Stock Issuance System*, which aimed to further reduce administrative controls on market pricing and issue timing of new stocks, give more autonomy to issuers, strengthen the responsibilities of issuers and intermediaries with respect to information disclosures, and protect the rights and interests of investors. On June 19, at its executive meeting the State Council decided to expand the pilot program of the national SMEs equity transfer system to the whole country so as to facilitate the financing of innovative enterprises and start-up enterprises. On June 20, the NEEQ (National Equities Exchange and Quotations) issued the *Provisional Procedures for Listing on the National Equities Exchange and Quotations*, which specified the listing requirements to promote standardization and normalization of SME listings.

Institutional arrangements in the insurance market were improved. On June 21, the CSRC and the CIRC jointly issued the *Provisional Procedures for the Establishment of Fund Management Companies by Insurance Companies* so as to support insurance companies to set up fund management companies. Efforts were made to regulate the agricultural insurance business, strengthen the operational management and the terms and rates of the agricultural insurance business, further expand the coverage of the agricultural insurance business, and support insurance companies to carry out the pilot

insurance business for locality-specific agricultural products and local pillar agricultural products. The building of the second solvency regulatory system was strengthened. The overall framework for the second solvency regulatory system was released, and a “three pillar” regulatory system, including quantitative regulations, qualitative regulations, and market discipline, was established. Some fundamental and general issues have been resolved, including the general principles, framework, and technical principles. Efforts were made to improve the market access system for insurance intermediaries, raise the market access threshold for insurance intermediaries, guide the scale of operations for insurance intermediaries, and promote the professionalization of part-time insurance agencies whose business covers.

Efforts were made to advance infrastructural building in the foreign exchange market, improve the market-maker system in the inter-bank foreign market, promote the building of trading platforms on the inter-bank foreign exchange market, and better regulate the OTC transaction net clearing business on the inter-bank foreign exchange market.

Product innovation and infrastructural building were advanced on the gold market. The Shanghai Gold Exchange introduced the 12.5 kg Au99.5 gold bullion spot contract and the inter-bank market OTC gold forward business to provide more options for gold investors. The 2.5 generation version of the trading system was successfully launched on the Shanghai Gold Exchange and its functioning was improved significantly. In addition, Friday night trading was launched to cover the major trading hours of the international gold market.

Part 4 Macro-economic Analysis

I. Global economic and financial developments

The recovery of the world economy remained slow in the first half of 2013. Though showing a generally upbeat trend, the US economy was not yet solidly based. Due to the deepening impact of the euro debt crisis on the core countries and on economic activities, the economy in the euro zone was relatively sluggish. The Japanese economy improved, but its outlook remained unclear. Growth in most of the emerging market economies slowed down, with heightened risks of capital outflows.

1. Economic development in the major economies

Though showing a generally upbeat trend, the US economy was not yet solidly based. Due to the continued recovery of the housing market and improved consumption, annualized quarter-on-quarter GDP growth posted 1.7 percent in the second quarter,

higher than that in the first quarter of the year and in the fourth quarter of last year. However, the unemployment rate remained at an elevated level, and the growth of the manufacturing sector moderated. Public finance improved, with the federal fiscal deficit dropping in the first nine months of the 2013 fiscal year (from October 2012 to June 2013) by 44 percent in year-on-year terms. However, due to the uncertainties in fiscal consolidation, in particular the dispute between Democrats and the Republicans over the “debt ceiling” and the absence of a mid-term fiscal consolidation plan, businesses watched with caution. This situation may put a drag on the economy. Uncertainty about when and how to exit the quantitative easing will impact financial market stability to some extent.

The economy of the euro zone remained sluggish. As a result of recent progress in the building of the banking union and the admission of a new member state into the euro zone and the EU, the situation in Europe was eased temporarily and market confidence recovered to some extent; however, the effects of the crisis on the real economy were still unfolding. First quarter GDP declined by 0.2 percent in quarter-on-quarter terms, including growth of 0.1 percent in Germany and a drop of 0.2 percent in France. In June, the unemployment rate registered 12.1 percent, representing the highest level for the fourth consecutive month since the beginning of the euro zone. In July, the reading of the PMI climbed to 50.4, the first time since February 2012 to be above the threshold of 50, showing signs of an upturn in business production, but its further development remains to be seen. On June 7, the ECB cut the projection of euro zone growth in 2013 to -0.6 percent, about 0.1 percentage points lower than the estimate made in March of this year.

Table 10 Macro-economic and Financial Indices of the Major Economies

| Country | Index | 2012Q2 | | | 2012Q3 | | | 2012Q4 | | | 2013Q1 | | | 2013Q2 | | |
|---------------|-----------------------------------------------------|--------|-------|-------|--------|-------|-------|--------|-------|-------|--------|-------|-------|---------------------|-------|-------|
| | | Apr. | May | Jun. | Jun. | Jul. | Aug. | Oct. | Nov. | Dec. | Jan. | Feb. | Mar. | Apr. | May | Jun. |
| United States | Real GDP Growth Rate (annualized quarterly rate, %) | 1.3 | | | 3.1 | | | 0.4 | | | 1.1 | | | 1.7 (initial value) | | |
| | Unemployment Rate (%) | 8.1 | 8.2 | 8.2 | 8.3 | 8.1 | 7.8 | 7.9 | 7.8 | 7.8 | 7.9 | 7.7 | 7.6 | 7.5 | 7.6 | 7.6 |
| | CPI (YOY, %) | 2.3 | 1.7 | 1.7 | 1.4 | 1.7 | 2.0 | 2.2 | 1.8 | 1.7 | 1.7 | 2.0 | 1.5 | 1.1 | 1.4 | 1.8 |
| | DJ Industrial Average (closing number) | 13214 | 12393 | 12880 | 13009 | 13091 | 13486 | 13096 | 13025 | 13104 | 13861 | 14054 | 14579 | 14840 | 15116 | 14910 |
| | NASDAQ (closing number) | -0.2 | -0.1 | -0.6 | -0.2 | | | | | | | | | | | |
| Euro Area | Real GDP Growth Rate (quarterly YOY, %) | 11.2 | | | 11.3 | | | 11.4 | | | 11.4 | | | 11.5 | | |

| | | | | | | | | | | | | | | | | |
|-------|-----------------------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| | Unemployment Rate (%) | 2.6 | 2.4 | 2.4 | 2.4 | 2.6 | 2.6 | 2.5 | 2.2 | 2.2 | 2.0 | 1.8 | 1.7 | 1.2 | 1.4 | 1.6 |
| | HICP (YOY, %) | 2423 | 2257 | 2381 | 2479 | 2509 | 2518 | 2525 | 2551 | 2569 | 2641 | 2647 | 2698 | 2725 | 2662 | 2605 |
| | EURO STOXX 50 (closing number) | -0.6 | -3.6 | 1.2 | 4.1 | | | | | | | | | | | |
| Japan | Real GDP Growth Rate (annualized quarterly rate, %) | 4.6 | | | 4.4 | | | 4.3 | | | 4.3 | | | 4.3 | | |
| | Unemployment Rate (%) | 0.2 | -0.1 | -0.2 | -0.3 | -0.3 | -0.1 | 0.0 | -0.1 | -0.2 | -0.2 | -0.3 | -0.5 | -0.4 | 0.0 | 0.4 |
| | Core CPI (YOY, %) | 10084 | 9521 | 8543 | 9007 | 8695 | 8840 | 8928 | 9446 | 10395 | 11139 | 11559 | 12398 | 13861 | 13775 | 13677 |
| | NIKKEI225 (closing number) | 13214 | 12393 | 12880 | 13009 | 13091 | 13486 | 13096 | 13025 | 13104 | 13861 | 14054 | 14579 | 14840 | 15116 | 14910 |

Sources: Statistical Bureaus and Central Banks of the Relevant Economies.

