China Monetary Policy Report Quarter Two, 2014

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the first half of 2014, performance of the Chinese economy was stable. Economic growth, new jobs in the urban areas, and general price levels were all within a reasonable range and the economic structure experienced positive changes. In the first half of 2014, the GDP reached 26.9 trillion yuan, up 7.4 percent year on year; the consumer price index was up 2.3 percent year on year.

In accordance with the decisions and overall arrangements of the State Council, the PBC has continued its sound monetary policy, remained focused on the goal of macro-economic management, actively taken measures to respond to downward pressures and moderate growth in price levels, made innovations in the approach to macro-economic management, diversified policy instruments, optimized the combination of policy measures, dealt with salient issues in economic performance, and conducted pre-emptive adjustments and fine-tuning with a proper intensity at opportune times to promote stable and sustainable growth of the economy. The PBC has conducted open market operations flexibly and has used short-term liquidity operations to make adjustments in both directions in order to keep aggregate liquidity at a reasonable volume. Branch offices continued the pilot Standing Lending Facilities program to improve the regular channels for the central bank to provide liquidity to small and medium financial institutions. On two occasions, the RMB deposit reserve requirement ratio was lowered for selected financial institutions and the parameters of the macro-prudential policy were adjusted. A credit policy supportive central bank lending was added to the spectrum of central bank lending. The role of the credit policy supportive central bank lending and central bank discounts were used to optimize the distribution and structure of liquidity, to guide and encourage financial institutions to channel a larger share of their credit resources to key areas and weak links in the economy, including the agricultural sector, the rural areas, and the farmers, and small and micro enterprises. The market-based interest-rate reform progressed steadily and the RMB exchange-rate regime was further improved. The floating range of the trading price of the RMB against the US dollar was expanded from 1 percent to 2 percent on the inter-bank spot foreign exchange market.

In general, the various policies have been implemented in an orderly manner and the effects are still unfolding. Liquidity in the banking system was sufficient, money, credit and all-system financing aggregates were growing fairly rapidly, and the loan structure continued to improve. Market interest rates declined and the RMB exchange rate was more flexible. At end-June 2014, broad money M2 was up 14.7 percent year on year. Outstanding RMB loans were up 14.0 percent year on year and registered an increase of 5.74 trillion yuan from the beginning of 2014, 659 billion yuan more than the increase in the first half of 2013. The growth of small and micro enterprise loans and agro-related loans both exceeded that of total loans. In the first half of 2014, all-system financing aggregates totaled 10.57 trillion yuan, an increase of 414.6

billion year on year. The lending rates offered by financial institutions were generally lower. In June, the weighted average interest rate offered to non-financial enterprises and other sectors was 6.96 percent, a reduction of 0.22 percentage point from end-March. At end-June, the central parity of the RMB against US dollar was 6.1528 yuan per dollar, a depreciation of 0.91 percent from end-2013.

The Chinese economy is changing gears and undergoing structural adjustments. Therefore, the side-effects of the structural adjustments and the vitality released by the adjustments and reform are both coming into play. While the traditional growth drivers are weakening, the newly emerging industries are very dynamic. Interactions among the economic variables, including growth, job creation, prices, and the environment, are changing and economic performance, with new features, has displayed a new normal state. Supported by the many positive factors and a good macro-economic policy environment, the Chinese economy is expected to maintain its stable growth during the coming periods. Yet, given the remaining risks in the global recovery, the yet-to-be-strengthened endogenous drivers in China, the rapidly growing indebtedness of the Chinese economy, and resource and environmental constraints, the structural adjustments and reforms still have a long way to go.

The PBC will follow the strategic arrangements of the Party Central Committee and the State Council, follow the requirements of seeking progress while maintaining stability, promoting reform and innovation, and maintaining stable macro-economic policies but flexible micro policies, strike a balance among preserving growth, promoting reform, adjusting the economic structure, improving people's welfare, and preventing risks, continue the sound monetary policy, maintain policy stability and continuity, and continue the stance of keeping aggregates at stable levels and optimizing the structure. We will remain focused on macro-economic management, adopt measures at our own initiative, conduct fine-tunings and preemptive adjustments when necessary, make adjustment measures more forward looking, targeted, and coordinated, strike a balance among preserving stable economic growth, promoting reforms, adjusting the economic structure, improving people's welfare, and preventing risks, continue to provide a stable monetary and financial environment for structural adjustments, transformation, and the upgrading of the economic structure, and promote sustainable economic development. A combination of both quantitative and price-based monetary policy instruments will be employed, the macro-prudential policy framework will be improved, and the combination of policy measures will be further diversified and optimized to keep liquidity at a reasonable volume and to realize opportune growth of money, credit, and all-system financing aggregates. There will be continued efforts to mobilize the stock of credit assets, optimize the structure of new loans, and improve the financing and credit structures. Moreover, the reforms will be integrated with the macro-economic management policies so that monetary policy will work closely with the reform measures to further tap into the decisive role of the market in terms of resource allocations. To improve the efficiency of the financial sector and its capacity to serve the real sector, and in light of the financial deepening and innovation, the mode of macro-economic management will be improved and the transmission mechanisms will be straightened up，the quality of financial services will be improved by increasing supply and enhancing competition, and numerous measures will be adopted to reduce the financing costs of the real sector. A comprehensive set of measures will be put in place to safeguard the bottom lines of allowing neither systemic financial risks nor regional financial risks to emerge.

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Part 1 Monetary and Credit Performance

In the first half of 2014, liquidity in the banking system was abundant, money, credit, and all-system financing aggregates grew at a relatively rapid pace, and the credit structure was further improved.

I. Growth of money supply rebounded

At end-June 2014, outstanding broad money (M2) stood at 121.0 trillion yuan, up 14.7 percent year on year and an acceleration of 2.6 percentage points from the end of March. Outstanding narrow money (M1) stood at 34.1 trillion yuan, up 8.9 percent year on year and an acceleration of 3.5 percentage points from the end of March. Currency in circulation M0 stood at 5.7 trillion yuan, up 5.3 percent year on year and an acceleration of 0.1 percentage point from the end of March. In the first half of 2014, cash withdrawals from circulation amounted to 162 billion yuan, 102.5 billion yuan more than that during the corresponding period of the last year. In general, since the beginning of 2014, the growth of M2 moved up amid fluctuations and was higher than the annual target of 13 percent that was set for the whole year. Monetary conditions were relatively accommodative.

At end-June, outstanding base money was 28.0 trillion yuan, up 8.6 percent year on year and 887.9 billion yuan more than that at the beginning of the year. The money multiplier was 4.32, which was 0.10 and 0.24 higher than that at the end of March and the end of the last year respectively. The excess reserve ratio of financial institutions was 1.7 percent and that of rural credit cooperatives was 4.4 percent.

II. Growth of deposits in financial institutions accelerated

At end-June, outstanding deposits of domestic and foreign currencies in all financial institutions (including foreign-funded financial institutions, the same hereafter) posted 117.3 trillion yuan, up 13.1 percent year on year. This represented an acceleration of 1.6 percentage points from the end of March, growth of 10.0 trillion yuan from the beginning of the year, and an acceleration of 803 billion yuan year on year. Outstanding RMB deposits posted 113.6 trillion yuan, up 12.6 percent year on year. This represented an acceleration of 1.2 percentage points from the end of March, growth of 9.2 trillion yuan from the beginning of the year, and an acceleration of 135.4 billion yuan year on year. Outstanding deposits in foreign currencies posted USD593.6 billion, up 34.5 percent year on year. This represented growth of USD128.6 billion from the beginning of the year, an acceleration of USD97.3 billion year on year, and flat with the growth during the corresponding period of 2012. It is worth noting that, due to factors such as the maturing of a large volume of off-balance-sheet wealth management products and the expansion of the inter-bank business, the phenomenon of abrupt increases in deposits at the end of the quarter was prominent. During the last three business days of June, RMB deposits increased by more than 4 trillion yuan, followed by a large decline in early July. It is possible that this will result in shocks to the money supply.

Broken down by sectors, growth of household and non-financial business deposits rose steadily, while growth of deposits of non-deposit-taking financial institutions continued to accelerate. At end-June, outstanding household deposits in financial institutions posted 50.2 trillion yuan, up 12.0 percent year on year. This represented an acceleration of 0.6 percentage points from the end of March, growth of 4.1 trillion yuan from the beginning of the year, and a deceleration of less than 78.9 billion yuan year on year. Outstanding deposits of non-deposit-taking financial institutions posted 38.4 trillion yuan, up 9.7 percent year on year. This also represented an acceleration of 4.1 percentage points from the end of March, growth of 2.5 trillion yuan from the beginning of the year, and an acceleration of 194.8 billion yuan year on year. Outstanding fiscal deposits posted 3.7 trillion yuan, representing growth of 654.1 billion yuan from the beginning of the year and a deceleration of 304.6 billion yuan year on year. Outstanding deposits of non-deposit-taking financial institutions posted 8.2 trillion yuan, up 66.2 percent year on year. This also represented an acceleration of 26.3 percentage points from the end of March, growth of 2.3 trillion yuan from the beginning of the year, and an acceleration of 2.3 trillion yuan year on year. This was mainly due to the rapid development of the off-balance-sheet wealth management business of commercial banks and money-market funds.

III. New loans of financial institutions grew rapidly

At the end of June, outstanding loans of domestic and foreign currencies in all financial institutions registered 82.9 trillion yuan, up 13.7 percent year on year and with growth on par with that at the end of March. This was 6.2 trillion more than that at the beginning of the year, representing a year-on-year acceleration of 670.2 billion yuan. Among the total, outstanding RMB loans stood at 77.6 trillion yuan, up 14.0 percent year on year. This represented an acceleration of 0.1 percentage point from the end of March, an increase of 5.7 trillion yuan from the beginning of the year, and an acceleration of 659 billion yuan year on year.

In terms of the credit structure, RMB loans to the household sector moderated, while the growth of loans to the non-financial corporate sector and other sectors picked up. At the end of June, outstanding loans to the household sector registered 21.7 trillion yuan, up 19.3 percent year on year. This represented a deceleration of 2.1 percentage points from the end of March, an increase of 1.9 trillion yuan from the beginning of the year, and a deceleration of 194.1 billion yuan year on year. In particular, home mortgage loans increased by 870.4 billion yuan from the beginning of the year, representing a deceleration of 9.2 billion yuan year on year. Since the beginning of 2014, the real estate market diverged among the various regions and showed signs of making adjustments. As some commercial banks faced increased pressures from the strengthened credit policy guidance, to receive better returns they tended to allocate the limited credit resources to small and micro enterprises and to self-employed businesses, and their willingness to extend credit to the real estate sector declined somewhat. However, the share of home mortgage loans among new loans remained at an elevated level. In the first half of the year, the share of home mortgage loans among total new loans stood at 15.2 percent, which was above the average level between 2010 and 2013. At the end of June, outstanding RMB loans to non-financial enterprises and other sectors posted 55.7 trillion yuan, up 12.1 percent year on year. This represented an acceleration of 0.8 percentage point from the end of March, an increase of 3.9 trillion yuan from the beginning of the year, and an acceleration of 853.8 billion yuan year on year.

In terms of RMB loan maturities, growth of medium- and long-term loans picked up, while growth of short-term loans moderated. At the end of June, outstanding medium- and long-term loans registered 43.2 trillion yuan, up 13.9 percent year on year. This represented an acceleration of 0.5 percentage point from the end of March, an increase of 3.3 trillion yuan from the beginning of the year, and an acceleration of 697.8 billion yuan year on year. New medium- and long-term loans accounted for 57.2 percent of total new loans, up 6.3 percentage points from the corresponding period of the last year. In particular, fixed-asset loans contributed a large share. In the first half of the year, new fixed-asset loans posted 1.7 trillion yuan, an acceleration of 495.6 billion year on year. This was related to the increased infrastructural investments during recent periods, which helped to gradually stabilize investments. At the end of June, outstanding short-term loans stood at 31.1 trillion yuan, an increase of 15.4 percent and a deceleration of 1.0 percentage point from the end of March. Short-term loans, including bill financing, increased 2.3 trillion yuan from the beginning of the year, a deceleration of 90.7 billion yuan year on year. Broken down by financial institutions, all types of financial institutions reported accelerations of loans compared with the same period of the last year, with the largest increase coming from Chinese-funded national banks.

Table 1 RMB Loans of Financial Institutions in the First Half of 2014

Unit: 100 million yuan

	First Half of 2014		First Half of 2013	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded large-sized national banks ①	26,940	3,654	23,286	1,141
Chinese-funded small- and medium-sized national banks②	15,950	2,001	13,948	677
Chinese-funded small- and medium-sized local banks③	8,834	655	8,179	1,371
Small-sized rural financial institutions④	9,002	188	8,814	224
Foreign-funded financial Institutions	321	411	-90	-379

Notes: ①Chinese-funded large-sized national banks refer to banks with assets (both in domestic and foreign currencies) of at least 2 trillion yuan (according to the amount of total assets in both domestic and foreign currencies at end-2008).

②Chinese-funded small- and medium-sized national banks refer to banks operating across provinces with assets (both in domestic and foreign currencies) of less than 2 trillion yuan.

③Chinese-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.

④Small-sized rural financial institutions include rural commercial banks, rural cooperative banks, and rural credit cooperatives.

Source: People's Bank of China.

Foreign currency–denominated loans increased steadily. At the end of June, outstanding foreign currency loans of financial institutions posted USD852.6 billion, up 9.9 percent year on year. This was USD75.7 billion more than that at the beginning of the year and a deceleration of USD16.7 billion year on year. In terms of the loan structure, trade financing increased by USD19.1 billion, accounting for 25.2 percent of total new foreign currency–denominated loans; outward lending and medium- and long-term domestic loans increased by USD24.8 billion, accounting for 32.7 percent of the total new foreign currency–denominated loans.

IV. The amount of all-system financing aggregates hit a historical high

According to preliminary statistics, in the first half of 2014 all-system financing aggregates reached 10.57 trillion yuan, representing an increase of 414.6 billion yuan year on year and hitting a record high compared with the corresponding periods.

All-system financing aggregates in the first half of 2014 displayed the following four structural characteristics. First, RMB loans registered a larger increase compared with the same period of the last year. In the first half of the year, new RMB loans accounted for 54.3 percent of all-system financing aggregates, up 4.3 percentage points over the same period of the last year. Second, the growth of new foreign currency–denominated loans was significantly lower than that during the same period of the last year. New foreign currency–denominated loans registered an equivalent of 463.2 billion yuan, a deceleration of 115.9 billion yuan year on year. Third, direct financing was brisk and accounted for a larger share of all-system financing aggregates. In the first half of the year, net financing via enterprise bonds and equity issuances registered 1.5 trillion yuan, an acceleration of 163.5 billion yuan year on year. In particular, financing by enterprise bonds registered 1.30 trillion yuan, representing an acceleration of 86.1 billion yuan year on year and hitting a historical high. Fourth, trust loans shrank significantly, resulting in a moderation in the growth of off-balance-sheet financing. In the first half of the year, the combined financing by the real sector via entrusted loans, trust loans, and undiscounted bankers' acceptances amounted to 2.60 trillion yuan, a deceleration of 266.9 billion yuan year on year, among which trust loans increased 460.1 billion yuan, a deceleration of 776.4 billion yuan year on year.

Table 2 All-system Financing Aggregates in the First Half of 2014

Unit: 100 million yuan

Period	All-system financing aggregates①	Of which:						
		RMB loans③	Foreign currency–denominated loans(RMB equivalent)	Entrusted loans	Trust loans	Undiscounted bankers' acceptances	Enterprise bonds	Financing by non-financial institutions via the domestic stock market
First half of 2013	101,529	50,792	5,791	11,118	12,365	5,169	12,164	1,248
First half of 2014②	105,675	57,382	4,632	13,511	4,601	7,871	13,025	2,022

Notes: ① All-system financing aggregates refer to the total volume of funds in the financial system to the real economy during a certain period of time. It is a flow value.

② Data for the current period are preliminary.

③ Data for RMB loans are the historical numbers that were 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 & Clearing Co., Ltd., National Association of Financial Market Institutional Investors, and so forth.

V. Lending rates of financial institutions declined

In June the weighted average lending rate offered to non-financial institutions and other sectors was 6.96 percent, down 0.22 percentage point from March. In particular, the weighed average interest rate of loans was 7.26 percent, down 0.11 percentage point from March; the weighed average bill financing rate was 5.51 percent, down 0.77 percentage points from March. Home mortgage rates rose slightly. In June the weighed average home mortgage interest rate was 6.93 percent, up 0.23 percentage point from March.

The shares of loans with lending rates lower than or flat with the benchmark rates rose, whereas the share of loans with lending rates higher than the benchmark rates declined. In June the shares of loans with interest rates lower than or flat with the benchmark rates were 9.32 percent and 21.57 percent respectively, up 0.97 and 0.17 percentage points from March, and the share of loans with interest rates higher than the benchmark rates was 69.11 percent, down 1.14 percentage points from March.

Table 3 Shares of Loans of Rates at, above, and below the Benchmark Rate, January through June 2014

Unit:%

Month	Lower than the benchmark	At the benchmark	Higher than the benchmark					
			Sub-total	(1.0，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2.0]	Above 2.0
January	8.20	22.81	68.99	17.90	27.39	11.00	9.78	2.92
February	7.56	24.96	67.48	20.61	26.09	10.13	8.05	2.60
March	8.35	21.40	70.25	18.81	27.69	11.17	9.56	3.02
April	6.14	20.60	73.26	20.20	28.47	11.93	9.69	2.97
May	7.35	19.81	72.84	20.45	28.12	11.97	9.52	2.78
June	9.32	21.57	69.11	20.24	26.71	11.19	8.42	2.55

Source: People’s Bank of China.

Due to interest-rate movements on international markets and changes in the supply and demand of foreign exchange in China, the deposit and lending rates of foreign currencies were generally lower than those in March. In June the weighted average interest rates of large-value US dollar demand deposits and US deposits with a maturity within 3 months were 0.22 percent and 1.99 percent respectively, down 0.03 and 0.61 percentage point from March. The weighted average interest rates of US dollar loans with a maturity within 3 months and within 3–6 months (including 3 months) were 2.87 percent and 3.03 percent respectively, down 0.21 and 0.17

percentage points from March.

Table 4 Average Interest Rates of Large-value Deposits and Loans Denominated in US Dollars, January through June 2014

Unit:%

	Large-value deposits						Loans				
	Demand deposits	Within 3 months	3–6 months (including 3 months)	6–12 months (including 6 months)	1 year	Over 1 year	Within 3 months	3–6 months (including 3 months)	6–12 months (including 6 months)	1 year	Over 1 year
January	0.21	2.41	3.43	3.48	3.54	2.68	2.82	2.90	3.14	2.88	3.56
February	0.20	2.50	3.54	3.68	3.66	3.08	3.08	3.13	3.46	3.10	3.08
March	0.25	2.60	3.68	3.63	3.85	2.72	3.08	3.20	3.35	3.30	3.16
April	0.27	2.45	3.56	3.70	3.66	2.81	3.11	3.24	3.59	3.52	3.47
May	0.26	2.21	3.24	3.43	3.58	2.83	2.97	3.09	3.45	3.52	3.63
June	0.22	1.99	3.03	3.17	3.69	2.78	2.87	3.03	3.37	3.42	3.45

Source: People's Bank of China.

Box 1 Observations on Financing Costs

Some enterprises and localities have recently reported that they face a shortage of funds and financing costs are rising substantially. This has attracted attention far and wide. The costs of financing directly reflect changes in capital prices, and more deeply they are a reflection of the interactions between aggregate demand and supply and the impact of a number of structural factors on the price of capital. The costs of social financing should be examined in an objective, comprehensive, and dynamic way.

With the development of the financial market and the market-based interest-rate reform, financial products have become more diversified and interest rates have become more diverse. To monitor changes in the financing costs, we need not only to look at the interest rates of loans, bonds, trust funds, private financing, and other financing channels, but also at the term structure of the interest rates. In addition, we need to examine the differences in financing costs among large, medium, and small enterprises, as well as non-interest expenses. Since the beginning of 2014, both the lending rates and the corporate bond rates declined somewhat, and in general the financing costs fell slightly. However, some enterprises, especially small and micro enterprises, still faced financing difficulties and high financing costs.

In general, changes in interest rates automatically adjust the supply and demand for funds. On the demand side, if economic agents consider the financing costs are too high, their demand for financing will decline and the growth of money and credit aggregates will moderate. As a result, interest rates will follow the fall and a new equilibrium will be formed. On the supply side, increases in money and credit supply tend to cause a fall in interest rates and subsequently the supply and demand for funds will adjust. But it is worth noting that while some enterprises report that problems of financing difficulties and high financing costs have become more acute, monetary and credit aggregates have maintained relatively rapid growth. At end-June, the year-on-year growth of M2 outpaced the nominal GDP growth during the corresponding period by 5.7 percentage points. The overall liquidity was ample, whereas the debt ratio of the entire economy was still rising. This suggests that structural issues in the economy are impacting the supply and demand for liquidity. From the basic framework of economic theory, savings and investments collectively determine the level of (real) interest rates. In recent years, the deceleration in China's savings rate has exceeded the deceleration in China's investment rate, which may lead to an increase in (real) interest rates even though the growth in investments decelerated. This indicates that the demand for investments and borrowings is larger than the supply of savings, while some structural factors on the supply side also affect the financing costs.

The reasons behind the high financing costs are multifaceted. First, the debt ratio of the corporate sector was relatively high, while the high debt burden and financing demands reinforced one another. In recent years, China's overall debt ratio, in particular the debts of the non-financial corporate sector, has been rising rapidly. A high leverage ratio and a large amount of financing during the previous period will create ongoing financing needs and push up interest rates. Second, soft budget constraints pushed up the financing rates. Some sectors were not price-sensitive in terms of financing, while inefficient enterprises held massive credit resources, crowding out other real sectors, small and micro enterprises in particular. Partly due to the demand for financing by these sectors that can endure the high costs, commercial banks, wealth management products, and Internet financing can pay high interest rates to their clients, leading to an increase in the liability costs of commercial banks. Third, due to the underdevelopment of equity financing, the corporate sector relies heavily on debt financing. In the years prior to the global financial crisis, equity financing by enterprises on the capital market was relatively large and the debt ratio of the corporate sector on the whole was declining. However, in recent years equity financing has been shrinking. In 2013 financing by enterprises on the domestic stock market totaled a mere 221.9 billion yuan, and the share of debt financing, bank loans in particular, rose significantly. In addition, due to the shortage of supply in financial services and the lack of competition in some areas, ongoing economic structural adjustments, coupled with relatively less resilience of small and micro enterprises and the agricultural sector, rural areas, and farmers, risk premiums increased. In addition, the weak foundation for the social credit system and the unreasonable surcharges also pushed up the costs of corporate financing. The tapering of the unconventional monetary policies in foreign central banks also resulted in spillovers.

In summary, the causes of “financing difficulties and high financing costs” were very complex, including both macro-economic and micro-economic factors and problems in the real and financial sectors. In particular, the high debt ratio and the rising risk premiums were important factors, which, in turn, were related to some institutional issues, such as inadequate equity financing, soft budget constraints of some financing bodies, investment-driven growth patterns, and so forth. To solve the problems of “financing difficulties and high financing costs,” efforts should be made to deepen the reforms in a comprehensive manner and to seek both temporary and permanent solutions. Days ago, the Executive Meeting of the State Council made arrangements to step up financial support and to take a variety of measures to ease the high corporate financing costs. The proposed measures include continuing the sound monetary policy, carrying out structural adjustments, optimizing credit allocations, containing unreasonable growth in the financing costs of financial institutions, shortening the chain of corporate financing, removing unreasonable charges, improving small and micro enterprise loan management by commercial banks, prudently but steadily promoting the development of small and medium-sized financial institutions specializing in providing services to small and micro enterprises, the agricultural sector, rural areas, and farmers, increasing financial services, vigorously supporting the development of direct financing, improving the performance evaluation system of commercial banks, supporting insurance products to facilitate access of small and micro enterprises to credit services, and advancing the market-based interest-rate reform in an orderly manner. In sum, efforts should be made to further promote structural reforms and adjustments, deepen the reform of the financial system, and strengthen financial services and regulations so as to step up financial support to the real economy, increase employment, and improve the people’s livelihood.

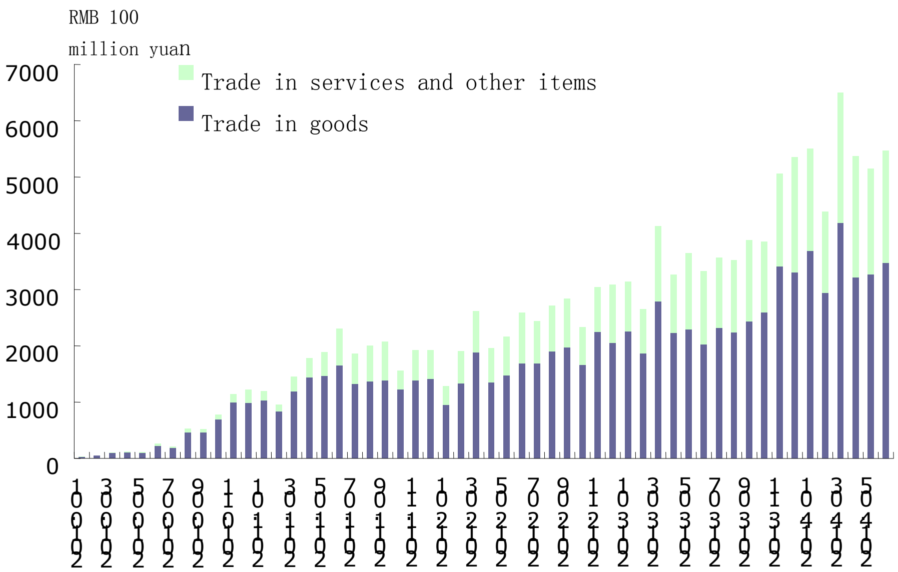
VI. The flexibility of the RMB exchange rate was strengthened considerably

In the first half of 2014, the RMB exchange rate registered a mild depreciation but moved in both directions with much stronger flexibility. At end-June, the central parity of the RMB against the US dollar was 6.1528 yuan per dollar, representing a depreciation of 559 basis points, or 0.91 percent, from end-2013. From the reform of the RMB exchange-rate regime in 2005 to end-June 2014, the RMB registered a cumulative appreciation of 34.52 percent against the US dollar. According to calculations by the BIS, in the first half of 2014 the NEER and REER of the RMB depreciated by 2.82 and 3.97 percent respectively; from the RMB exchange-rate regime reform in 2005 to June 2014, the NEER and REER of the RMB appreciated by 28.33 and 36.51 percent respectively.

VII. Cross-border RMB business maintained steady growth

According to preliminary statistics, in the first half of 2014 commercial banks processed 3.27 trillion yuan of RMB settlements of cross-border trade, up 59 percent year on year. In particular, settlements of trade in goods registered 2.09 trillion yuan and settlements of trade in services and other items under the current account registered 1.18 trillion yuan. Actual RMB receipts and payments in cross-border trade registered 1.23 trillion yuan and 2.04 trillion yuan respectively, resulting in a receipt-payment ratio of 1:1.66. Bank settlements of cross-border RMB direct investments reached 469.88 billion yuan. In particular, outward direct investments settled in RMB totaled 86.49 billion yuan, an increase of 2.94 times from the corresponding period of the last year, and foreign direct investments settled in RMB totaled 383.39 billion yuan, an increase of 1.37 times.

Figure 1 RMB Settlement of Cross-border Trade



Source: People's Bank of China.

Part 2 Monetary Policy Operations

Since the beginning of 2014, the PBC, in accordance with the overall arrangements of the State Council, continued to implement a sound monetary policy. Responding to downward pressures in economic operations and price inflation, the PBC remained focused on macro-economic adjustments and took initiatives as called for. Innovation was made in the approach to macro-economic management on a continuous basis, including diversifying policy instruments and optimizing the policy mix, to target the acute issues in macro-economic operations. Fine-tunings and preemptive adjustments were conducted as appropriate in the form of structural adjustments so as to promote stable and sustainable economic growth.

I. Flexible open market operations were conducted and the balance of SLFs remained at zero

The PBC strengthened its analysis and monitoring of factors influencing the demand and supply of liquidity in the banking system, properly managed the direction, intensity, and pace of open market operations based on the supply and demand for liquidity within each period, and adjusted liquidity in the banking system in a flexible and appropriate manner. In the first quarter, the PBC conducted open market operations in both directions, using a mix of policy instruments, such as open market repo, reverse repo operations, and short-term liquidity operations. In the second quarter, in view of the complex factors influencing the supply and demand for liquidity, the PBC conducted 28-day reverse repo operations for sterilization purposes and dealt with the volatilities in short-term liquidity caused by a number of factors. In the first half of 2014, a total of 525 billion yuan of repo operations was conducted and the volume of reverse repo operations amounted to 2.33 trillion yuan. In the meantime, efforts were made to keep the interest rates of open market operations at generally stable levels to guide market expectations and to promote the stable movement of market interest rates. At end-June, the interest rate of 28-day reverse repo operations was 4 percent.

Given the overall liquidity situation in the money market, in the second quarter the PBC did not conduct Standing Lending Facility (SLF) operations and kept the balance of the SLFs at zero. The interest rates of the SLFs, serving in effect as a ceiling on the money market rates, helped anchor market expectations and keep money market rates at generally stable levels.

State treasury cash management operations were conducted in an appropriate manner. In the first half of 2014, a total of 280 billion yuan of state treasury funds was deposited in commercial banks in six separate operations, including 90 billion yuan in three-month time deposits, 100 billion yuan in six-month time deposits, and 90 billion yuan in nine-month time deposits.

II. Targeted reductions in the deposit reserve requirement ratios on two occasions

To follow the decisions adopted at the Executive Meeting of the State Council, to beef up credit support to the agricultural sector, rural areas, and farmers, and small and micro enterprises, and to enhance the capacity of the financial sector to serve the real economy, in April and June, 2014, the PBC conducted targeted reductions of the deposit reserve requirement ratio (RRR) on two occasions, lowered the RRR of rural commercial banks and rural cooperative banks at the county-level by 2 and 0.5 percentage points respectively, and cut by 0.5 percentage point the RRR of commercial banks (excluding those that were subject to the deposit reserve requirement ratio reduction in April 2014) that have complied with prudential requirements and have reached the required ratios in their lending to the agricultural sector, rural areas, and farmers (agro loans), and lending to small and micro enterprises. In addition, to encourage finance companies, financial leasing companies, and automobile finance companies to play a role in facilitating the efficient use of funds and to boost consumption, their RMB deposit RRR was cut by 0.5 percentage point.

Box 2 Targeted Reductions in the Deposit Reserve Requirement Ratio

To follow the decisions of the State Council's Executive Meeting, to beef up support to the agricultural sector, rural areas, and farmers, and micro and small enterprises, and to enhance the capacity of the financial sector to serve the real sector, the PBC carried out targeted reductions of the deposit reserve requirement ratio on two occasions, i.e., in April and June 2014.