The Japanese economy improved, but its outlook remained unclear. The annualized quarter-on-quarter GDP growth in the first quarter posted 4.1 percent, beating market expectations. Since the beginning of 2013, the Household Consumer Confidence Index rebounded, indicating improved domestic demand. The increase in exports due to the depreciation of the yen was offset by higher costs of imports; as a result, the trade account did not show significant improvement, and June was the 12th successive month with a trade deficit. The core CPI in June posted 0.4 percent year on year, the first ever positive growth since Premier Shinzo Abe took office and the highest increase since the end of 2008. On June 14, after adopting a monetary easing policy and a flexible fiscal policy, the Abe administration announced a package of strategies for stimulating economic growth, but the reform package was not as forceful as the market expected. It remains to be seen whether the combined fiscal, monetary, and economic growth policies will help the Abe administration to overcome the deflation and to rekindle growth as planned.

Box 4 Economic policies of the Abe administration and their effects

Since Prime Minister Shinzo Abe took office on December 26, 2012, his administration has announced a series of fiscal, financial, and economic policy measures, also known as Abeconomics, signaling an important experiment in economic policies following the two decades of recession in Japan. Abeconomics has the following planks. The first plank is a quantitative and qualitative easing monetary policy. The Bank of Japan announced on April 4, 2013 that in the next two years it would double the monetary base and the outstanding amounts of Japanese Government Bonds (JGB), as well as double the average remaining maturity of JGB purchases (i.e., grow the monetary base by 60 to 70 trillion Japanese yen), while increasing the purchases of risky assets, in order to achieve the 2 percent inflation target within two years. The second plank is a flexible fiscal policy. The Abe administration drafted the Supplementary Budget for FY2012 and the Budget for

FY2013 (15 months in total) within one month after it took office, exceeding a total of 100 trillion Japanese yen. The objective of reducing the deficit gave way to the objective of stimulating the economy, and government spending was reoriented from social welfare to infrastructure construction and national defense. The third plank is an economic growth strategy. The Japanese government formally passed its economic growth strategy during a cabinet meeting in June 2013, which covers industrial revitalization, creation of strategic markets, and developing international markets, and raised the objectives for the next decade, namely real and nominal GDP growth of 2 percent and 3 percent respectively per annum, and increasing per capita national income by 1.5 million yen within 10 years.

The economic policy of the Abe administration features a highly accommodative monetary policy that suppresses mid- and long-term yields of government bonds in order to support a fiscal stimulus and economic reforms and to promote private investments; the use of the exchange-rate depreciation to boost profits of export enterprises, to push up asset prices, and to strengthen the wealth effect, which combined with inflationary expectations, will simulate consumption, thus spurring economic growth. The policy has achieved short-term gains. From September 2012 to end-June 2013, the Nikkei 225 Index surged by 54 percent, and the yen depreciated by 28 percent against the US dollar. The stock market hike boosted consumer confidence, whereas the weaker yen stimulated exports. Driven by private consumption and exports, annualized real GDP grew by 4.1 percent quarter on quarter in Q1, or 0.4 percent year on year, beating market expectations. However, the reform program for economic growth launched in June was not as forceful as the market expected. For example, measures to deregulate the labor market and the agriculture market were not forceful enough, with the absence of a comprehensive tax reduction program and other concrete measures expected by the business community. Shinzo Abe announced that a second round of the economic growth strategies would be launched in autumn 2013.

As monetary policy cannot address structural problems such as the aging of the population and the inadequate demand for investment and financing that have led to protracted economic downturn in Japan, if the new strategies for economic growth are short of key structural reform measures or if the measures are not carried out in a determined and comprehensive manner, the effects of the accommodative monetary policy cannot be sustained and might even create asset bubbles, deteriorate fiscal conditions, and trigger a competitive devaluation throughout the world. On the one hand, inflation might run counter to depressing market interest rates. The heavy burden of government bond interest will increase concerns among investors about fiscal sustainability. On the other hand, boosting inflation is contradictory to stimulating economic growth. If inflation is driven by demand, investment and consumption will expand before the interest rate crawls up; as a result, the economic fundamentals and the fiscal conditions will be improved accordingly. However, if the inflation is pushed by debt monetization, the interest rate will increase before the

economy recovers, which will dampen consumption and investment and deteriorate fiscal conditions. If massive liquidity flows into the stock market rather than the real economy, asset bubbles are likely to be created. In addition, the international community is concerned about a yen depreciation triggering a competitive devaluation throughout the world. Since the beginning of 2013, the joint communiqués of the finance ministers of the G7 and the G20 and central bank governors have emphasized that efforts should be made to avoid a competitive devaluation, not to target exchange rates for competitive purposes, to resist all forms of protectionism, and to keep markets open.

In general, if Japan can expand domestic demand and grow the economy through structural reforms, this will play a positive role in global economic growth. However, merely relying on a quantitative monetary policy and a weaker yen in the absence of effective structural reforms might have negative spillover effects and aggravate the risks of massive capital movements in global financial markets.

Growth slowed down in most emerging market economies. In the first quarter, the GDP in Russia, India, and South Africa grew by 1.6 percent, 4.8 percent, and 1.9 percent respectively year on year, slower than that during the same period of last year. In June, the HSBC's Emerging Market Index (EMI) that reflects the purchasing managers' indices in 16 emerging market economies dropped to 50.6, the lowest level since May 2009. Specifically, the component index for manufacturing activities posted 49.5, the first contraction since October 2012, indicating a weakened growth momentum in the emerging market economies.

2. Development of the global financial market

Affected by a number of factors such as expectations of an early exit of the quantitative easing by the Federal Reserve, the quantitative and qualitative easing monetary policy in Japan, and the slower global recovery, volatility in the international financial market heightened.

Major reserve currencies fluctuated within a wide band against the US dollar, whereas the currencies of the major emerging markets depreciated against the US dollar. On June 28, the exchange rate of the USD/EUR, USD/GBP, and JPY/USD closed at 1.3008, 1.5210, and 99.12 respectively. Since the end of March, the euro and the British pound appreciated by 1.5 percent and 0.1 percent respectively against the US dollar, whereas the Japanese yen depreciated by 5.0 percent against the US dollar. Among the major emerging market currencies, the Brazilian real, the Indian rupee, and the South African rand depreciated by more than 6 percent over end-March, with the real depreciation by as much as 9.3 percent; and the Russian ruble, the Thai baht, the Mexican peso, and the Argentine peso depreciated by more than 4 percent against the US dollar over end-March, and the Korean won and the Indonesian rupiah depreciated by more than 2 percent against the US dollar over end-March.