Specifically, in April 2014 the RRRs of county-level rural commercial banks and rural cooperative banks were cut by 200 and 50 basis points respectively, as the two categories of financial institutions had a higher proportion of loans to the agricultural sector, rural areas, and farmers. The targeted RRR reductions in June were mainly applicable to other types of commercial banks that complied with the prudential requirements and had reached the required ratios, either in their lending to the agricultural sector, rural areas, and farmers (agro loans), and to small and micro enterprises, and their RRRs were cut by 50 basis points. Specifically, the ratio of new agro loans to total new loans should be 50 percent or above during the last year and the ratio of outstanding agro loans to total loans should be 30 percent or above at the end of the last year; or the ratio of new loans to small and micro enterprises to total new loans should be 50 percent or above in the last year and the ratio of outstanding small and micro enterprise loans to total loans should be 30 percent or above at the end of the last year. Based on these standards, the targeted reduction in the RRR applied to two-thirds of the city commercial banks, more than 80 percent of the rural commercial banks that are not incorporated at the county-levels, more than 90 percent of the rural cooperative banks that are not incorporated at the county-levels, and several joint-stock banks and foreign-funded banks. The two rounds of targeted reductions in the RRRs covered almost all financial institutions except rural credit cooperatives and village and township banks. Because the rural credit cooperatives and village and township banks had much lower reserve requirement ratios, they were not included in these two rounds of RRR reductions.

Targeted reductions in RRRs played a major role in signaling and guiding the credit structural adjustments. The creation of this positive incentive system facilitated credit structural adjustments and helped beef up financial support to the agricultural sector, rural areas, and farmers, and small and micro enterprises. Given the large and rapidly growing monetary and credit stocks, it is inappropriate to rely on overly expansive policies to address the structural problems. The targeted reductions in the RRRs in June linked the reduction in the RRRs to the evaluation of outstanding loan ratio indicators and the incremental loan ratio indicators, favoring those commercial banks that had a high proportion of loans to the agricultural sector, rural areas, and farmers, and small and micro enterprises during the past year. In the future, evaluations of commercial banks will be conducted regularly to adjust their reserve requirement ratios on an ongoing basis. As a result of this arrangement, a positive incentive mechanism will function as a guide for commercial banks to make good use of incremental loans and to revitalize the credit stock so that the agricultural sector, rural areas, and farmers, and small and micro enterprises will obtain more bank loans even though the aggregate amount of loans does not increase substantially.

Since the outbreak of the global financial crisis, conducting targeted operations to straighten out the monetary policy transmission channel has become a new trend among the central banks of the major economies. For example, the Federal Reserve carried out Operation Twist to straighten out the transmission from short-term interest rates to medium and longer-term interest rates, and the ECB launched the Targeted Long-term Refinancing Operations to guide credit to flow to the real economy. The PBC also actively used monetary policy instruments to support economic structural adjustments. The two targeted reductions in RRRs by the PBC are a reflection of this idea.

Of course, monetary policy focuses on aggregate financial indicators and its role in guiding structural adjustments is supplementary. If structural measures, such as targeted reductions in the RRRs, are implemented for an extended period, this will cause some problems, including compromising the authenticity of data, weakening the role of the market in determining the flow of funds, and even damaging the uniform nature of the reserve requirement ratio. In the medium to long run, to strengthen the indigenous drivers for economic growth, promote structural adjustments, transformation, and upgrading, and optimize credit resources, efforts will be made to deepen the institutional reforms and to allow the market to play a decisive role in resource allocations.

III. Macro-prudential management was strengthened and the dynamic adjustment mechanism of the differentiated reserve requirement continued to play a role in counter-cyclical management

The PBC continued to use the dynamic adjustment mechanism of the differentiated reserve requirement as a way to strengthen macro-prudential management. Based on domestic and global economic and financial developments, the soundness of financial institutions, and implementation of the credit policy, the PBC recalibrated the parameters of the dynamic adjustment mechanisms for the differentiated reserve requirement. During the second quarter, the PBC strengthened the recalibration of the policy parameters relating to implementation of credit policy for small and micro enterprises and agro-linked loans to guide and encourage financial institutions to step up credit support to small and micro enterprises, the agricultural sector, rural areas, and farmers, and under-developed areas in central and western China, and to guide reasonable credit growth.

IV. The role of credit policy lending by the central bank was tapped to ratchet up credit support to the agricultural sector, rural areas, and farmers, and small and micro enterprises

In March 2014, the PBC and six other departments jointly issued the *Guidelines on Improving Financial Services for Poverty Alleviation and Development*. According to the *Guidelines*, the lending rates of agro-supporting central bank loans offered to eligible financial institutions with legal-person status in the poor areas can be one percentage point lower than the prevailing rates of the preferential agro-supporting central bank lending. At end-June 2014, outstanding agro-supporting central bank loans posted 184.2 billion yuan, representing an increase of 23.7 billion yuan year on year. To implement the decisions adopted at the Executive Meeting of the State Council that convened on May 30, the PBC further improved the incentive mechanism for central bank lending to support small and micro enterprises and beefed up central bank lending to local financial institutions with legal-person status to extend loans to small and micro enterprises. At end-June, outstanding small and micro enterprise–supporting central bank loans totaled 26.1 billion yuan. The weighted average rate of loans offered by local financial institutions with legal-person status to small and micro enterprises by using the small and micro enterprise-supporting central bank loans was 2 percentage points lower than the interest rates of loans of same maturity that they extended by using other sources of funds. Overall, the credit policy–supporting central bank lending has produced good results, helped guide financial institutions to increase credit support to small and micro enterprises, the agricultural sector, rural areas, and farmers, and eased financing difficulties and lowered financing costs.

V. Strengthening window guidance and credit policy guidance

The PBC continued to use monetary policy, macro-prudential management policy, and credit policy to send signals and guide structural adjustments, strengthened the coordination of credit policy and industrial policy, and guided the optimization of the credit structure of financial institutions. Financial institutions were encouraged to adopt modern IT applications and management skills, to make innovations in financial products and services, and to improve their performance and evaluation systems. Financial resources were consolidated to support the development of small and micro enterprises. Efforts were made to increase financial support to new types of agricultural entities such as family farms. Consumer finance was further developed and financial services were improved to promote poverty alleviation and economic development. Financial services were enhanced to improve the people's livelihood and to promote balanced regional development. Credit inputs were increased to advanced manufacturing industries with good market outlooks, strategic emerging industries, modern IT industries, and information consumption, labor-intensive industries, the services industry, the transformation and upgrading of traditional industries, industry promoting green and environmental-friendly growth, and so forth. The reasonable funding needs of ongoing key and follow-up projects were guaranteed and efforts were made to support key livelihood projects, such as major infrastructure programs including reconstruction of shanty dwellings and railway construction, to help improve the quality and efficiency of growth. Lending to heavy energy-consuming, highly polluting industries and those burdened with overcapacity was strictly controlled. For enterprises that wanted to consolidate their excess capacity, targeted credit support was provided to support mergers and acquisitions and to address their overcapacity problems. The pilot program of credit asset securitization was expanded to help financial institutions better manage the stock of their credit assets. Evaluations of the effectiveness of credit policy guidance were improved to enhance the role of evaluations in guiding loan underwriting.

In terms of the effectiveness of the credit policy, changes in the credit structure supported the economic structural adjustments, transformation, and upgrading. At end-June, outstanding RMB loans to small and micro enterprises of financial institutions grew 15.7 percent year on year, outpacing the growth of loans to large and medium enterprises by 5.6 and 2.3 percentage points respectively; outstanding RMB and foreign currency–denominated agro-linked loans increased 16.6 percent year on year, outpacing the growth of total loans by 2.9 percentage points. At end-June, outstanding long- and medium-term loans to the services industry grew 13.1 percent year on year, an acceleration of 1.7 percentage points from the end of March. In particular, outstanding loans to the cultural, sports, and recreational industries grew 35.9 percent year on year, whereas those to the wholesale and retail industries grew 30.1 percent year on year.

VI. Further improvements in the RMB exchange-rate regime

The RMB exchange-rate regime reform was further improved in a self-initiated, controllable, and gradual manner. Focusing on the role of market supply and demand and with reference to a basket of currencies, the flexibility of the RMB exchange rate was enhanced and the RMB exchange rate was kept basically stable at an adaptive and equilibrium level. In the first half of the year, the central parity of the RMB against the US dollar peaked at 6.0930 yuan per dollar and reached a trough of 6.1710 yuan per dollar. It appreciated on 51 out of the 119 trading days and depreciated on the remaining 68 trading days, with the largest day-to-day appreciation at 0.22 percent (or 138 points) and the sharpest day-to-day depreciation at 0.18 percent (or 111 points).

The RMB exchange rate moved in both directions against the euro, the Japanese yen, and other major currencies. At end-June, the central parity of the RMB against the euro and the Japanese yen registered 8.3946 yuan per euro and 6.0815 yuan per 100 yen, representing an appreciation of 0.29 percent and a depreciation of 5.01 percent respectively from the end of 2013. Beginning from the reform of the RMB exchange-rate regime reform in 2005 to end-June 2014, on a cumulative basis the RMB has appreciated 19.29 percent and 20.13 percent against the euro and the Japanese yen respectively.

In the second quarter, supply and demand of foreign exchange on the market were generally balanced. Against the backdrop of more fluctuations in the RMB exchange rate in two directions, economic entities were less willing to sell their foreign exchange to banks and had more incentives to hold their foreign exchange. As a result, foreign exchange deposits increased considerably. If trade receipts, payments, and the trade surplus increase further in the future, sales of foreign exchange to banks are likely to accelerate, while the foreign exchange market may face oversupply pressures.

To facilitate bilateral trade and investment between China and the United Kingdom, on June 19, 2014, direct trading between the RMB and the pound sterling (GBP) was launched on China’s inter-bank foreign exchange market and London’s foreign exchange market. Since the launch of direct trading, quotes and trading between the RMB and GBP have been brisk, with enhanced liquidity and narrowed trading spreads.

The direct trading has helped lower the currency conversion costs for economic entities and has facilitated the use of RMB and GBP in bilateral trade and investment.

Table 5 Trading Volume of the RMB against Other Currencies on the Inter-bank Foreign Exchange Spot Market in the First Half of 2014

Unit: 100 million yuan

Currency	USD	Euro	Japanese Yen	HKD	GBP	Australian Dollar	New Zealand Dollar	Canadian Dollar	Malaysian Ringgit	Russian Ruble	Thai Baht
Trading volume	122,018.72	1,103.98	2,517.49	821.53	257.68	806.01	118.42	2.19	4.27	62.45	0.47

Source: China Foreign Exchange Trade System.

In the first half of 2014, based on the bilateral local currency swap agreements with the PBC, overseas monetary authorities conducted a total of 511 billion yuan of currency swap transactions with the PBC. These transactions played an active role in promoting bilateral trade and investment. In the second quarter, for the first time the PBC used 400 million won (equivalent to 2.4 million yuan) under the China-ROK bilateral currency swap arrangement to support trade financing for the corporate sector. This was also the first time for the PBC to use foreign currency funds under the bilateral currency swap agreements.

VII. Deepening the reform of financial institutions

Development finance played a greater role in the renovations of shanty dwellings. On April 2, the 43rd Executive Meeting of the State Council made arrangements for the development finance sector to beef up support to renovations of shanty dwellings. It was emphasized at the meeting that funding for renovations of shanty dwellings should be guaranteed and efforts should be made to combine policy support and market mechanisms and to make full use of the development finance sector, which relies on the creditworthiness of the state, serves national strategies, and produces modest profits, so as to provide convenient, cost-effective, and stable funding that complies with the regulatory requirements for renovations of shanty dwellings.

The reform of the rural credit cooperatives (RCCs) produced remarkable results. The performance and financial condition of the RCCs improved steadily, and the RCCs continued to play a dominant role in providing rural financial services. Based on the five-category loan classifications, as of the end of June 2014, outstanding NPLs and the NPL ratio of the RCCs were 380.9 billion yuan and 3.8 percent respectively, with the NPL ratio 0.3 percentage point lower than that at the end of 2013; the capital adequacy ratio of the RCCs was 10.5 percent, up 0.1 percentage point from the end of

2013. Outstanding agro-linked loans and loans to farmers posted 6.7 trillion yuan and 3.3 trillion yuan respectively, an increase of 8.4 percent and 9 percent from the end of 2013. The reform of the property rights of the RCCs was pushed ahead. The structure of the property rights of the RCCs was optimized on a continuous basis, and investment equity accounted for more than 90 percent of total equity. The property rights of the RCCs were diversified. At end-June, there were 529 rural commercial banks, 113 rural cooperative banks, and 1,637 RCCs with legal-person status at the county (city) level. The corporate governance structure of the RCCs, comprised of a shareholders' representative assembly, a board of trustees (directors), a board of supervisors, and senior management, was put in place throughout the country and internal management was strengthened.

VIII. Deepening the reform of foreign exchange administration

Measures were taken to promote trade facilitation. First, the reform of foreign exchange administration under the trade account was deepened. Reform of foreign exchange administration under trade in goods and services was deepened, rules for the administration of cross-border trade were improved, and agency receipts for export payments in foreign currency and foreign currency cash settlements of border trade were regulated and facilitated.

Second, the pilot program of foreign exchange payments for cross-border e-commerce through payment institutions was expanded so as to facilitate foreign currency–denominated payments and receipts for online purchases and subsequent sales and purchases of foreign exchange by domestic institutions and individuals. Third, a pilot program was launched in Zhejiang and Fujian provinces to streamline the procedures for examinations and approvals of foreign exchange receipts and sales in trade activities of individuals so as to facilitate foreign trade businesses operated by individuals.

RMB convertibility under the capital account was steadily promoted. First, the pilot program of centralized operations and management of foreign exchange funds by multinationals (MNCs) was further expanded. MNCs were allowed to conduct centralized management and netting settlements of their domestic and overseas foreign exchange, to sell foreign exchange capital funds at their own discretion, and to share the quota of foreign debt among their domestic and overseas units so as to reduce their financial costs. Second, efforts were made to promote facilitation of investments. Regulations regarding upfront cost reviews and approvals of outward investments and overseas lending by domestic enterprises to their overseas affiliates and subsidiaries were relaxed, and procedures for the repatriation of profits were simplified. Third, the qualified institutional investor scheme was steadily advanced. As of the end of June 2014, an investment quota of USD56.548 billion was approved under the QFII scheme, an investment quota of 250.3 billion yuan was approved under the RQFII scheme, and an investment quota of USD80.496 billion was approved under the QDII scheme. Fourth, management of external debts was improved. Management of cross-border guarantees was further simplified. Limits on the amount of overseas lending with domestic guarantees, as well as prior reviews and approvals and qualification requirements, were all abolished; foreign exchange administration for the conversion of proceeds of external borrowings into loans was simplified, and the business procedures for payment of principal and interest were delegated to banks. Five, foreign exchange policies in the China (Shanghai) Pilot Free Trade Zone were implemented, and it was clearly stated that a number of innovative measures in the administration of foreign exchange can be adopted to explore RMB convertibility under the capital account.

The monitoring and management system for cross-border payments and receipts was strengthened. First, the monitoring of cross-border capital inflows and outflows was further strengthened. Indicators and projection models were established to strengthen analysis of the factors influencing cross-border capital flows. Second, system building was optimized and foreign exchange regulatory information and data sharing were enhanced, laying a solid foundation for strengthening the capacity to supervise entities with legal-person status, ex-post monitoring and analysis, and off-site supervision. Third, efforts were made to crack down on illegal and criminal activities in the field of foreign exchange and special inspections were conducted on false transit trade and forward settlements of foreign exchange. In the first half of 2014, a total of 684 illegal cases was investigated and handled, with the amount of administrative fines posting 129 million yuan.

Part 3 Financial Market Analysis

In the first half of 2014 China's financial market performed in a stable manner. Growth in the volume of transactions on the money market rebounded and market rates declined slightly; bond market indices generally rose, and the volume of bond issuances expanded; and financing on the equity market increased somewhat.

I. Financial Market Analysis

1. Growth of transactions on the money market rebounded, while market rates declined slightly

Growth in the volume of bond repos rebounded significantly while inter-bank borrowings declined by a smaller margin. During the first half of the year, the turnover of bond repos totaled 94.3 trillion yuan, with an average daily turnover of 773.2 billion yuan, an increase of 18.6 percent year on year and an acceleration of 15.9 percentage points from the first quarter. The turnover of inter-bank borrowings reached 17.8 trillion yuan, with an average daily turnover of 145.8 billion yuan and down 13.6 percent year on year. This decline was 17 percentage points lower than that during the first quarter. In terms of the maturity structure, overnight products still dominated bond repo and inter-bank borrowing transactions, accounting for 80.6 percent and 82.7 percent of their respective turnovers during the first half of 2014, up 2.6 and 3.8 percentage points from the first quarter. The turnover of government securities repos on the stock exchanges rose 51.2 percent year on year to 40 trillion yuan, with growth 11 percentage points lower than that during the first quarter.

The flow of funds among financial institutions exhibited the following characteristics: First, large banks remained net fund providers, and the amount of their lending registered larger year-on-year growth. In the first half of the year, the amount of net lending by large banks increased 29.3 percent year on year. Second, securities and fund management companies, small- and medium-sized banks, and insurance companies were net fund borrowers. In particular, net financing of securities and fund management companies increased 67.6 percent year on year, higher than the 29.6 percent growth of small- and medium-sized banks. Third, net borrowing of other financial institutions and products registered a decline of 16.9 percent year on year.

Table 6 Fund Flows among Financial Institutions in the First Half of 2014

Unit: 100 million yuan

	Repo		Inter-bank Lending	
	In the first half of 2014	In the first half of 2013	In the first half of 2014	In the first half of 2013
Domestically-funded large banks①	-302,248	-231,822	-29,964	-25,048
Domestically-funded small- and medium-sized banks ②	92,232	71,558	-20,921	-16,551
Securities and fund management companies	124,114	73,112	36,580	22,751
Insurance companies	38,370	29,045	99	—
Foreign-funded financial institutions	9,195	8,307	-1,049	4,159
Other financial institutions and vehicles ③	38,337	49,800	15,256	14,690

Notes: ①Domestically-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.
②Domestically-funded small- and medium-sized banks include the China Merchants Bank and sixteen other medium-sized banks, small-sized city commercial banks, rural commercial banks, rural cooperative banks, and village and township banks.
③Other 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. Some of these financial institutions and vehicles do not participate in the inter-bank funding market.

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

Source: China Foreign Exchange Trade System.

Transactions of RMB interest-rate swaps became more brisk. In the first half of the year, the aggregate notional principal of RMB interest-rate swaps amounted to 1698.29 billion yuan, an increase of 10.7 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 1353.54 billion yuan, accounting for 79.7 percent of the total. In terms of the reference rate, the base rate of the floating end of the RMB exchange-rate swaps mainly included the 7-day fixing repo rate and the Shibor, and their notional principals accounted for 78.5 percent and 20.5 percent of the total respectively.

Table 7 Transactions of Interest-rate Derivatives in the First Half of 2014

	Interest-rate swaps		Bond forwards		Forward-rate agreements	
	Transactions (lots)	Amount of notional principal (100 million yuan)	Transactions (lots)	Amount of notional principal (100 million yuan)	Transactions (lots)	Amount of notional principal (100 million yuan)
In the first half of 2013	12,540	15,335.7	1	1.0	—	—
In the first half of 2014	18,180	16,982.9	—	—	—	—

Source: China Foreign Exchange Trade System.

The issuance of inter-bank CDs continued steadily. Since the launch of inter-bank CDs in December 2013, the scope of issuers has expanded in an orderly manner and the number of investors has increased gradually. As of end-June 2014, 20 financial institutions had issued inter-bank CDs, with the investors including commercial banks, securities firms, trust and investment companies, finance companies, and other financial institutions. Meanwhile, issuances on the primary market were increasingly brisk, while trading on the secondary market was on the rise. In the first half of 2014, a total of 93 CDs was issued, with an aggregate amount of 136.87 billion yuan, while the transaction volume on the secondary market amounted to 89.87 billion yuan. The steady advance in the issuance and trading of inter-bank CDs played a role in regulating inter-bank business, helped improve pricing transparency, and provided a basis for quoting medium- and long-end Shibor rates. In addition, the development of the inter-bank CDs market coincided with an improved benchmarking role of the medium- and long-end Shibor rates.

On the whole, money-market rates declined. In June, the weighted average interest rate of inter-bank borrowings and bond-pledged repos posted 2.85 percent and 2.89

percent respectively, down 131 and 139 basis points from December 2013 and down 372 and 393 basis points from the corresponding period of the last year. At end-June, overnight and 7-day Shibor rates posted 2.91 percent and 3.87 percent respectively, down 24 and 138 basis points from the beginning of the year; 3-month and 1-year Shibor rates were 4.75 percent and 5.00 percent, down 81 and up 4 basis points.

2. Bond market indices generally rose and bond issuances expanded rapidly

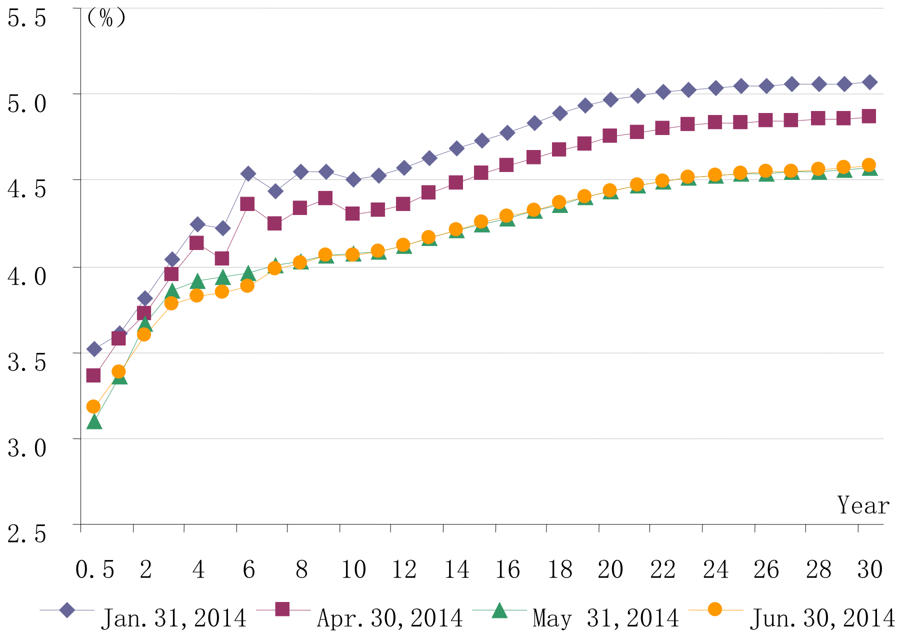
The year-on-year decline in the turnover of spot bond transactions on the inter-bank market moderated. In the first half of the year, a total of 17.5 trillion yuan of bonds was traded, with a daily average of 143.7 billion yuan, down 45.8 percent year on year and with the decline narrowing by 21.5 percentage points from the first quarter. In terms of the trading entities, Chinese-funded large banks, previously net purchasers, became net sellers. In the first half of the year, net bond selling by Chinese-funded large banks and small- and medium-sized banks amounted to 36.2 billion yuan and 535.2 billion yuan respectively, while other financial institutions and foreign-funded financial institutions, as net bond purchasers, recorded net bond purchases of 326.1 billion yuan and 237.7 billion yuan respectively. In terms of the trading products, the turnover of spot government securities was 3.43 trillion yuan, accounting for 19.5 percent of the total spot transactions on the inter-bank market, up 5.6 percentage points from the first quarter; the turnovers of spot financial bonds and spot corporate debenture bonds were 7.29 trillion yuan and 6.74 trillion yuan respectively, accounting for 41.6 percent and 38.4 percent of the total. In the first half of the year, a total of 1.08 trillion yuan of spot government securities was traded on the stock exchanges, up 32.8 percent year on year.

Bond indices moved up. The China Bond Composite Index (net price) rose from 96.03 points in early January to 99.48 points at end-June, up 3.59 percent, whereas the China Bond Composite Index (full price) rose from 107.44 points in early January to 111.84 points at end-June, up 4.10 percent. The Government Securities Index on the stock exchanges rose from 139.62 points in early January to 142.02 points at end-June, up 1.71 percent.

The yield curves of government securities on the inter-bank market showed a notable downward trend. At end-June, the average yield of 1-year, 3-year, and 5-year government securities was 23, 26, and 38 basis points respectively, lower than that in early January, while the decline of 7-year or above government securities was about 50 basis points.

The volume of bond issuances expanded significantly year on year. During the first half of the year, a total of 5.38 trillion yuan of bonds (including central bank bills) was issued, representing growth of 1.13 trillion yuan year on year. In particular, the issuance of financial bonds and corporate debenture bonds registered a larger year-on-year increase. Among the corporate debenture bonds, the issuance of debt-financing instruments by the non-financial corporate sector and enterprise bonds continued to expand. At end-June, outstanding bonds posted 32.5 trillion yuan, an increase of 14.6 percent year on year.

Figure 2 Yield Curve of Government Securities on the Inter-bank Bond Market



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

Table 8 Issuance of Major Bonds in the First Half of 2014

Type of bonds	Issuance(100 million yuan)	Year-on-year growth(100 million)
Government securities①	8,720	10
Central bank bills	0	-1,140
Financial bonds②	18,243	6,344
Of which: Bonds issued by the China Development Bank and policy financial bonds	13,525	3,896
Corporate debenture bonds③	26,869	6,074
Of which: Debt-financing instruments of non-financial enterprises	21,197	5,489
Enterprise bonds	5,197	2,075
Corporate bonds	355	-1,270
Total	53,832	11,287

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

②Including 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.
③Including debt-financing instruments issued by non-financial enterprises, enterprise bonds, corporate bonds, convertible bonds, bonds with detachable warrants, privately placed SME bonds, and so forth.
Sources: People's Bank of China, National Development and Reform Commission, China Securities Regulatory Commission, and China Government Securities Depository Trust and Clearing Co., Ltd.

Bond issuance rates declined. The interest rate of 10-year government bonds issued in June 2014 was 4 percent, down 8 basis points from that of the same maturity issued in November 2013. The interest rate of 10-year bonds issued by the China Development Bank in June 2014 was 4.9 percent, down 14 basis points from that of the same maturity issued in December 2014. The interest rates of short-term financing bills (rated A-1) issued by AA-rated enterprises in June were between 4.7 percent and 5.4 percent, lower than the range of 6.25 percent and 6.8 percent in December 2013; the interest rate of 7-year bonds (rated AAA) issued by AA-rated enterprises was 6.5 percent, lower than the 7.9 percent to 8 percent range in December 2013. The Shibor played a greater role in bond pricing. All 368 fixed-rate enterprise bonds issued in the first half of 2014 were based on the Shibor, with a gross issuance volume of 439.2 billion yuan; a total of 577.3 billion yuan of fixed-rate short-term financing bills was issued based on the Shibor, accounting for 98 percent of the total.

3. The volume of bill financing increased slightly and bill-financing rates showed a downward trend

The bill acceptance business grew steadily. In the first half of 2014, commercial bills issued by enterprises totaled 11.0 trillion yuan, up 2.5 percent year on year; outstanding commercial bills posted 10.2 trillion yuan at end-June, up 11.4 percent year on year. At the end of June, the outstanding balance of bankers' acceptances had increased by 1.2 trillion yuan from the beginning of the year. In terms of the issuing entities, bankers' acceptance bills were mainly issued by enterprises in the manufacturing, wholesale, and retail industries, with small- and medium-sized enterprises issuing about two-thirds of the total. The steady growth of bill acceptances provided greater support to the real sector, in particular to small- and medium-sized enterprises.

The outstanding volume of bill financing rose slightly, and the bill-financing rates revealed a downward trend. In the first half of 2014, financial institutions discounted 25.6 trillion yuan of commercial bills on a cumulative basis, representing year-on-year growth of 14.7 percent; at end-June the outstanding balance of discounted bills posted 2.2 trillion yuan, representing a decline of 5.4 percent year on year. In the second quarter, financial institutions adjusted the structure of assets and liabilities and properly increased the amount of bill financing. As a result, the outstanding balance of bill financing at end-June increased by 243.3 billion yuan from the beginning of the year, representing a deceleration of 36 billion yuan year on year, accounting for 2.84 percent of total loans and down 0.58 percentage point year on year. Interest rates on the bill market fluctuated within a small margin and generally showed a downward trend.

4. Financing on the equity market increased somewhat

The Growth Enterprise Board Index rallied. At end-June, the Shanghai Stock Exchange Composite Index closed at 2,048 points, shedding 68 points from the end of 2013, or down 3.2 percent; the Shenzhen Stock Exchange Component Index closed at 1,097 points, gaining 39 points from the end of 2013, or up 3.7 percent; the Growth Enterprise Board (GEB) Index (Chinext Price Index) closed at 1,405 points, gaining 101 points from the end of 2013, or up 7.7 percent. The weighted average P/E ratio on the A-share market of the Shanghai Stock Exchange declined from 11.0 times at end-2013 to 9.8 times at end-June 2014, while that of the Shenzhen Stock Exchange moved from 28 times to 26.2 times.

Trading volume on the stock markets increased slightly year on year. In the first half of 2014, turnover on the Shanghai and Shenzhen stock exchanges totaled 21.7 trillion yuan, up 2.4 percent year on year, and the daily turnover averaged 182 billion yuan. Among this total, the volume of transactions on the GEB amounted to 3.3 trillion yuan, up 73.7 percent year on year. At end-June, the combined market capitalization of the Shanghai and Shenzhen exchanges posted 20.3 trillion yuan, up 1.7 percent from end-2013; market capitalization on the GEB amounted to 1.1 trillion yuan, a hike of 33.1 percent from end-2013.

The amount of equity financing increased year on year. In the first half of 2014, a total of 256.5 billion yuan was raised by enterprises and financial institutions on domestic and overseas stock markets by way of IPOs, additional offerings, rights issuances, and warrant exercises, representing an increase of 60.1 billion yuan year on year. Among this total, 221.3 billion yuan was raised on the A-share market, 68.9 billion yuan more than that raised during the same period of the last year.

5. Growth of investment-linked assets in the insurance industry accelerated

In the first half of 2014, total premium income in the insurance industry amounted to 1.15 trillion yuan, representing year-on-year growth of 20.8 percent, an acceleration of 9.3 percentage points from the corresponding period of the last year; total claim and benefit payments amounted to 353.2 billion yuan, representing year-on-year growth of 19.2 percent. Specifically, total claim and benefit payments in the property-insurance sector increased 14.6 percent, while that in the life-insurance sector increased 23.8 percent.

Growth of insurance assets gained traction and that of investment-linked assets accelerated. At end-June, total assets in the insurance industry posted 9.37 trillion yuan, representing year-on-year growth of 18.9 percent and an acceleration of 2.5 percentage points from the corresponding period of the last year. Among this total, banks deposits increased 9.5 percent year on year, while investment-linked assets increased 22 percent.

Table 9 Use of Insurance Funds, End-June 2014

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-June 2014	End-June 2013	End-June 2014	End-June 2013
Total assets	93,737	78,840	100	100
Of which: Bank deposits	25,618	23,405	27.3	29.7
Investments	60,288	49,424	64.3	62.7

Source: China Insurance Regulatory Commission.