The USD Libor edged down while the Euribor fluctuated at a subdued level. Affected by the Federal Reserve's quantitative easing monetary policy, the USD Libor edged

down; however, since late June, affected by the expectation that the Federal Reserve might taper the quantitative easing, the Libor edged up slightly. On June 28, the 1-year Libor was 0.6857 percent, a decline of 0.046 percentage points from the end of March. The 1-year Euribor registered 0.5270 percent, a decrease of 0.020 percentage points from the end of March.

T-bond yields in the US, Germany, and Japan continued to grow. On June 28, 10-year T-bond yields in the US, Germany, and Japan closed at 2.488 percent, 1.726 percent, and 0.869 percent respectively, up 63.6, 45.1, and 35.3 basis points respectively compared with end-March.

The major stock indices fluctuated markedly. On June 28, the Dow Jones Industrial Average Index and the NASDAQ Composite Index closed at 14910 and 3403 points respectively, gaining 2.3 percent and 4.1 percent over end-March. The STOXX50 Index closed at 2605 points, losing 3.5 percent over end-March. The Nikkei 225 Index closed at 13677 points, surging by 10.3 percent over end-March.

3. Monetary policies in the major economies

The major advanced economies continued to implement quantitative easing policies. In its May statement, the FOMC announced that it would keep the target range for the federal funds rate at 0 to 0.25 percent and would continue to link the adjustment of the interest rate with the development of inflation and the unemployment rate. It also expressed its preparedness for more policy flexibility and announced that it would increase or reduce the pace of asset purchases as the outlook for the labor market or inflation changes. At present, the Federal Reserve's asset purchases are kept at a pace of USD 85 billion per month. After the FOMC meeting in June, Chairman Bernanke indicated that if the US economy continued to improve as expected, the Federal Reserve might taper the size of purchases of securities in late 2013 and terminate purchases in mid-2014. However, when testifying before the Congress on July 17 and 18 on semi-annual monetary policy, Bernanke said that in the foreseeable future, the US would need to maintain a highly accommodative monetary policy. On May 2, the ECB announced that it would cut the minimum bid rate on the main refinancing operations by 25 basis points to 0.5 percent and would cut the rate on the marginal lending facility from 1.5 percent to 1 percent. On July 4, the ECB announced that it would maintain the prevailing or even lower interest rates for a long period to come. In early-April, the Bank of Japan decided to change the target for monetary policy operations from the uncollateralized overnight call rate to the monetary base. Quantitative and qualitative monetary easing was introduced by doubling the monetary base and the outstanding amounts of Japanese Government Bonds (JGB), as well as by more than doubling the average remaining maturity of JGB purchases so as to achieve the 2 percent inflation target within two years. The Bank of England maintained the Bank Rate at 0.5 percent, and the size of asset purchases at 375 billion pounds remained unchanged.

The monetary policies pursued by the emerging markets differed. The Bank of Korea cut the benchmark interest rate by 25 basis points to 2.50 percent on May 9, the lowest level since 2011. The Reserve Bank of India lowered the benchmark interest rate on May 3 by 25 basis points to 7.25 percent. The National Bank of Poland reduced the target benchmark interest rate on May 8, June 5, and July 3 by cumulative 125 basis points to 2.50 percent, a level unprecedented in history. Starting from August 2012, the Central Bank of Hungary cut the benchmark interest rate on 12 successive occasions to a historical low level of 4.0 percent. Unlike these economies, the Central Bank of Brazil increased the benchmark interest rate on April 17, May 29, and July 10 by a cumulative 125 basis points to 8.50 percent. The Bank of Indonesia increased the benchmark interest rate on June 13 and July 11 by a cumulative 75 basis points to 6.50 percent. In addition, the Central Bank of the Republic of Turkey cut the benchmark interest rate on April 16 and May 16 by a cumulative 100 basis points to 4.50 percent, but later, on July 13, increased the upper end of the interest-rate corridor in order to alleviate inflationary pressures and to maintain price stability.

4. The world economic outlook and major risks

Uncertainty is still weighing on global economic prospects, and the global growth rate in 2013 is expected to remain low. In the July *World Economic Outlook Update*, the International Monetary Fund (IMF) revised downward the projection for global growth to 3.1 percent, about 0.2 percentage points lower than its projection in April. The IMF made downward revisions to the projections for growth in the US, the euro zone, and the emerging markets and developing economies to 1.7 percent, -0.6 percent, and 5.0 percent respectively, while raising the forecast for Japan to 2.0 percent.

Going forward, the major risks in the global economy include the following:

First, uncertainty exists concerning the exit of the accommodative monetary policy in the major advanced economies. Recently, the world and global financial market participants are closely following the potential fallout of the Federal Reserve's tapering of the quantitative easing monetary policy, which shows that the exit of the quantitative easing monetary policy, similar to its adoption, has significant spillover effects. If an exit from the quantitative easing monetary policy reflects substantive improvements in the US economy and employment and if it proceeds in an orderly manner, it will have generally positive effects on the world economy. However, the short-term impact of an exit, in particular the impact on the emerging market economies and the developing countries, cannot be ignored. The impact might include: increased volatility in cross-border capital flows, the global foreign exchange market, asset prices, and commodity prices, heightened depreciation risks in the currencies of the emerging market economies, and more difficulties and greater uncertainties in macro-economic management and structural reforms.

Second, the European sovereign debt crisis is in a relatively stable period, but it remains one of the most prominent risks that might threaten a global economic recovery. The revelation of the problems in Slovenia's banking system has caused

concerns about an outbreak of a banking crisis; going forward the political situations in Italy and Portugal and their impact on the progress of the various reform programs remain to be seen; the fiscal deficit and banking sector problems in Spain remain daunting; the economic recession continues in Greece, and the long-term debt sustainability faces grave challenges; fiscal consolidation in France has made less progress than planned, and its economic outlook is less than optimistic; and the prospects with regard to the banking union in the euro zone and other integration mechanisms remain unclear.

Third, trade and investment protectionism is on the rise. The slow recovery in the major advanced economies, coupled with the lack of policy tools and policy space for stimulating economic growth, the persistently high unemployment rate, and the acute political polarization in these countries has aggravated trade and investment protectionism. In addition, the deteriorating political situation in the Middle East and the geopolitical tensions in East Asia that cannot be lessened within a short period of time threaten to hinder bilateral trade and economic relations and regional economic cooperation, thus containing the recovery of the global economy.