6. Swap and forward transactions on the foreign exchange market maintained rapid growth

In the first half of 2014, the turnover of RMB/foreign exchange spot transactions totaled USD2.07 trillion, representing an increase of 8.7 percent year on year and a deceleration of 12.7 percentage points from the end of 2013. The turnover of RMB/foreign exchange swap transactions totaled USD2.04 trillion, representing an increase of 35.1 percent year on year. Among this total, overnight USD swap transactions amounted to USD1.01 trillion, accounting for 49.5 percent of the total; the turnover on the RMB/foreign exchange forward market totaled USD25.9 billion, representing an increase of 258.4 percent year on year. The turnover of foreign currency pair transactions amounted to USD28.5 billion, a decline of 16.1 percent year on year. In particular, the Euro/USD accounted for the bulk, or 43.4 percent of the total.

The number of participants on the foreign exchange market increased further. At end-June, there were 429 members on the foreign exchange spot market, 92 members on the foreign exchange forward market, 91 members on the foreign exchange swap market, 81 members on the currency swap market, and 35 members on the foreign exchange options market. In addition, there were 31 market-makers on the spot market and 27 market-makers on the forward and swap markets.

7. The gold market as a whole showed a slight rally

In the first half of 2014, the price of gold on the international market reached a peak of USD1,385 per ounce and a trough of USD1,221 per ounce, and it closed at USD1,315 per ounce at end-June, a rise of USD113.50 or 9.45 percent from the end of the last year. The movement in the price of domestic gold kept pace with that on the international market. The highest price (AU9999) on the Shanghai Gold Exchange was 273.60 yuan per gram and the lowest price was 238.85 yuan per gram. At end-June, the price of gold on the domestic market closed at 261.86 yuan per gram, a rise of 25.40 yuan, or 10.74 percent, from the end of the last year. In the first half of 2014, the weighted price averaged 256.92 yuan per gram.

The volume of transactions on the Shanghai Gold Exchange declined somewhat. In the first half of 2014, the turnover of all sorts of precious metals on the Shanghai Gold Exchange amounted to 2.4 trillion yuan, down 7.5 percent year on year. Specifically, the trading volume of gold was 6,579.1 tons, an increase of 21.6 percent year on year, and its turnover posted 1.7 trillion yuan, an increase of 5.0 percent year on year. The trading volume of silver was 155,000 tons, a decline of 13.8 percent year on year, and its turnover posted 644.25 billion yuan, a decline of 29.2 percent year on year. The trading volume of platinum was 32.6 tons, a decline of 23.4 percent year on year, and its turnover posted 9.74 billion yuan, a decline of 27.3 percent year on year.

II. Institutional building in the financial market

1. Promoting the sound development of the inter-bank bond market

The pricing mechanism for bond issuances on the inter-bank market was improved. The threshold requirement for non-financial enterprise issuers to use the tender system was adjusted so as to provide institutional support to non-financial enterprises to tap into the tender system to issue bonds. Financing channels for non-banking financial institutions, such as consumer finance companies, were broadened, and the preconditions for financial leasing companies and automobile finance companies to issue financial bonds were adjusted. After coverage of the bond business on commercial bank counters expanded from book-entry government bonds to other bonds, such as financial bonds issued by the China Development Bank, policy financial bonds, and bonds issued by the China Railway Cooperation and other government-backed agencies, bonds issued by the China Development Bank and the Export and Import Bank of China were distributed through commercial bank counters for the first time. This was a meaningful trial to meet the diverse investment needs of households by making use of formal financial channels.

2. Improving institutional arrangements in the securities market

The institutional building of a multi-tier capital market has made significant progress.

On May 9, the State Council issued *Several Opinions on Further Promoting the Healthy Development of the Capital Market* (State Council Document [2014] No.17), laying out the next step in the development of the capital market in terms of developing a multi-tier stock market, regulating and developing the bond market, fostering the private equity market, promoting the development of the futures market, increasing the competiveness of the securities and futures industry, increasing the opening-up of the capital market, preventing and resolving financial risks, and creating a favorable environment for capital market development. This will help accelerate the development of a modern market system, expand the investment and financing channels for the corporate and household sectors, optimize the allocation of resources, and promote the transformation and upgrading of the economic structure.

The Shanghai–Hong Kong Exchanges Connectivity Mechanism (SHSECM) proceeded steadily. On June 13, the CSRC issued *Several Guidelines on the Pilot Program of the Shanghai–Hong Kong Exchanges Connectivity Mechanism*, defining the major requirements for mainland securities companies to conduct connectivity business, specifying the coverage of connectivity business, the share of foreign ownership, the clearing and squaring methods, the settlement currencies, and other relevant issues, and stipulating the requirements for investor protection, supervision, management, and data storage.

The market-making system of the new third board was formally launched. On June 5, the *Interim Administrative Rules on the Market-making Business of the National SMEs Equity Transfer System* were issued. According to the *Rules*, securities companies that apply to carry out market-making business shall satisfy the following five requirements, i.e., meeting the qualifications to conduct proprietary securities trading, to set up a special department for the market-making business, to have the necessary personnel, to establish a market-making management system, and to have a specialized technical system for the market-making business.

3. Improving institutional arrangements in the insurance market

The reform of market access and exit mechanisms for insurance institutions continued. To regulate acquisitions and mergers of insurance companies, the CIRC made provisions for the acquiring entities, procedures, corporate governance, information disclosures, and penalties for insurance companies, and provided for a takeover transitional period and an equity lock-in period so as to protect the legitimate rights and interests of consumers, insurance companies, and shareholders. Restrictions on the funding sources and the shareholders' qualifications were relaxed and takeovers of insurance companies by another insurer were no longer prohibited. All sorts of high-quality capital from home and abroad were encouraged to invest in the insurance sector, especially private capital, so as to optimize the allocation of resources on the insurance market.

The insurance industry was encouraged to participate in the new urbanization process. On March 25, the CIRC issued the *Guidelines on the Insurance Industry to Serve the New Urbanization Process*. According to the *Guidelines*, the role of the insurance sector in providing funding and maintaining social security will be brought into full play, and innovations in insurance products and services, market participants, and insurance regulation and supervision will be accelerated. Efforts will be made to encourage the insurance industry to serve the new type of urbanization process in six respects, i.e., developing commercial pension insurance and medical and health insurance in a comprehensive way, making innovations in the use of insurance funds, improving the agricultural insurance service system, and so forth.

Supervision of the use of insurance funds was strengthened. Supervision of investments in collective trust schemes by insurance companies was further strengthened. Insurance funds are prohibited from investing in a single trust scheme and are not allowed to invest in trust schemes whose underlying assets are in industries or sectors banned by the state. The regulatory agency will evaluate and score internal controls and compliance in the use of funds by insurance companies on an annual basis and will divide insurance companies into four grades. For insurance companies that fall into the lower two grades, the CIRC will include them on the regulatory focus list and take measures to limit their scope and share in the use of insurance funds.

A pilot scheme of reverse mortgage endowment insurance business was carried out. Within two years starting from July 1, 2014, a pilot scheme of reverse mortgage endowment insurance business will be launched in Beijing, Shanghai, Guangzhou, and Wuhan for elderly people over the age of 60 who own independent homes.

4. Promoting development of the foreign exchange and gold markets

The foreign exchange market developed further. Instruments on the foreign exchange market were enriched. Banks were allowed to conduct foreign exchange options and related portfolio business with their clients based on actual demand to meet the hedging needs of enterprises. Market access was streamlined and the threshold of access to the foreign exchange options market was lowered. Administrative powers were delegated to lower levels and management of market access of the banks' branch offices was simplified. The institutional infrastructure of the foreign exchange market was improved and the foreign exchange options business of currency brokerage companies was launched.

Institutional arrangements for the gold market were improved. Rules were made for gold lending business on the Shanghai Gold Exchange and development of gold leasing business was promoted. Rules on OTC gold trading and trading by commercial banks on behalf of clients were improved to prevent risks. A market-making system of OTC gold trading was established on a trial basis to promote the price discovery on the OTC gold market and to increase the liquidity of the OTC gold trading.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

The global economy continued to recover at a moderate pace. The U.S. economy accelerated again, but the momentum for recovery still required strengthening. The euro area continued its weak recovery, and faced pressures of sustained low inflation. The pace of recovery in the Japanese economy accelerated, but the medium to long-term outlook remained to be seen. Capital inflows to the emerging market economies increased to some extent, but some emerging market economies still faced downward pressures.

1. Economic development in the major economies

The U.S. economy accelerated again. As the impact of the severe weather gradually diminished, industrial activities and fixed-asset investments picked up and consumer spending rose moderately. The GDP growth rate (quarter-on-quarter and annualized) in the second quarter was 4.0 percent. Expansion of the manufacturing and service sector gained speed, and the PMI indicators of the manufacturing and non-manufacturing sectors in June, released by the Institute for Supply Management (ISM), reached 55.3 and 56.0 respectively. The labor market continued to improve, with the unemployment rate in June dropping to 6.1 percent, the lowest level since August 2008. However, some structural problems still remained. U.S. fiscal conditions changed for the better. As of the end of June, the fiscal deficit of the federal government in FY2014 was USD365.9 billion, USD144.0 billion less than that during the same period of the last year.

The euro area continued its weak recovery. The GDP growth rate (quarter-on-quarter and annualized) during the first quarter was 0.8 percent, the fourth consecutive positive quarterly growth. In June, the comprehensive PMI registered 52.8, exceeding the 50-point threshold for twelve successive months. The economies of the periphery countries improved, and government bond yields in these economies continued to decline. On May 17, Portugal, after the exit of Ireland, also exited the aid program provided by the troika. But aggregate demand recovered slowly, with inflation at a low level and the unemployment rate relatively high. The Harmonized Index of Consumer Prices (HICP) in June was up by 0.5 percent year on year, far below the 2 percent inflation target of the European Central Bank (ECB). The unemployment rate in May was 11.6 percent.

The Japanese economy recovered at an accelerated pace, but the medium- to long-term prospects were still unclear. Due to the increased consumption ahead of the consumption tax hike and the expansion of private investment, the GDP growth rate (quarter-on-quarter and annualized) during the first quarter reached 6.7 percent, the highest in the past two and one-half years. Deflation eased substantially, with the core CPI exceeding 3 percent in the three months of the second quarter, reaching 3.4 percent in May, a record high over the past 32 years. However, the higher consumption tax enforced since April 1 weighed down on the growth in the second quarter. In April and May, retail sales contracted by 4.3 percent and 0.4 percent respectively year on year. In June, the PMI for the manufacturing sector rebounded to 51.5, while the PMI for the service sector was still at the low level of 49.0. In June, the trade deficit registered at 822.0 billion yen, marking twenty-four successive months of a trade deficit.

Table 10 Macroeconomic and Financial Indices of the Major Economies

Country	Index	2013Q2			2013Q3			2013Q4			2014Q1			2014Q2		
		Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.
United States	Real GDP growth rate (annualized quarterly rate, %)	1.8			4.5			3.5			-2.1			4.0 (advance estimate)		
	Unemployment rate (%)	7.5	7.5	7.5	7.3	7.2	7.2	7.2	7.0	6.7	6.6	6.7	6.7	6.3	6.3	6.1
	CPI (YOY, %)	1.1	1.4	1.8	2.0	1.5	1.2	1.0	1.2	1.5	1.6	1.1	1.5	2.0	2.1	2.1
	DJ Industrial Average (closing number)	14840	15116	14910	15500	14810	15192	15237	16086	16577	15699	16322	16458	16581	16717	16827
Euro Area	Real GDP growth rate (annualized quarterly rate, %)	1.3			0.4			1.2			0.8			…		
	Unemployment rate (%)	12.0	12.0	12.0	12.0	12.0	12.0	11.9	11.9	11.8	11.8	11.7	11.7	11.6	11.6	…
	HICP (YOY, %)	1.2	1.4	1.6	1.6	1.3	1.1	0.7	0.9	0.8	0.8	0.7	0.5	0.7	0.5	0.5
	EURO STOXX 50 (closing number)	2725	2662	2605	2699	2671	2789	2774	2901	2919	2853	2968	2916	2978	3033	3014

Japan	Real GDP growth rate (annualized quarterly rate, %)	2.9			1.3			0.3			6.7			…		
	Unemployment rate (%)	4.1	4.1	3.9	3.9	4.1	4.0	4.0	3.9	3.7	3.7	3.6	3.6	3.6	3.5	3.7
	Core CPI (YOY, %)	-0.4	0.0	0.4	0.7	0.8	0.7	0.9	1.2	1.3	1.3	1.3	1.3	3.2	3.4	3.3
	Nikkei 225 (closing number)	13861	13775	13677	13668	13389	14456	14328	15662	16291	14915	14841	14828	14304	14632	15162

Source: Statistical bureaus and central banks of the relevant economies.

To some extent, capital inflows to the emerging market economies increased, but some emerging market economies still faced significant downward pressures. Due to the strengthened expectations of continued low interest-rate policies in the advanced economies, capital inflows to the emerging market economies increased to some extent in the second quarter and financial markets were generally stable. According to estimates by the Institute of International Finance (IIF), net inflows to the stock and bond markets of the emerging market economies were USD43.4 billion in May, representing a record high since September 2012 and they reached USD37.1 billion in June. However, the economic recovery in the advanced economies did not significantly boost external demand in the emerging market economies and some emerging market economies still faced downward pressures as domestic structural problems could not be resolved in the short term, monetary policy faced the dilemma of being caught between a slowdown in growth and relatively high inflation, and financial risks accumulated due to the relatively rapid rise in leverage during the earlier stage.

2. Developments in global financial markets

Financial markets continued to post gains in the United States and the other major advanced economies. The financial markets of the emerging market economies were generally stable, with government bond yields declining and stock indices rallying in most economies.

The euro depreciated slightly against the US dollar, while the pound sterling and yen appreciated slightly against the US dollar. The currencies of most emerging market economies were stable against the US dollar. On June 30, the euro closed at 1.37 dollar per euro, down 0.6 percent compared with the end of the first quarter. The pound sterling and yen closed at 1.71 dollar per pound sterling and 101.30 yen per dollar, up 2.5 percent and 1.5 percent compared with the end of the first quarter, respectively. During the same period, the currencies of most emerging market economies were stable against the US dollar, but the Indonesian rupiah depreciated significantly against the US dollar by 4.7 percent and the Korean won experienced a large appreciation of 5.2 percent against the US dollar.

Money market rates fluctuated but remained low. Influenced by the expectation that the target federal funds rate of the United States would remain low, the USD Libor in the London inter-bank market was generally low. On June 30, the one-year Libor was 0.5451 percent, 1.3 basis points lower than that at the end of March. Due to interest-rate cuts by the European Central Bank, the Euribor generally declined. On June 30, the one-year Euribor was 0.488 percent, down 10.2 basis points compared with the end of March.

Government bond yields in the advanced economies and most emerging market economies declined. On June 30, 10-year government bond yields in the United States, Germany, and Japan closed at 2.52 percent, 1.25 percent, and 0.57 percent respectively, declining by 21 basis points, 32 basis points, and 8 basis points since the end of the first quarter. During the same period, government bond yields for most emerging market economies also went down, among which the yields in Argentina, Turkey, and Brazil declined by 890 basis points, 128 basis points, and 60 basis points, respectively.

The stock indices of the advanced economies and most emerging market economies went up. On June 30, the Dow Jones Industrial Average, the EURO STOXX 50, and the Nikkei 225 Index closed at 16826.6, 3014.2, and 15162.1, respectively, up 2.2 percent, 3.4 percent, and 2.3 percent compared with the end of the first quarter. In the second quarter, the stock markets in most of the emerging market economies rallied. In particular, economies whose financial markets had underperformed in the first quarter rebounded relatively rapidly, among which the Argentinean BUSE Merval Index and the Turkish BIST Index rose 23.7 percent and 12.9 percent respectively.