II. Analysis of China's Macro-economic Performance

The Chinese economy maintained stable growth and structural adjustments made headway. Consumption grew in a stable manner while investment rose rapidly. The outlook for the agricultural sector was good, and progress was made in the restructuring of the industrial sector. Price levels and the employment situation were basically stable. In the first half of 2013, GDP totaled 24.8 trillion yuan, up 7.6 percent year on year. The GDP growth rate in Q1 and Q2 2013 were 7.7 percent and 7.5 percent respectively year on year, and 1.6 percent and 1.7 percent quarter on quarter. In the first two quarters of this year, the Consumer Price Index (CPI) was up 2.4 percent year on year, and the trade surplus posted USD 107.95 billion.

1. Consumer demand registered steady growth and investment grew in a fairly rapid manner, while the growth of imports and exports slowed down

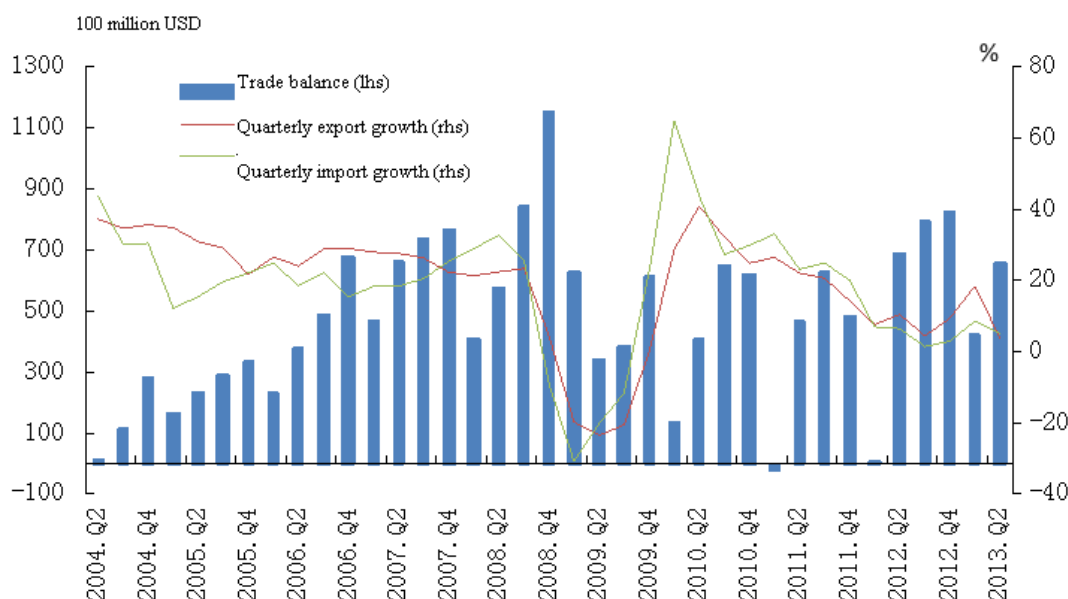
The growth of household income was basically stable, while consumption in the rural areas rose more rapidly than that in the urban areas. In the first half of 2013, per capita disposable income of urban households posted 13,649 yuan, representing year-on-year growth of 9.1 percent and price-adjusted real growth of 6.5 percent. The per capita cash income of rural households registered 4,817 yuan, up 11.9 percent in nominal terms and 9.2 percent in real terms. The growth of urban and rural household income slowed down year on year, but was still slightly higher than the growth of GDP during the same period. According to the PBC Survey of Urban Depositors in the second quarter, the household income index stood at 50.7 percent, a decline of 3.9 percentage points compared with the previous quarter, but 0.6 percentage points more than Q2 2012. In the first half of the year, retail sales of consumer goods totaled 11.1 trillion yuan, representing year-on-year growth of 12.7 percent or 11.4 percent in real terms, which was 0.2 percentage points higher than that during the same period of

last year. Retail sales in urban areas registered 9.6 trillion yuan, up 12.5 percent year on year, whereas retail sales in rural areas grew 14.3 percent year on year to reach 1.5 trillion yuan.

Fixed-asset investments grew fairly rapidly, and investment in the tertiary industry accelerated. In Q1 and Q2, fixed-asset investments (excluding investments by rural households) totaled 18.1 trillion yuan, up 20.1 percent year on year in both nominal and real terms, representing an acceleration of 2.1 percentage points compared with real growth during the same period of last year. Among this total, investment by state-owned or state-controlled sectors was 5.7 trillion yuan, representing year-on-year growth of 17.5 percent, while private investment registered 11.6 trillion yuan, increasing 23.4 percent over the same period of last year. In terms of the regional distribution, growth of fixed-asset investments in the central and western regions outpaced that in the eastern region; growth in the eastern, central, and western regions registered 18.7 percent, 23.6 percent, and 22.7 percent respectively. In terms of the sectoral distribution, fixed-asset investments in the primary, secondary, and tertiary industries grew 33.5 percent, 15.6 percent, and 23.5 percent respectively, with the growth of the primary and tertiary industries accelerating by 4.9 and 6.1 percentage points respectively, while the growth of the secondary industry decelerating by 8.2 percentage points. In the first half of the year, total planned investments in new projects grew 15.1 percent year on year to reach 17.3 trillion yuan, representing a deceleration of 8.1 percentage points over the same period of last year. Total planned investments in projects under construction grew 18.8 percent year on year to 64.5 trillion yuan, accelerating by 3.5 percentage points compared with the same period in 2012.

The structure of imports and exports improved but growth fell. In the first half of 2013, exports gained 10.4 percent year on year to USD 1052.8 billion, while imports rose 6.7 percent to USD 944.9 billion compared with the same period of last year. Total exports and imports grew 8.6 percent year on year and the trade surplus registered USD107.95 billion. In particular, import and export growth fell notably in May and June, with imports declining by 0.3 percent and 0.7 percent year on year respectively and exports growing by 1 percent and -3.1 percent respectively compared with the same period of last year. The slowdown in trade growth can be attributed to weak external demand, repressed over-invoicing carry trade with Hong Kong, and the decline in the prices of exports and imports. The trade structure improved, with the share of exports from the central and western regions increasing by 0.3 percentage points and the share of exports by the private sector rising by 4.1 percentage points year on year. The share of exports of machinery and electronic products, and hi-tech products was enhanced by 0.2 and 2.0 percentage points respectively to reach 57.8 percent and 30.5 percent. The growth of general trade was 10.9 percentage points higher than that of processing trade. The share of exports to markets other than the US, the European Union, and Japan increased to 62.4 percent.

Figure 4 Import and Export Growth and the Trade Balance



Sources: General Administration of Customs, People's Bank of China.

2. The outlook for agricultural production was optimistic and the growth of industrial production slowed down

In the first half of 2013, the value-added of the primary, secondary, and tertiary industries was 1.9 trillion yuan, 11.7 trillion yuan, and 11.2 trillion yuan respectively, up 3 percent, 7.6 percent, and 8.3 percent year on year. It accounted for 7.5 percent, 47.2 percent, and 45.3 percent of total GDP respectively.

The outlook for agricultural production was positive. In the first half of the year, summer grain production rose by 1.5 percent to reach 131.89 million tons. Total output of meat (including pork, beef, mutton, and poultry) dropped by 0.2 percent year on year to reach 39.16 million tons. Among this total, pork output totaled 26.14 million tons, up 1.0 percent year on year.

Growth of industrial output picked up, and industrial restructuring made progress year on year. In Q1 and Q2, the value-added of statistically large enterprises grew 9.3 percent year on year, representing a deceleration of 1.2 percentage points. In June, seasonally-adjusted industrial value-added was up by 0.68 percent month on month, an acceleration of 0.07 percentage points compared with May. Industrial restructuring made gradual progress. Growth of the hi-tech industry maintained a strong momentum. Development of the emerging industries of strategic importance picked up pace. In the first half of 2013, profits of statistically large enterprises posted 2.6 trillion yuan, up 11.1 percent year on year and representing a deceleration of 1.0 percentage points compared with Q1. The profitability of statistically large enterprises from their main business posted 5.4 percent, up 0.12 percentage points compared with Q1. The sales-output ratio of statistically large enterprises registered 97.5 percent, a

rise of 0.3 percentage points compared with the first quarter. The Survey of 5,000 Industrial Enterprises conducted by the PBC indicated that market demand remained stable and the profitability of the corporate sector improved despite the low business index. In Q2, the business index posted 57.1 percent, declining by 5.5 quarter on quarter and by 6.5 percentage points year on year respectively. The enterprise export order index stood at 49.9 percent, growing by 3.3 and 1.1 percentage points respectively compared with the last quarter and the same period of last year. The domestic order index registered 50.3 percent, a rise of 1.5 percentage points quarter on quarter and 0.1 percentage points year on year. The corporate profitability index posted 55.6 percent, up by 2.8 percentage points over Q1 2013 and by 3.0 percentage points over the same period of last year.

3. Consumer prices were generally stable while producer prices declined by a larger margin

Consumer prices remained generally stable. In the first half of 2013, the CPI rose 2.4 percent year on year. The CPI in April, May, and June went up by 2.4 percent, 2.1 percent, and 2.7 percent respectively compared with last year, amounting to a 2.4 percent year-on-year increase for Q2 2013, which was flat with the previous quarter. In terms of food and non-food items, the price of non-food items was generally stable while the price of food fluctuated. In Q2, the price of food grew 4 percent year on year, accelerating by 0.1 percentage points compared with the previous quarter and contributing 1.3 percentage points to the increase in the CPI. The price of non-food items rose 1.6 percent year on year, which was 0.2 percentage points lower than that in the previous quarter, and it pushed up the CPI by 1.1 percentage points. In terms of consumer goods and services, the price of consumer goods grew 2.2 percent year on year, down 0.1 percentage points from the previous year, and the price of services was up 2.8 percent year on year, the same as that during Q1.

The quarter-on-quarter decrease in producer prices widened, and quarter-on-quarter upstream producer prices continued to decline. In the first half of this year, ex-factory prices of industrial products fell 2.2 percent year on year, and the average decline in the second quarter was 2.7 percent, widening by 1.0 percentage points compared with the previous quarter. In Q1 and Q2, producer purchasing prices dropped by 2.4 percent year on year, and in Q2 they declined by an average of 2.8 percent. The Corporate Goods Price Index (CGPI) has registered a year-on-year decrease for 15 consecutive months, and fell by 1.7 percent year on year during the first half of 2013. The prices of midstream and upstream products declined by a larger margin, and the price of downstream products edged up. In the first half of 2013, the prices of primary, intermediate, and final products grew by -1.7 percent, -2.4 percent, and 0.7 percent respectively year on year, which were 3.0, 1.4, and 0.6 percentage points lower than those during same period of last year. The price of capital goods went down while the price of consumer products rose slightly. In Q1 and Q2, the prices of capital goods and consumer products gained -2.1 percent and 1.7 percent respectively year on year, 1.5 and 0.9 percentage points lower than during the first half of 2012. In Q2, the

producer price of agricultural products increased 1.1 percent year on year, 3.0 percentage points lower than the growth of the price of agricultural capital goods.

Due to factors such as the overall decline in commodity prices on the international market, the fall in import prices picked up. In the second quarter, the average price of WTI crude oil futures on the New York Mercantile Exchange dropped by 0.2 percent compared with the previous quarter, while the average price of Brent crude oil futures on the Intercontinental Exchange plunged by 8.2 percent from the last quarter. The average LME spot copper and aluminum prices fell by 9.9 percent and 8.4 percent respectively from Q1. In the first half of the year, import and export prices declined by 2.4 percent and 0.3 percent respectively year on year. From April through June, import prices slipped by 2.5 percent, 4.5 percent, and 1.8 percent respectively year on year, averaging a decline of 2.9 percent in the second quarter. Meanwhile, export prices edged downward by 0.1 percent, 0.9 percent, and 0.7 percent respectively in the three months year on year, averaging a decrease of 0.6 percent in Q2.

The GDP deflator (the ratio of nominal GDP to real GDP) continued to fall. In the first two quarters, the GDP deflator was 1.1 percent, which was 1.3 percentage points lower than that during the same period in the previous year, and 0.6 percentage points lower than that during the previous quarter.

The resource products pricing reform made new progress. On June 28, the National Development and Reform Commission released a notice on the basic principle for adjusting the pricing mechanism for natural gas. A dynamic price adjustment mechanism that reflects market supply and demand and resource scarcity and is linked with the price of renewable energy will be established so as to straighten out the relationship between the price of natural gas and renewable energy. The notice stipulated that the government would manage the city-gate price rather than the ex-factory price of natural gas, putting in place a ceiling for the city-gate price. It was also decided that the city-gate price of natural gas for non-residential users would be increased by 0.26 yuan per cubic meter beginning on July 10, while the price of natural gas for residential use would not be adjusted.

4. Fiscal revenue and expenditures grew at a subdued pace

In the first half of 2013, fiscal revenue (excluding revenue from debt issuances) grew 7.5 percent year on year to 6.9 trillion yuan, representing a deceleration of 4.7 percentage points. Fiscal expenditures rose 10.8 percent to 6.0 trillion yuan, representing a deceleration of 10.5 percentage points year on year. Fiscal revenue exceeded expenditures by 887.7 billion yuan.

As for the structure of fiscal revenue, in the first half of 2013 tax revenue posted 5.9 trillion yuan, up 7.9 percent year on year and representing a deceleration of 1.9 percentage points from the same period of last year. Among this total, revenue from domestic value-added taxes rose by 6.6 percent year on year, whereas that from

value-added taxes and business taxes on imports declined by 17.1 percent compared with the previous year. Meanwhile, revenue from corporate income taxes, business taxes, the domestic excise duty, and personal income taxes went up by 14.2 percent, 12.9 percent, 3.6 percent, and 11 percent respectively year on year. Revenue from the six above items accounted for 76.5 percent of the total.