3. Monetary policies in the major economies

The major advanced economies continued their accommodative monetary policies, but in different ways. The Federal Reserve continued to reduce the pace of asset purchases by USD10 billion on three successive occasions after its monthly meetings in April, June, and July, and emphasized that the current super-easing monetary policy position was still appropriate and a wider range of indicators would be referred to in order to determine the right time to raise interest rates. The European Central Bank launched a series of easing policies after its regular June meeting. First, the rates of the main refinancing operations (MROs), the marginal lending facility, and the deposit facility were lowered by 10 basis points, 35 basis points, and 10 basis points, respectively, which resulted in a negative deposit facility rate of -0.1 percent. Second, the ECB prepared to conduct a series of targeted longer-term refinancing operations (TLTROs). The initial entitlement amounts to 400 billion euro, and all operations will mature in September 2018. Third, the ECB will accelerate preparatory work related to outright purchases of asset-backed securities of the private sector. Fourth, the ECB decided to prolong the fixed-rate tender procedures of the MROs with full allotments until the end of 2016 to provide low short-term interest-rate credits to banks and to suspend the fine-tuning operation sterilizing the liquidity injected under the Securities Markets Program. ECB President Draghi stated in the press conference following the regular meeting that the euro area was not in deflation, but the Governing Council unanimously agreed to continue to use unconventional instruments within the authority of the ECB when necessary. The Bank of Japan continued to implement a quantitative and qualitative easing monetary policy, using the monetary base as the monetary policy target and increasing the monetary base at a pace of 60 to 70 trillion yen per year so as to reach the inflation target of 2 percent within two years. The Bank of England (BOE) maintained its policy rate of 0.5 percent and the scale of asset purchases at 375 billion pounds. But in the minutes of the Monetary Policy Committee meeting in June, the BOE stated that the speed with which the UK absorbs its spare capacity might be faster than expected, and it is possible that the decision makers will increase the Bank Rate by the end of the year.

The monetary policies of the emerging market economies diverged. In response to the inflationary pressures, some emerging market economies increased their policy rates. On April 2, the Central Bank of Brazil raised the Selic rate by 25 basis points to 11 percent. On April 25, the Central Bank of Russia announced it would raise the policy rate by 50 basis points to 7.5 percent. In addition, in order to address the inflation and financial stability risks brought about by the excessive liquidity, on May 8 the Central Bank of the Philippines decided to raise the reserve requirement ratio by one percentage point for commercial and thrift banks, and on June 19 it decided to raise the interest rate on the Special Deposit Account (SDA) facility from 2.0 percent to 2.25 percent. Meanwhile, some emerging market economies lowered their interest rates after considering the changes in their domestic inflation situation and their economic performance. Against the background of recent decreasing risks of uncertainties and moderating inflation, the Central Bank of the Republic of Turkey lowered the 1-week repo rate on three occasions, on May 22, June 24, and July 17, respectively, by a total amount of 175 basis points to 8.25 percent, but it emphasized its intention to maintain a relatively tight monetary policy. Aiming to stimulate the economy, the Bank of Mexico lowered the policy rate by 50 basis points to 3.0 percent on June 6, and the Central Bank of Hungary lowered the policy rate on four successive occasions by a total of 50 basis points to 2.1 percent, on April 30, May 28, June 25, and July 22, respectively.

Box 3 The European Central Bank Launches a Negative Interest-Rate Policy and Targets Longer-term Refinancing Operations

Against the background of weak economic recovery and subdued inflation, to pursue price stability in the medium term and to guide banks to channel funds to the real economy, particularly small and medium-sized enterprises, the European Central Bank announced a series of easing policies on June 5, 2014, including a negative interest rate, the introduction of targeted longer-term refinancing operations (TLTRO), preparatory work related to outright purchases of asset-backed securities (ABS), the prolongation of the fixed-rate tender procedures for the main refinancing operations (MROs) with a full allotment until the end of 2016, and the suspension of the fine-tuning operation sterilizing the liquidity injected under the Securities Markets Program (SMP), among which the negative interest rate and the TLTRO attracted the most attention.

The ECB uses the interest-rate corridor to adjust short-term market rates and liquidity in the banking system. The floor of the interest-rate corridor is the rate of the deposit facility, i.e., the interest rate offered by the ECB to banks on overnight deposits. The ceiling of the interest-rate corridor is the rate of the marginal lending facility, i.e., the interest rate asked by the ECB for providing collateralized overnight liquidity to financial institutions. The rate of the MROs is the policy rate. The negative interest rate refers to the rate of the deposit facility, which was lowered by 10 basis points to -0.1 percent by the ECB and applies to excess reserves. This means that the ECB charges fees on bank deposits and excess reserves in the ECB. Meanwhile, the ECB lowered the rates of the MROs and marginal lending facility by 10 basis points and 35 basis points to 0.15 percent and 0.40 percent, respectively. As a result, the interest-rate corridor was asymmetrically adjusted downward, and its full width contracted from 75 basis points to 50 basis points. The ECB emphasized that the negative interest rate targeted only banks and that household deposits in banks would not be directly affected.

The ECB introduced the TLTRO to encourage the supply of credit by banks to households and non-financial enterprises. Compared with the LTRO, the TLTRO has a longer term of up to four years and its scale is linked to the loans made by banks to the non-financial private sector (excluding loans to households for home purchases, the same hereinafter), which might be as high as 1 trillion euro. The TLTROs will be implemented in two steps. First, two successive TLTROs will be conducted in September and December 2014. Banks will be entitled to initially borrow up to 7 percent of the total amount of their loans to the euro area non-financial private sector, and the combined initial entitlement is expected to amount to 400 billion euro. Second, from March 2015 to June 2016, all banks will be able to borrow, quarter by quarter, up to three times the amount of their net lending to the euro area non-financial private sector in excess of a specified benchmark. All TLTROs will mature in September 2018, and the interest rate on the TLTROs will be the rate on the MROs plus a fixed spread of 10 basis points. Starting two years after each TLTRO, banks will have the option to make repayments, in part or in full. However, those banks that have not fulfilled the condition that their net lending to the real economy reaches the benchmark specified by the ECB will be required to pay back their borrowings in September 2016.

The grim economic and financial situations in the euro area are the main reasons for the ECB to launch the above unconventional policy toolbox. First of all, recovery has been sluggish. In the first quarter of 2014, the (preliminary) GDP growth rate was only 0.9 percent, and the IMF forecasted that the growth rate in 2014 would be slightly higher than 1 percent. Second, the euro area faced continued low inflation pressures, with the Harmonized Index of Consumer Prices (HICP) lower than the 2 percent target of the ECB for a long time. In May and June 2014, the HICP declined further to 0.5 percent, and the ECB expected that the HICP might continue to remain at a relatively low level for the short term. Third, the monetary environment in the euro area showed signs of tightening. Because banks continued to repay the LTROs on a large scale, the balance sheet of the ECB contracted by 350 billion euro in the past year. As a result, the super-easing market liquidity condition was not stable and fluctuations in short- term rates increased. At the same time, growth of money was sluggish, with the growth rate of broad money (M3) remaining at around 1 percent since 2014. The credit environment differed among the member countries. Monetary policy was not transmitted smoothly, as banks used most of the liquidity injected by the ECB to purchase government bonds instead of lending to the private sector and the financing costs of small and medium-sized enterprises remained high. Moreover, indirect financing held a dominant share in the euro area and the corporate bond market was relatively small. As a result, the ECB could not follow the Federal Reserve by purchasing a large amount of agency debts. In consideration of all these reasons, the ECB launched a negative interest rate and the TLTRO, with the aim of reducing the financing costs for the economy, enhancing investment and consumption, pushing up inflation, improving the monetary policy transmission mechanism, encouraging banks to support the private sector with liquidity provided by the ECB, and stimulating activities by small and medium-sized enterprises.

In the short term, the negative interest-rate policy of the ECB has achieved some results, as the money market interest rates in the euro area have declined to some extent and the government bond yields for the periphery countries have obviously dropped notably. However, the long-term effects remain to be seen. Theoretically, in order to avoid paying fees to the ECB, banks should expand credits, create deposits with such loans, and increase payments of the required reserves to transfer reserves from the excess reserve accounts with negative interest rates to the required reserve accounts with positive interest rates. But some analysts argue that the problem in the euro area is the insufficient demand for credit and the negative interest rate is not large enough to stimulate credit demand. Moreover, if banks transfer the costs of the negative interest rate by raising the interest rates for loans, as shown in the case of Denmark, the demand for loans will be constrained.

As for the TLTRO, the market generally thinks it is reasonable to link the liquidity injecting operations of the central bank with the banks' lending activities, and the financing environment for small and medium-sized enterprises will thus be improved considerably. However, due to insufficient credit demand and some banks' concerns about credit risks, there are uncertainties as to whether the TLTRO can reach the expected scale of 1 trillion euro. In the long run, it will be difficult for monetary policy on its own to resolve the fundamental problems in the euro area, and fiscal and structural reforms are needed at deeper levels.

4. World economic outlook and major risks

Overall, the global economic recovery turned for the better in 2014 and the growth rate is expected to pick up. However, structural problems and destabilizing and uncertain factors still exist and may pose the following risks to the global economy:

First, the momentum of the U.S. recovery has yet to be strengthened. The effect of the Federal Reserve's tapering of the asset purchases is still quite uncertain. In the first half of 2014, fluctuations in U.S. financial markets reached a record low, and there are worries that the slow pace of the tapering might lead to market complacency, which in turn might increase risk tolerance, encourage risky behavior, and threaten financial stability. In addition, the United States has not made any substantial progress in terms of medium-term fiscal consolidation.

Second, recovery prospects in the euro area are unclear. Although the ECB launched a series of monetary easing policies in June to deal with the deflationary risks, it is still uncertain whether the banks will lend more to the real economy. In addition, the euro area has many long-term and structural problems, such as the deleveraging of the banking sector, the building of the fiscal union, and internal structural imbalances.

Third, the Japanese economy is still facing downward pressures. In the short term, the consumption tax hike has obviously weighed down on consumption and expansion of domestic demand, and the size and duration of this negative impact remains to be seen. For the long term, as Japan's structural reform is lagging, it is uncertain to what extent the structural reform will help enhance the competitiveness of the Japanese economy. Moreover, the Japanese government also faces the dilemma of cutting debts and stimulating economic growth.

Fourth, in the short term some emerging market economies still face risks. Externally, the moderate recovery of the advanced economies can hardly create strong external demand for the emerging market economies. Uncertainties about the Federal Reserve's tapering of the quantitative easing policy and investors' concerns about the fundamentals in the emerging market economies might have negative impacts on the exchange rates, financial markets, and capital flows of some emerging market economies. Domestically, some emerging market economies face additional pressures from problems such as rising leveraging in the private and public sectors, relatively rapid expansion of bank credits, and increased macroeconomic imbalances.

Moreover, geopolitical risks and political turmoil in some countries might also have a negative impact on the global economy. There is uncertainty regarding where the Ukraine crisis is heading and this crisis will be difficult to resolve. It might affect energy supplies and the economic recovery in Europe. The escalation of violence in Iraq might also reduce global supplies of crude oil and push up international oil prices.

II. Analysis of China's macroeconomic performance

In the first half of 2014, growth of the Chinese economy remained stable and the structural adjustments made progress. Domestic demand continued to be the major driver for growth, contributing 102.9 percent to GDP. Consumption and investment grew in a stable manner and growth of exports and imports reentered positive territory. With a bumper harvest in summer grain, the agricultural sector was in good shape, while the growth of industrial output picked up. Consumer prices rose at a moderate pace and the job market was basically stable. In the first half of 2014, the Gross Domestic Product (GDP) reached 26.9 trillion yuan, up 7.4 percent year on year. GDP growth in the first and second quarters registered 7.4 percent and 7.5 percent respectively. The Consumer Price Index (CPI) rose 2.3 percent year on year. The trade surplus posted USD102.9 billion.

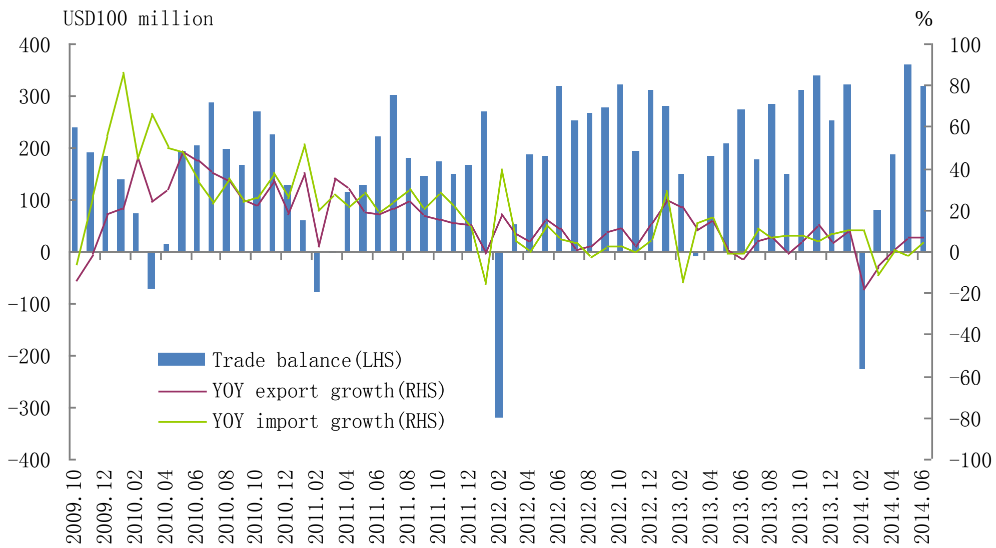
1. Consumption and investment grew in a stable manner, and the growth of exports and imports reentered positive territory

As a result of the continued gains in household income, consumption played a more important role in driving economic growth and the growth of consumption supported by new business models was especially rapid. In the first half of this year, per capita disposable income of urban residents was 14,959 yuan, up 9.6 percent year on year in nominal terms and 7.1 percent in real terms. Per capita cash income of rural residents registered 5,396 yuan, up 12.0 percent year on year in nominal terms and 9.8 percent in real terms. From January through June, 54.4 percent of the growth in GDP, namely 4 percentage points of the GDP growth rate, was contributed by final consumption, accelerating by 9.2 percentage points and 0.6 percentage point respectively year on year. Retail sales of consumer goods totaled 12.4 trillion yuan, up 12.1 percent year on year in nominal terms and 10.8 percent in real terms. Specifically, retail sales of consumer goods in urban and rural areas stood at 10.7 trillion yuan and 1.7 trillion yuan respectively, up 12.0 percent and 13.2 percent year on year. Consumption supported by new business models and green consumption grew rapidly. In the first half of 2014, online retail sales totaled 1137.5 billion yuan, up 48.3 percent year on year.

The share of private investment expanded further. From January through June, fixed-asset investments (excluding investments by rural households) totaled 21.3 trillion yuan, up 17.3 percent year on year in nominal terms and 16.3 percent in real terms. Real growth was flat with that in the first quarter. Among this total, private investment registered 13.9 trillion yuan, up 20.1 percent and accounting for 65.1

percent of total investment, accelerating by 1.4 percentage points year on year. Broken down by regions, growth of investment in the central and western regions continued to outpace that in the eastern region, and year-on-year growth in the eastern, central, and western regions registered 16.3 percent, 19.2 percent, and 18.6 percent respectively. As for the sectoral distribution, the primary, secondary, and tertiary industries grew 24.1 percent, 14.3 percent, and 19.5 percent year on year.

Import and export growth reentered positive territory. In the first half of this year, imports and exports totaled USD 2020.9 billion, up 1.2 percent year on year. Among this total, exports grew 0.9 percent year on year to USD1061.9 billion and imports rose by 1.5 percent to USD 959 billion. The trade surplus narrowed by USD 5.5 billion compared with the same period of the last year. In terms of the regional distribution, trade with the EU, the United States, Japan, and the ASEAN countries maintained a momentum of growth. In terms of the structure of traded goods, the export growth of machinery, electronic appliances, and labor-intensive products picked up, while the import growth of some commodities slowed down compared with the same period of the last year. In the first half of 2014, actually utilized foreign direct investment increased by 2.2 percent year on year to USD 63.33 billion; domestic investors invested in 3,224 overseas enterprises in 146 countries and regions, and cumulative non-financial outbound direct investments registered USD 43.34 billion.



Source: General Administration of Customs, People’s Bank of China.

Figure 3 Import and Export Growth and the Trade Surplus

2. Agricultural production was in good shape, and the growth of industrial production picked up

The growth of the value-added of the tertiary industry outpaced that of the secondary industry. In the first six months, the value-added of the primary, secondary, and tertiary industries were 2.0 trillion yuan, 12.4 trillion yuan, and 12.5 trillion yuan respectively, up 3.9 percent, 7.4 percent, and 8.0 percent respectively year on year. The value-added of the three industries accounted for 7.4 percent, 46.0 percent, and 46.6 percent of total GDP respectively, with the share of the tertiary industry rising by 1.3 percentage points from the same period of 2013, 0.6 percentage point more than the share of the secondary industry.

Agricultural production was in good shape with a bumper harvest in summer grain. Total production of summer grain rose 3.6 percent year on year to 136.6 million tons. In the first half of 2014, production of pork, beef, mutton, and poultry climbed by 1.7 percent year on year to 40.03 million tons, among which pork production rose 3.0 percent to 27.05 million tons.

The growth of industrial production picked up. In the first half of 2014, the value-added of statistically large enterprises grew by 8.8 percent year on year, representing an acceleration of 0.1 percentage point compared with the first quarter. Profits of statistically large enterprises gained 11.4 percent year on year to 2.93 trillion yuan. The share of sold industrial products of statistically large enterprises was 97.5 percent, which was flat with the share during the first half of the last year. The PBC Survey of 5,000 Industrial Enterprises in the second quarter showed that several indicators, including the business climate index and the profit index, were indicating an upward trend. The business climate index grew by 0.1 percentage point quarter on quarter to 55.4 percent; the profit index rose by 3.2 percentage points quarter on quarter to 54.1 percent. The domestic order index and the export order index stood at 48.5 percent and 49.7 percent respectively, up 4.1 percentage points and 4.3 percentage points compared with the previous quarter.

3. Overall price levels remained stable

Consumer prices registered a moderate increase. In the first half of 2014, the CPI rose 2.3 percent year on year, and the CPI in April, May, and June increased by 1.8 percent, 2.5 percent, and 2.3 percent respectively, rising by an average of 2.2 percent, narrowing by 0.1 percentage point compared with the first quarter. Broken down by food and non-food items, growth in food prices edged down while that of non-food items remained basically stable. In the second quarter of 2014, food prices rose by 3.4 percent year on year, which was 0.1 percentage point less than the increase in the previous quarter and accounted for 1.1 percentage points of CPI growth. The price of non-food items rose 1.7 percent year on year, which was flat with the growth in the previous quarter, contributing to 1.1 percentage points of CPI growth. Broken down by consumer goods and services, the price of consumer goods rose 2.0 percent year on year, accelerating by 0.1 percentage point compared with the first quarter; the price of services climbed by 2.7 percent year on year, decelerating by 0.4 percentage points compared with the first quarter.

The decline in producer prices narrowed. In the first half of 2014, the producer price index (PPI) dropped by 1.8 percent year on year. The year-on-year decrease for April, May, and June registered 2.0 percent, 1.4 percent, and 1.1 percent respectively and averaged 1.5 percent. The average monthly decrease in the second quarter was 0.5 percentage point less than that in the first quarter. The decline in the price of capital goods narrowed while the growth in the price of consumer goods reentered positive territory. In the second quarter, the price of capital goods dropped by 2.0 percent year on year, narrowing by 0.5 percentage point compared with the decline during the last quarter and contributing to 1.6 percentage points of the decline in the PPI. The price of consumer goods climbed 0.1 percent year on year, accelerating by 0.4 percentage point compared with the last quarter, explaining the 0.1 percentage point increase in the PPI. In the first half of 2014, producer purchasing prices dropped by 2.0 percent year on year. The average decline in the second quarter registered 1.9 percent, which was 0.2 percentage point less than the decline in the previous quarter. In the second quarter, the prices of major agricultural products went up by 0.3 percent year on year, accelerating by 1.5 percentage points compared with the previous quarter. The price of agricultural capital goods fell 1.1 percent year on year, which was 0.5 percentage point more than the decrease in the previous quarter.

As a result of the overall hike in commodity prices on the international market, the decline in imported prices narrowed significantly. In the second quarter, the average price of Brent Crude oil futures on the Intercontinental Exchange gained by 1.7 percent compared with the previous quarter, and the average LME aluminum price grew by 5.2 percent from the previous quarter. In the first half of 2014, import and export prices dropped by 3.1 percent and 1.9 percent year on year respectively. From April through June, import prices grew by -0.6 percent, 1.3 percent, and -4.1 percent respectively, averaging -1.1 percent, and the average monthly decline was 4 percentage points less than that during the previous quarter. Export prices dropped by 3.3 percent, 1.2 percent, and 1.5 percent respectively, averaging 2 percent and 0.2 percentage point more than that in the first quarter.

The GDP deflator rebounded. In the first quarter, the GDP deflator (the ratio of nominal GDP to real GDP) was 1.0 percent, which was 0.1 percentage point lower than that during the same period of 2013 and 0.5 percentage point higher than that during the first quarter of 2014.

The price reform made headway. On April 10, the NDRC and other relevant ministries jointly launched a pilot program of a targeted price reform of cotton in Xinjiang Autonomous Region. According to the pilot program, the target price is determined by production costs and basic returns. Government cotton purchases and the reserve policy were abolished. Instead, producers will sell cotton at market prices, while the government will subsidize cotton producers based on the price differential, plantation area, and output and sales volume. On April 26, the NDRC issued a circular on improving management of low-cost drugs and relaxing price controls on low-cost drugs. A standard for the daily average cost of low-cost drugs was developed, and an entry and exit mechanism of a list of low-cost drugs was established. On May 5, the Ministry of Industry and Information Technology (MIIT) issued a notice jointly with other relevant ministries to deregulate telecommunications services. Telecommunication service providers may, based on the market situation and client demand, set up their own pricing schemes and design the price structures, the price standards, and the billing system.

4. Growth of fiscal revenue and expenditures picked up

In the first half of 2014, fiscal revenue posted 7463.8 billion yuan, up 8.8 percent year on year, which was 1.3 percentage points more than that during the same period of 2013. Fiscal expenditures reached 6915.4 billion yuan, up 15.8 percent year on year, an acceleration of 5.0 percentage points from that during the same period of 2013. As a result, revenue was 548.4 billion yuan more than expenditures, which was 339.3 billion yuan less than that during the same period of 2013.

In terms of the structure of fiscal revenue, tax revenue registered 6426.9 billion yuan, up 8.5 percent year on year, and non-tax revenue registered 1036.9 billion yuan, up 11.1 percent year on year. In terms of the tax categories, revenue from the domestic value-added tax, the domestic consumption tax, the business tax, the corporate income tax, the value-added tax on imported goods and the excise tax, and the personal income tax rose by 6.1 percent, 4.8 percent, 4.0 percent, 8.6 percent, 8.6 percent, and 12.1 percent respectively. As for the structure of fiscal expenditures, fiscal expenditures for affordable housing, urban and rural community affairs, purchases and reserves of grain and oil grew relatively rapidly, increasing by 30.2 percent, 23.6 percent, and 20.3 percent respectively.

5. The employment situation was generally stable

In the second quarter, the registered unemployment rate in the urban areas posted 4.08 percent, flat with that in the first quarter. In the first half of 2014, the newly-employed in the urban areas reached 7.37 million, which was 120,000 more year on year. In the second quarter, a statistical analysis by the China Human Resources Market Information Monitoring Center on market demand and supply information of public employment service agencies in 100 cities revealed that overall labor supply and demand was in balance, with supply falling slightly short of demand, and the ratio of job seekers to job vacancies was 1.11, which was the same as that in Q1, growing by 0.04 year on year. Broken down by industry, demand in sectors such as manufacturing, wholesale and retail, transportation, warehousing and postal services, and real estate declined compared with the first quarter, but still increased compared with that in the first half of 2013. In comparison with the first quarter of this year, the number of job seekers who were fresh graduates from colleges and those who were from other localities increased, while the number of job seekers who were not able to find employment upon graduation, the newly unemployed, and the local rural residents declined. Demand for professionals with medium or high skill levels grew quite rapidly.

6. The current account surplus narrowed

According to preliminary statistics, the current account surplus was USD79.3 billion in the first half of 2014, representing a decrease of USD19.1 billion from the same period of 2013 and accounting for 1.8 percent of GDP during the same period. The surplus in the capital and financial account was USD81.5 billion. Reserve assets grew by USD161.5 billion.

Total external debt continued to grow. As of end-March 2014, outstanding external debt posted USD883.87 billion, up 15.5 percent year on year. Among this total, the stock of registered outstanding external debt posted USD564.87 billion, an increase of 22.4 percent year on year and accounting for 63.9 percent of the total; outstanding short-term external debt posted USD690.82 billion, an increase of 22.1 percent year on year and accounting for 78.2 percent of the total.

7. Sectoral analysis

The profits of industrial enterprises maintained stable growth. In the first half of 2014, the number of industries that saw gross profits higher, at par with, or lower than that in the first half of 2013 was 35, 1, and 5 respectively. In particular, gross profits of petroleum processing, coking, and nuclear fuel processing, automobile manufacturing, electronic machinery, and equipment manufacturing, manufacturing of computers, and telecommunications, and other electronic devices grew more rapidly compared with other industries, up 43.9 percent, 29.1 percent, 25.3 percent, and 24.1 percent respectively year on year; gross profits of coal mining and washing, and mining of petroleum and natural gas declined.

(1) The real estate sector

In the first half of 2014, nationwide turnover of commercial real estate declined year on year. Fewer cities reported a quarter-on-quarter increase in real estate prices compared with the previous quarter. The growth of investment in real estate development slowed down, while loans in the real estate sector registered stable growth.

Fewer cities reported rising real estate prices compared with the previous quarter. In June, out of 70 large- and medium-sized cities, the prices of newly-built commercial residential housing increased in 69 cities year on year, at par with that in March 2014; the prices of newly-built commercial residential housing increased from the previous quarter in 8 cities, 48 cities less than in March 2014. The prices of pre-owned residential housing increased in 62 cities year on year, 6 cities less than in March 2014; the prices of pre-owned residential housing increased from the previous quarter in 7 cities, 35 cities less than in March 2014

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Both the acreage and sales of commercial real estate declined year on year. In the first half of 2014, the floor area of sold commercial real estate nationwide posted 480 million square meters, down 6 percent year on year, which was 2.2 percentage points more than the decline in the first quarter of this year. The sales value of commercial real estate declined 6.7 percent year on year to 3.1 trillion yuan, which was 1.5 percentage points more than the decline in Q1 2014. Among this total, the sold area and sales value of commercial residential housing accounted for 87.8 percent and 82.3 percent respectively of the total sold area and of the turnover in commercial real estate.

Growth of investment in real estate development decelerated. In the first half of this year, nationwide investment in real estate development totaled 4.2 trillion yuan, up 14.1 percent year on year, a deceleration of 2.7 percentage points compared with the first quarter, registering a consecutive deceleration since the beginning of this year. In particular, investment in residential housing posted 2.9 trillion yuan, accounting for 68.3 percent of total investment in real estate development nationwide. The floor area of the start of new real estate declined 16.4 percent year on year to 800 million square meters. The margin of decline was 8.8 percentage points less than that in the first quarter. The floor area of real estate projects under construction grew 11.3 percent year on year to 6.11 billion square meters, a deceleration of 2.9 percentage points from the first quarter of this year. The floor area of completed real estate projects stood at 380 million square meters, representing a year-on-year increase of 8.1 percent, in comparison with a year-on-year decline of 4.9 percent in the first quarter.

Growth of real estate loans registered stable growth. As of end-June 2014, outstanding real estate loans of major financial institutions (including foreign-funded financial institutions) posted 16.2 trillion yuan, an acceleration of 19.2 percent year on year and an increase by 0.4 percentage point from end-March 2014. Outstanding real estate loans accounted for 20.8 percent of total outstanding loans, which was 0.2 percentage point more than that at the end of March 2014. In particular, outstanding mortgage loans rose 18.5 percent year on year to reach 9.9 trillion yuan, a deceleration of 1.7 percentage points from end-March 2014; outstanding housing development loans gained 26.9 percent year on year to reach 3.1 trillion yuan, an acceleration of 7.6 percentage points from end-March 2014; outstanding land development loans rose 9.7 percent year on year to reach 1.2 trillion yuan, a deceleration of 2.1 percentage points from end-March 2014. In the first half of 2014, new real estate loans registered 1538.5 billion yuan, accounting for 26.8 percent of all types of new loans, a rise of 0.4 percentage point from end-March 2014.

At end-June 2014, outstanding loans for welfare housing development posted 969.4 billion yuan, representing year-on-year growth of 47.3 percent, which was 20.6 percentage points higher than that at the end of March 2014. The outstanding volume of new welfare housing development loans stood at 240.2 billion yuan, accounting for

47.3 percent of the total new real estate development loans and 27.9 percentage points more than that in the first quarter of this year. In addition, the pilot program of using housing provident fund loans to support the construction of affordable housing was steadily promoted. At end-June, 323 welfare housing projects in 77 cities had passed loan approvals and had received 68.5 billion yuan in loan disbursements based on the construction progress, of which 21.4 billion yuan of the principal was repaid.

(2) The electronics and information technology industry

Information technology serves as an important driver in economic and social development. The electronics and information technology industry is a promising industry of strategic importance for the Chinese economy. It is an indispensable component of the infrastructure and leads the development of other industries. Against the background of industrial upgrading in China and the relocation of industrial capacities around the globe, the electronics and information technology industry in China has actively promoted structural adjustments and has enhanced its core competitiveness despite the negative impacts of the global financial crisis. It is playing an increasingly important role in supporting the development of the national economy.

The electronics and information technology industry is expanding in scale steadily and remains in the fastest growing cohort among all industries. The industry has become a pillar in China's real economy and foreign trade. In 2013, total sales in the industry registered 12.4 trillion yuan, up 12.7 percent year on year, and it accounted for more than 50 percent of total IT expenditures around the globe. In particular, the revenue of statistically-large electronics and IT manufacturers from major businesses rose 10.4 percent year on year to 9.3 trillion yuan; the revenue of software businesses from software and IT service providers reached 3.1 trillion yuan, growing by 24.6 percent year on year, which was significantly higher than the global average of 5.7 percent. China has become the largest manufacturing hub for electronics and IT products worldwide. In 2013, the output of mobile phones, computers, and color TVs registered 1.46 billion, 340 million, and 130 million units respectively, all accounting for more than half of the world's total. In 2013, total exports and imports of electronics and IT products stood at USD 1.3 trillion, growing by 12.1 percent year on year, which was 4.5 percentage points higher than total exports and imports nationwide during the same period. In particular, the share of general trade increased by 1.8 percentage points compared with the previous year.