As for the structure of fiscal expenditures, spending for the improvement of people's livelihood maintained rapid growth. Fiscal expenditures on education, health care and medical services, social security and employment, agriculture, forestry and water conservation, urban and rural communities, as well as energy savings and environmental protection went up by 10.7 percent, 22.3 percent, 15.4 percent, 11.3 percent, 19.6 percent, and 14.1 percent respectively year on year.

5. The employment situation was generally stable

New employment in the urban areas continued to increase. In the first half of 2013, new employment registered 7.25 million, accelerating by 310,000 year on year. In the second quarter, a statistical analysis conducted by the China Human Resources Market Information Monitoring Center on public employment service agencies in 104 cities showed that labor supply and demand both fell compared with the same period of last year and the previous quarter, contributing to an overall balance in the labor market. The ratio of job seekers to job vacancies registered 1.07, declining by 0.03 compared with the previous quarter and increasing by 0.02 over the same period of last year. Broken down by region, labor supply and demand edged up in the eastern region, but fell in the central and western regions compared with the previous quarter and the same period of last year. The ratios of job seekers to job vacancies were 1.04, 1.09, and 1.13 respectively, implying that labor demand exceeded labor supply in all regions. Broken down by industry, job openings in all industries but leasing and the business service industry declined. Among this total, job openings in the manufacturing industry, hotel and catering industry, residential services and other services, as well as the wholesale and retail industry declined by a larger margin. Broken down by employers, more than 90 percent of the job openings were concentrated in the corporate sector, while those in governmental agencies and public institutions accounted for merely 0.6 percent, with job openings provided by other employers taking up 2.3 percent of the total. In terms of the backgrounds of the job seekers, the share of this year's college graduates and job seekers from other provinces increased, whereas the percentage of unemployed and rural residents dropped sharply. Broken down by employer demand, medium- and high-level skilled workers were in short supply, while the demand for low-level skilled workers declined.

6. The balance of payments further improved

In Q1 2013, the current account balance stood at USD47.6 billion, accounting for 2.5

percent of GDP. The surplus under the capital and financial account registered USD 90.1 billion, up by 61 percent year on year. Foreign exchange reserves grew by USD 157 billion. According to preliminary statistics of the SAFE, in the first half of 2013 the current account surplus registered USD 95.7 billion, while the capital and financial account posted a surplus of USD 107.8 billion.

Growth of the external debt remained stable. As of end-March, the outstanding external debt stood at USD 765 billion, up 1.8 percent year on year. Among this total, the stock of registered external debt posted USD 461.4 billion, a decrease of 3.9 percent year on year; the outstanding short-term external debt posted USD 565.7 billion, an increase of 1.4 percent year on year and accounting for 73.9 percent of the total.

7. Sectoral analysis

Profits of industrial enterprises continued to increase, but differed among the various industries. In the first half of 2013, among 41 industries, 30 industries witnessed a rise in profits in their main businesses compared with the first half of the previous year, 8 suffered from lower profits, 2 earned profits in contrast to losses during the same period of last year, and one cut its losses compared with the same period of the previous year. The PBC's Survey of 5,000 Industrial Enterprises indicated that downstream industries producing consumer goods, such as the pharmaceutical manufacturing industry, the apparatus industry, the electronic machinery industry, and home appliance manufacturing industry, had high readings on the profitability index, whereas resource industries, including the coal mining industry, the petroleum and natural gas extraction industry, and the ferrous metal metallurgy and rolling industry, reported lower profitability.

(1) Real estate sector

Nationwide sales of commercial housing declined. The number of cities seeing a month-on-month increase in housing prices dropped for 3 consecutive months. Growth of investment in the real estate sector remained stable, while growth in real estate loans edged down.

The number of cities witnessing a year-on-year increase in housing prices was on the rise, and the number of cities where housing prices registered month-on-month growth continued to decline. In June 2013, prices of newly built commercial residential housing increased from the previous year in 69 out of 70 cities, representing an increase of 2 compared with March, and the largest increase margin was 16.7 percent. Prices of pre-owned residential housing gained year on year in 68 cities, 9 cities less than in March. The price of newly built commercial residential housing rose month on month in 63 cities, compared with 68 cities in March, the third consecutive month that witnessed a decline. The price of pre-owned housing grew month on month in 55 cities, which was 11 less than in March.

Sales of commercial real estate declined from an elevated level. In the first half of 2013, the nationwide sold floor area of commercial real estate gained 28.7 percent year on year to reach 510 million square meters, representing a deceleration of 8.4 percentage points from Q1. The sales value of commercial real estate was up 43.2 percent year on year to reach 3.3376 trillion yuan, representing a deceleration of 18.1 percentage points from the previous quarter. In particular, the sold area and turnover of commercial residential housing accounted for 89.6 percent and 84.5 percent respectively of the total sold area and of the turnover of commercial housing.

Growth of investment in real estate development edged up. Investment in real estate development in the first half of 2013 totaled 3.6828 trillion yuan, up 20.3 percent year on year, representing an acceleration of 0.1 percentage points. In particular, investment in residential housing was 2.5227 trillion yuan, accounting for 68.5 percent of the total. The floor area of newly built housing was 960 million square meters, representing a rise of 3.8 percent year on year, in contrast to a year-on-year decline of 2.7 percent in Q1. The floor area of housing under construction grew 15.5 percent year on year to reach 5.49 billion square meters, representing a deceleration of 1.5 percentage points from the previous quarter. The floor area of completed housing stood at 350 million square meters, up 6.3 percent and representing a deceleration of 2.6 percentage points from the previous quarter.

Growth of real estate loans registered a slight decline after rising for 13 consecutive months. As of end-June 2013, outstanding real estate loans of major financial institutions (including foreign-funded financial institutions) posted 13.6 trillion yuan, an increase of 18.1 percent year on year, representing an increase of 1.7 percentage points compared to end-March and a decline of 0.1 percentage points compared to end-May. Outstanding real estate loans accounted for 20.6 percent of the total outstanding loans, growing by 0.2 percentage points from the end of March. Among this total, outstanding mortgage loans rose 20.8 percent year on year to 8.3 trillion yuan, representing a rise of 3.9 percentage points from the end of Q1; outstanding real estate development loans gained 9.4 percent year on year to 2.4 trillion yuan, representing a deceleration of 1.2 percentage points from the end of the previous quarter; outstanding land development loans gained 17.2 percent year on year to 1.1 trillion yuan, which was 4.2 percentage points lower than the growth at end-March. New real estate loans reached 1.3 trillion yuan, accounting for 27.1 percent of the total new loans, which was 0.1 percentage points higher than that during the first quarter.

Credit support for welfare housing was further reinforced. As of end-June 2013, outstanding loans for welfare housing rose 37.5 percent year on year to 658 billion yuan, which was 26.5 percentage points higher than the growth of real estate development loans. Moreover, the pilot program of using housing provident fund loans to support the construction of affordable housing was steadily advanced. As of end-June 2013, based on the construction progress, a total of 51.9 billion yuan of such loans was disbursed to 227 projects in 59 cities under the affordable housing program,

and a total of 8.4 billion yuan of the principal had been recovered.

(2) Internet banking and finance

As the age of big data arrives, the accumulation of a huge amount of data and an improved capacity for data processing promoted the development of Internet banking. An emerging business combining traditional finance with the Internet, Internet banking enjoyed a number of advantages, including greater transparency, wider participation, lower costs of intermediation, more convenient payments, a greater pool of credit information, and higher efficiency in information processing.

In recent years, an Internet financial service platform has emerged, including third-party payments, Internet credit, and crowd funding. For example, the size of the third-party payment market exceeded 10 trillion yuan in 2012. Among this total, the amount of Internet payments by payment institutions, mobile payments, bank card acceptances, and pre-paid card business reached 6.9 trillion yuan, 181.19 billion yuan, 3.8 trillion yuan, and 57.56 billion yuan respectively. The scope of the online financing business expanded from the payment business to the traditional banking businesses, such as fund transfers, cross-border settlements, microcredit, cash management, asset management, supply chain financing, agency sales of funds and insurance products, as well as the repayment of credit card debt. Innovations in Internet financial products and services have made up for the inadequacy of the traditional financial services. Moreover, financial institutions, including commercial banks and securities firms, have been improving their online transaction platforms, including electronic banking and online shopping malls, applying a scientific approach to the analysis and mining of an enormous amount of data. More diversified and convenient financial services based on the consumption and behavioral patterns of consumers have enabled financial institutions to come up with more diversified and more convenient financial services, contributing to higher efficiency and lower costs of financial services.

As a new channel of intermediation between the supply side and demand side of funds compared with the traditional banking and securities market, Internet financing enhances the efficiency of financing and is a useful complement to the existing financial system. Its reliance on an analysis of a large amount of data helps address information asymmetries and to mitigate credit risks, enabling the provision of more tailor-made services and more diversified products. The reduction in transaction costs and the diversification of risks enhance the coverage of financial services, benefiting in particular small and micro-sized enterprises, self-employers, and residents. For example, it was reported that as of end-June 2013, more than 100 billion yuan of credit was extended by Alibaba micro-financing to more than 320,000 users, with a credit line of 40,000 yuan per user. Meanwhile, the wide base of participation and the accurate analysis of the behavioral patterns and preferences of consumers have contributed to an NPL ratio of no more than 0.84 percent, which is lower than the average for commercial banks.

As a new financing model, the Internet has raised new requirements for financial regulation, and for the protection of financial consumers, and for macro-economic management. Compared with traditional financing, the risks of Internet banking are concentrated in the security of consumer information and risk control. In the context of the rapid development of Internet financing, efforts should be made to study its development and to enact laws based on an adequate understanding and a reasonable evaluation of its characteristics and potential influence; to assign a competent regulatory authority and carry out more targeted and efficient regulation to the guide healthy development of Internet financing; and to promote the development of the credit system and strengthen education and protection of financial consumers so as to provide a more facilitating market environment for financial system innovation and its support for the real economy.

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

I. Outlook for the Chinese economy

At present, the structural adjustments, transformation, and upgrading of the Chinese economy are at a critical stage. Looking ahead, we expect the growth potential will be gradually released along with progress in the structural adjustments. Despite the complex environment and various constraints and challenges, there are a number of positive factors and favorable conditions to support sustained and healthy economic growth, and the fundamentals remain unchanged. On the one hand, much can be done in the field of industrialization and urbanization. After many years of rapid development, human capital, infrastructure, industrial capacity, and supporting industries have all improved. The size of the economy in the eastern regions is large, endogenous drivers and stability have both been strengthened, and economic performance has improved. The hinterland and western regions enjoy obvious late-mover advantages and have a strong will to accelerate development. There is ample room to achieve balanced regional development. The upgrading of consumption and service-sector development have picked up pace. In particular, once the weak points and bottlenecks are resolved, the enormous demand potential will be released. On the other hand, positive progress has been made in the adjustments of the economic structure. After declining for ten consecutive years, the consumption ratio has rallied a bit in the recent two years. In 2012, consumption posted 49.2 percent. The tertiary industry has expanded at a faster pace. In the first half of 2013, growth of the service sector accelerated 0.5 percentage points year on year and growth of investment in the tertiary industry outpaced that in the secondary industry by almost 8 percentage points. A modern service sector, high-tech industries, and some new

industries are developing with a good momentum. In particular, enterprises and sectors that have worked actively to promote upgrading, transformation, and independent innovation have shown remarkable resilience and dynamism. In terms of the external environment, though the deep-rooted institutional issues have yet to be resolved effectively, and the recovery performance and monetary policy stances have differed among the various economies, the global economy as a whole is relatively stable and conducive to the preservation of a stable environment for external demand.

The Chinese economy faces various risks and challenges, and the situation is very complex. Against the background of deceleration in potential GDP growth, the overcapacity in the traditional manufacturing industries that has matched the growth pattern during the high-growth period is quite serious. Investment in the manufacturing industry has declined continuously. To a large extent, economic growth has relied on infrastructural investments. In the first half of 2013, growth of infrastructural investments was 5.2 percentage points higher than that of total investments. As the investment rate remains at a high historical level, the movement of the investment rate to a more sustainable range will place pressures on economic performance. The indebtedness and leverage ratio of some enterprises have risen rapidly. Some of the local financing platforms are using even more complicated channels for financing and financing costs are on the rise. At the same time, the resources and environment are overly stretched, and given the serious pollution of the air, water, and soil, environmental constraints are becoming stronger. The structural imbalances in economic performance have mitigated the effects of the policies that were designed to regulate aggregate demand and supply, and it is difficult to further increase leveraging. It is necessary to transform the growth model, speed up the structural adjustments and reforms, make progress to boost household consumption, develop a new-type of urbanization and new service industries, nurture new growth engines, and strengthen endogenous drivers and dynamics. It is worth noting that the adjustment of the economic structure and the transformation of the growth pattern will inevitably affect the growth rate. A new situation and new problems might arise and interactions among some variables might change as well. The key is to properly manage the balance between the short term and the long term, take into consideration and strike a balance among preserving stable growth, adjusting the economic structure, promoting reform, and preventing risks, and promote sustained and sound economic growth.

The overall price situation is relatively stable, but uncertainties remain. The stable economic performance, the gain in the output of the summer crop, the abundant capacity in the industrial sector, and the relatively stable prices of commodities and capital goods are all conducive to price stability. According to the quarterly Depositors' Survey conducted by the PBC in Q2, the future price expectation index

remained at 66.8 percent, at par with the reading in Q1. There are structural characteristics in the price movements. On the one hand, traditional industries that did well in the recent boom have an overcapacity and low level of utilization, and the PPI has remained on negative ground. On the other hand, due to the upward pressures on labor costs, service prices, and rent, the basis for stable consumer prices is not yet solid. The CPI is fairly sensitive to changes in aggregate demand and inflation expectations can be easily stirred. In June, the CPI rebounded somewhat, with its month-on-month growth larger than the historical average during the same period. The structural changes in price movements to a certain extent reflect problems in the economic structure. In general, one should not be overly optimistic about the price outlook for the immediate future, and it is necessary to guide and maintain stable inflation expectations.