Structural adjustments in the electronics and IT industry accelerated. First, efforts were made to integrate software with hardware to climb up the value chain. As the industry develops, the value of hardware increasingly hinges on the technology content of its supporting software. To enhance the value-added of their products, some leading hardware manufacturers invested in in-house research and development or cooperated with software enterprises to develop supporting software. Meanwhile, software firms and Internet firms were also entering the hardware manufacturing industry. In 2013, gross profits of statistically-large electronics and IT enterprises grew 21.1 percent year on year, which was significantly more than the average growth of 12.2 percent of all industries; revenue from software businesses accounted for 25 percent of total revenue of the electronics and IT industry, which was 2.3 percentage points higher than the share during the last year. Second, domestic manufacturers took a larger share in the domestic market and the competitiveness of domestic firms improved. In 2013, the total value of products sold on the domestic market accounted for 48.3 percent of the output value of the electronics and IT industry, growing by 3.3 percentage points compared with the previous year. The sales value of Chinese-funded firms accounted for 33 percent of the nation's total, which was 2.1 percentage points more than that in the previous year. Third, industrial transfers proceeded in an orderly manner. In 2013, the sales value of statistically-large electronics and IT manufacturers in the central and western regions registered 1020.8 billion yuan and 765.9 billion yuan respectively, growing by 28 percent and 28.9 percent year on year. Their growth rates were 17 and 17.9 percentage points higher than average. The sales value in the central and western regions accounted for 19 percent of the nation's total, 2.5 percentage points more than that in the previous year.

At present, the electronics and IT industry is a window of strategic importance to accelerate development and to make structural upgrading, but some deeply-rooted constraints and structural imbalances remain salient, such as a lack of core technology, the absence of global leaders, a mismatch in the workforce structure, and a lackluster capability for sustainable development. To address such challenges, the industry should focus on industrial transformation and upgrading, prioritize research and development to make breakthroughs in core technologies in key areas and innovations in the development pattern, combine manufacturing with software and information services, coordinate domestic and foreign markets, optimize the industrial layout, guide the orderly relocation of industrial capacity, and improve the industrial organizational structure. Efforts will be made to use the special funds earmarked for technological upgrading more efficiently, to encourage financial institutions to provide more financial services to small and medium-sized electronics and IT firms, and to guide financial institutions to provide more financial support to modern IT industries and the information consumption industries that have promising market prospects.

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

I. Outlook for the Chinese economy

The Chinese economy is changing gears and undergoing structural adjustments.

Therefore, the side-effects of the structural adjustments and the vitality released by the adjustments and reforms are both at play. While the traditional growth drivers are weakening, the newly emerging industries are very dynamic. Interactions among the economic variables, including growth, job creation, prices, and the environment, are changing and economic performance is displaying new features and a state of new normal. Supported by many positive factors and a good macro-economic policy environment, the Chinese economy is expected to maintain stable growth in the coming periods. Given the size of the economy, there is plenty of room for coordinated progress in the new type of industrialization, and the application of information technology, urbanization, and modernization of the agricultural sector is supported by the size of the market. Looking at regional developments, the eastern regions have exhibited stronger adjustment flexibility and resilience and have made good progress in structural adjustments; the central, western, and northeastern regions have been affected by resource and heavy-industry fluctuations, but they still have a large growth potential due to the effects of the balanced regional development and the upgrading of industries. In terms of macro-economic policy, economic growth will be supported by continued innovation, improvements and accumulation of experience in macro-economic management, a focus on targeted adjustments, accuracy in the direction and intensity of the adjustment measures within the framework of range management, as well as the combination of short-term demand adjustments and the adoption of a series of policy measures to promote reform, adjust the economic structure, and improve the people’s welfare. The positive results of the structural adjustments are gradually unfolding. The service sector has continued its rapid growth, and the tertiary industry as a share of GDP has continued to rise after exceeding that of the secondary industry. The high-tech industry, equipment manufacturing industry, and new modes of business operations such as e-commerce are expanding with a strong momentum, while the growth of high energy-consuming industries and those with excess capacities is moderating. The quality of economic growth has improved. In the first half of 2014, the concentration of PM2.5 in some areas declined year on year. The investment structure has improved further, with investment in the information and business service industries expanding rapidly and the share of private investment going up further. With the changes in the demographic and economic structures and the expansion of the services industry, per unit of GDP has created more jobs and the overall employment situation is good. Household income has continued its rapid growth and the household consumption structure is changing. According to the urban depositors survey conducted by the PBC in Q2, the willingness of households to purchase automobiles and other large-value items in the next three months will decline but their willingness to travel went up by 4 percentage points quarter on quarter and 1.2 percentage points month on month. Looking at the external environment, although growth in the various regions differed somewhat, the global economy was on the track for a moderate recovery and global growth is expected to be higher than last year, presenting a relatively stable environment for external demand.

Yet there are still many challenges and risks. The endogenous growth drivers are yet to be strengthened and the tasks of structural adjustment and reform remain demanding. As external demand, real estate, and other traditional growth drivers have weakened, new drivers for strong growth have yet to emerge. Since the beginning of the twenty-first century, the investment ratio has been on an upward trend for more than a decade. In particular, the investment ratio in recent years has been notably higher than before. As such, it will be difficult to continue to maintain the fairly rapid growth of investment. As both the manufacturing sector and the real estate industry are moving downward and experiencing fluctuations, to a large extent growth is buttressed by infrastructure investments. Furthermore, with inefficient enterprises absorbing a large volume of resources, the efficiency of fund use low, and the indebtedness of the economy increasing relatively rapidly, the potential risks in the financial and real sectors need be watched. Moreover, the growing resource and environmental constraints and serious air and water pollution have all made it imperative that the existing growth pattern be transformed. There are also risks in terms of the global recovery. The uncertainties in the adjustment of U.S. economic policy may have a large impact on global capital flows and costs of financing. Growth in the euro area remains lukewarm against the background of deflationary risks. Growth in the emerging economies is tepid and there are multiple structural problems in the global economy. Major international organizations have made downward adjustments in their projections for global growth. In general, given the complexities and uncertainties in the external and internal environments, it is imperative to advance the structural adjustments and transformation of the growth pattern. Balance at the aggregate level and structural optimization should both be pursued, and the economic growth points should be explored at a strategic level. The deep-rooted structural problems in the economy should be resolved by deepening reform and innovation and development should be promoted to bring about more dynamic growth and to increase the competitiveness of the economy.

The price situation was generally stable. The stable external environment, the economic performance within a reasonable range, sufficient capacity, and good harvest of summer crops all contributed to stable price expectations. According to the urban depositor survey conducted by the PBC in Q2, the household future price expectation index was 63.8 percent, down 0.1 percentage point quarter on quarter. However, due to supply-side changes and potential upward pressures in the supply of labor, service prices, and other factors, prices are generally very sensitive to changes in aggregate demand, as reflected in the impact of the economic recovery on price movements earlier this year. In the future, upward pressures on price movements may be exacerbated by the continued strengthening of aggregate demand. In 2013, prices went up relatively rapidly after aggregate demand became stronger. In addition, shocks to the price levels may occur when climatic hazards have an impact on the supply of agricultural produce. Trends in price movements need to be closely watched.

II. Monetary policy during the next stage

The PBC will follow the strategic arrangements of the State Council, implement the requirements of seeking progress while maintaining stability, continuing reform and innovation, implementing stable macro policies and flexible micro policies, properly managing the balance among promoting stable growth, reform, adjusting the economic structure, benefitting the people's welfare, and preventing risks, continue the sound monetary policy, maintain the continuity and stability of policy, continue the stance of keeping aggregates at a stable volume while optimizing structures, remain focused while actively taking measures, make macro-economic management measures more forward looking, targeted, and effective, continue to create a stable monetary and financial environment for the adjustment and transformation of the economic structure, and promote the sustainable development of the economy. Moreover, the reform measures will be integrated with the macro-economic measures and the use of monetary policy measures will be combined with measures to deepen the reforms to allow the market to play a decisive role in resource allocations to a fuller extent. With financial deepening and ongoing innovation, the macro-economic management approach will be improved, the transmission mechanism will be straightened out, and financial services will be improved by increasing supply and competition to improve the efficiency of the financial sector and its capacity to serve the real economy.

First of all, a combination of quantitative, price, and other monetary policy instruments will be used, the macro-prudential policy framework will be improved, and the combination of policy measures will be diversified and optimized to keep liquidity at reasonable volumes and to realize the proper growth of money, credit, and all-system financing aggregates. In view of the changes in the economic and financial situations and the impact of financial innovation on liquidity in the banking system, a mix of instruments, including open market operations, the deposit reserve requirement ratio, central bank lending, central bank discounts, the Standing Lending Facility, Short-term Liquidity Operations, and so forth, will be used flexibly and the central bank collateral management framework will be improved to manage the aggregate liquidity properly and to maintain a stable money market. Moreover, financial institutions will be guided to enhance liquidity, assets, and liability management, to make good arrangements for liquidity at various time-points, to properly manage the aggregates of assets and liabilities and the term structure, and to improve the quality of liquidity risk management. The macro-prudential policy will continue to play a counter-cyclical adjustment role. The various parameters will be adjusted when necessary based on the changes in economic performance, the soundness of the financial institutions, and implementation of the credit policy to guide financial institutions to support real sector development in a more targeted way.

Second, the stock of credit assets will be revitalized and use of new loans will be optimized to support the structural adjustments and transformation. Measures will be taken to optimize the direction and structure of the provision of liquidity, properly implement the targeted reduction in the deposit reserve requirement, tap the role of credit policy supporting central bank lending and the central bank discount policy, and guide financial institutions to optimize the credit structure. Measures will be taken to encourage financial institutions to make innovations in the organizational structure, institutional arrangements, product and service models, and to support economies of scale in agricultural activities and the development of new types of agricultural entities. The effects of credit guidance assessments will be improved to better mobilize the stock of credit assets and to channel a larger share of new loans to small and micro enterprises. The financial sector will function properly and there will be enhanced support to science and technology, culture, information consumption, strategic new industries, and other key areas in the national economy. The implementation of credit policy resources will be continuously improved to further beef up financial services and provide support to poverty alleviation, job creation, students in need, ethnic minorities, rural migrant workers, college graduates-turned village officials, and other welfare-enhancing areas. Reasonable demands for funds will be satisfied from ongoing and follow-up projects and welfare projects, such as railway and other major infrastructure projects, urban infrastructure, welfare housing, and other livelihood improvement projects. Lending to high energy-consuming, highly-polluting industries, and those with an overcapacity will be strictly controlled to promote the removal of excess capacity. A green credit mechanism will be established and improved to improve financial services for energy conservation, a circular economy, reductions in air pollution, and so forth and to enhance credit support to technological upgrading in relevant fields. A differentiated housing mortgage policy will be implemented to support the building of welfare housing and common commercial housing with small and medium floor plans and purchases by first-time home-buyers of common commercial housing for self-use and to contain demand for speculative purchases. Development finance will continue to play a role in the reconstruction of shanty towns. A number of measures will be taken to reduce the costs of financing in the entire economy.

Third, the market-based interest-rate reform and the RMB exchange-rate regime reform will be furthered to improve the efficiency of allocation of financial resources and to improve the monetary policy framework. The self-regulatory market interest-rate pricing mechanism will be improved to build the independent pricing capacity of financial institutions. The issuance and trading of inter-bank certificates of deposit will be promoted while we will explore issuing certificates of deposit to corporate and individual customers and to gradually increase the range of liability products for market pricing. Efforts will be made to develop the Shibor and Loan Prime Rate, to build a fairly complete market interest-rate system. The central bank interest-rate adjustment framework will be improved to strengthen price-based adjustments and the transmission mechanism. The RMB exchange-rate regime will be further improved to allow market demand and supply to play a larger role, to enhance two-way flexibility of the RMB exchange rate, and to keep the exchange rate basically stable at an adaptive and equilibrium level. Development of the foreign exchange market will be accelerated to provide exchange rate risk management services to importers and exporters based on actual demand. 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 RMB against other currencies will be promoted to provide better services for RMB settlement of cross-border trade activities. The impact of the changing international situation on capital flows will be carefully watched and effective monitoring of cross-border capital movements will be strengthened.

Fourth, there will be continued efforts to improve the system of financial markets, to support the role of financial markets in preserving stable economic growth, supporting economic structure adjustments and transformation, deepening reform and opening up, and preventing financial risks. The financial infrastructure and institutional mechanisms will be strengthened to provide a more efficient investment and financing market for economic structural adjustments and upgrading. Market innovations will be encouraged to diversify the products and layers in the bond market and to meet investor demands. The market-making mechanism will be improved to enhance the liquidity of the bond market and to lay a solid foundation for an effective yield curve. Market participants will be diversified, the diversity of financial markets, financial products, investor bases, and financing intermediaries will be further promoted, and the risk-sharing and market discipline mechanisms will be strengthened. We will implement measures to promote direct financing and the development of a multi-layered capital market. Market supervision and the role of the corporate debenture bond joint ministerial coordination mechanism will be enhanced, while regulatory coordination will be strengthened to regulate the transaction behavior of market participants, to prevent financial risks, and to promote the efficient operation and sound development of the financial markets.

Fifth, reform of financial institutions will be deepened to improve financial services by increasing supply and enhancing competition. Reform of large commercial banks and other large financial institutions will be furthered so as to continue to improve corporate governance, build effective mechanisms for decision making, execution, and checks and balances, and translate the principle of corporate governance into daily operations and risk control behavior. The pilot reform program of the Rural Financial Business Division of the Agricultural Bank of China will be advanced to explore a sustainable model for market-based financial services to the agricultural sector, rural areas, and farmers and to improve financial services to the agricultural sector, rural areas, and farmers, and to customers in the counties. Reform of the Export-Import Bank of China and the Agricultural Development Bank of China will be accelerated by strengthening the definition of their policy functions, requiring separate book-keeping and management of policy-based business and proprietary business, establishing a sound regulatory capital requirement mechanism, and improving the governance structure and the fiscal and financial support policy for the purpose of creating a favorable policy environment and developing policy financial institutions with Chinese characteristics that operate on a sustainable basis to provide good services to support economic development. Reform of the China Development Bank will be deepened to enable development finance to rely on sovereign credit to provide services for the implementation of national strategy while making decent profits and focusing on the transformation of shanty towns, urban infrastructure, and related projects. The change to commercial operations of asset management companies will be further promoted. Under the precondition of stronger supervision, development of various kinds of financial institutions, financial service organizations, and intermediary agencies will be encouraged to build a financial eco-environment for competition and participation by all kinds of market participants. The standards and rules for Internet finance will be further improved to promote fair play, to enhance industry self-regulation, to build a capacity for risk management, to safeguard the rights and interests of investors, and to promote Internet finance to develop soundly.

Sixth, effective measures will be adopted to mitigate systemic financial risks and to preserve stability in the financial system. Macro-prudential management will be enhanced to guide financial institutions to operate on a sound basis and to encourage them to strengthen internal controls and liquidity and risk management. While supporting financial innovations, monitoring and prevention of potential risks in the wealth management and inter-bank business will be enhanced. Continued monitoring of local government debt and debt service capacity will be strengthened to manage and prevent risks and we will explore using market mechanisms to address the problem of local government indebtedness. The systemic financial risk early-warning and assessment mechanism will be improved, monitoring and analysis of local government financing vehicles, shadow banking businesses, and mutual guarantees and group guarantees of enterprises will be enhanced to identify potential risks on a continual basis and to urge financial institutions to draft response plans for various scenarios. The Financial Regulatory Coordination Joint Ministerial Conference will play a role to enhance risk monitoring and regulatory coordination of cross-sector and cross-market products and to establish a system of comprehensive financial statistics and an information-sharing mechanism. There will be efforts to accelerate the establishment of a deposit insurance regime and to improve the market exit mechanism for financial institutions. A comprehensive set of measures will be taken to preserve financial stability and to safeguard the bottom line in preventing systemic risks and regional financial risks.