II. Monetary policy in the next stage

The PBC will follow the overall arrangements of the State Council, follow the principle of seeking macro-economic stability, enhancing vitality at the micro-level, making progress and improving quality amidst stability, maintain policy stability and continuity, continue to implement a sound monetary policy, make policy measures more targeted and better coordinated, conduct fine-tuning and preemptive adjustments when necessary, strike a balance among preserving stable economic growth, adjusting the economic structure, promoting reform and preventing risks, and create a stable financial environment and monetary conditions for economic structural adjustments, transformation, and upgrading. The allocation of financial resources will be further optimized. Financial institutions will be encouraged to properly manage their stock of credit assets, make good use of new loans, consolidate financial resources to support key areas and weak links in the economy including small- and micro-sized enterprises, and provide better services for the transformation and upgrading of the growth pattern and the expansion of domestic consumption. Reform will be continued to strengthen the role of market mechanisms, improve the transmission mechanism of monetary policy, and promote sustained and healthy growth.

First, a mixture of quantitative and price monetary policy instruments will be used, and the macro-prudential policy framework will be improved to guide the stable and reasonable growth of money, credit, and all-system financing aggregates. In view of the BOP situation and the supply and demand of liquidity, a combination of open market operations, the reserve requirement ratio, central bank lending, the central bank discount window, short-term liquidity operations, the standing lending facility, and other instruments will be used to manage and adjust liquidity in the banking system, enhance communications with the market and the public, and keep expectations stable and guide the stable movement of market interest rates. Moreover, commercial banks will be guided to strengthen management of liquidity and balance

sheets, to properly arrange liquidity at all time points, properly manage the total volume of assets and liabilities and their maturity structure, and improve liquidity risk management. The macro-prudential policy will continue to play a counter-cyclical role. Based on the changes in macro-economic performance, the soundness of financial institutions, and the implementation of credit policy, the relevant parameters will be adjusted to guide financial institutions to support real economic development in a more focused way.

Second, financial institutions will be encouraged to properly manage the stock of credit assets, make good use of new loans, and support economic structural adjustments, transformation, and upgrading of the growth model. Financial resources will be consolidated to support small- and micro-sized enterprises and to increase credit support to the agricultural sector, rural areas, and farmers. Consumer financing will be further developed to promote an upgrading of consumption. Financial institutions will be guided to provide credit to ongoing and follow-up key national projects, the modern service industry, and the emerging industries, and to promote the transformation and upgrading of key areas and industries. Financial services will be further improved to contribute to better livelihood of the people, to support job creation, poverty reduction, students in need of loans, to support the regional development policies, and to provide financial support and services for balanced regional development. Lending to energy-intensive, highly polluting industries, and those with excess capacities will be strictly controlled. Differentiated housing mortgage policies will be properly implemented to support the construction of welfare housing and common commercial housing projects with apartments of modest floor plans and purchases by first-time home buyers of common commercial housing for one's own use, and to contain purchases for speculative investment purposes. Financial institutions will be guided to take differentiated approaches based on their specific circumstances to adjust and properly manage their stock of credit assets, improve evaluation and incentive mechanisms, reasonably evaluate the performance of banking institutions, optimize the organization of the financial system, and further improve financial services.

Third, the market-based interest-rate reform and the RMB exchange-rate regime reform will be furthered to improve allocation efficiency of the financial system and improve the monetary policy framework. The market-based interest-rate mechanism will be improved, the financial market benchmark interest-rate system will be optimized, and a mechanism for financial institutions to independently price interest rates will be improved. Gradually a larger range of liability products will be market-priced so as to allow the market to play a fundamental role in the allocation of financial resources. The central bank's capacity to guide and adjust market interest rates will be further enhanced to strengthen price-based mechanisms and to promote the balanced development of the financial sector and the real economy. The RMB exchange-rate regime will be improved to enable market demand and supply to play a larger and fundamental role, to enhance two-way flexibility of the RMB exchange rate,

to keep the exchange rate basically stable at an adaptive and equilibrium level, and to promote a balanced position of the BOP account. Development of the foreign exchange market will be accelerated to facilitate innovation in exchange-rate risk management. Measures will be taken to support the use of RMB in cross-border trade and investment activities, and more channels will be made available for the inflow and outflow of RMB funds. Direct trading of the RMB against other currencies will be promoted to provide better services for RMB settlements of cross-border trade. The impact of the changing international situation on capital flows will be carefully watched and effective monitoring of cross-border capital will be strengthened.

Fourth, there will be continued efforts to promote the sound development of financial markets, to support the development of direct financing, and to broaden direct financing channels available to small- and micro-sized enterprises. The bond issuance pricing mechanism and regulation of bond issuances will be improved. Innovation will be encouraged and awareness of risk prevention will be strengthened. The focus will be on allowing market mechanism to play a role and to strengthen market infrastructure building. Supervision and regulation will be strengthened to promote the sound development of the financial markets.

Fifth, the reform of financial institutions will be deepened. Reform of large commercial banks will be intensified so that they will continue to upgrade corporate governance, improve the modern financial enterprise system, speed up the transformation of the growth pattern and profit model, and build an innovative capability and international competitiveness. The pilot reform program of the Rural Financial Business Division of the Agricultural Bank of China will be advanced to explore sustainable models for financial institutions to provide services on a commercial basis to the agricultural sector, rural areas, and farmers. The development of policy-based financing will be considered as an independent category for financial institutions; the reform of the China Development Bank will be deepened, and the reform of the Export-Import Bank of China and the Agricultural Development Bank of China will be advanced. Work will continue to promote the market-based transformation of asset management companies. The pilot reform of cross-sectoral operations will be implemented on a prudent but progressive basis. The pilot program of the regional financial-sector reform will be continued. Private capital will be given more access to the financial sector, and private capital will be encouraged in the equity investments of financial institutions and the restructuring of financial institutions. There will be experimentation to allow private capital to establish banks, financial leasing companies, and consumer financing companies that will manage their own risks to provide widely available, differentiated, and highly efficient financial services to the real sector.

Sixth, effective measures will be adopted to mitigate systemic financial risks and to preserve stability in the financial system. Macro-prudential regulation will be enhanced to guide financial institutions to operate on a sound basis. Financial

institutions will be urged to strengthen liquidity management, internal controls, and risk management. While supporting financial innovation, measures will be taken to continue to strengthen monitoring and prevention of the potential risks in wealth management products, bill businesses, and inter-bank transactions, and to prevent the spread to the financial system of the risks associated with the real economy in some regions, industries, and enterprises and risks arising from financing activities outside of the formal financial system. It is necessary to improve the mechanism for financial regulation coordination and the early-warning, prevention, and assessment system of systemic risks. A crisis management and risk resolution framework will be established and the creation of a deposit insurance scheme will be promoted. A variety of measures will be taken to preserve financial stability and to safeguard the bottom line in preventing systemic risks and regional financial risks.