China Monetary Policy Report
Quarter Three, 2014

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the third quarter of 2014, the Chinese economy performed within a reasonable range. Consumption increased steadily, exports and imports improved, and the employment situation was stable. Investment growth and price-level hikes moderated. Structural adjustments picked up steam. In the third quarter, GDP growth was 7.3 percent year on year and 1.9 percent quarter on quarter, and the consumer price index was up 2.0 percent year on year.

In accordance with the decisions and overall arrangements of the Party Central Committee and the State Council, the PBC has continued its sound monetary policy, taken measures to respond to the downward pressures and the moderation in price inflation while remaining focused on the goal of macro-economic management, making innovations in the approach and methodology of macro-economic management, diversifying policy instruments, optimizing the combination of policy measures, dealing with salient issues in economic performance, and conducting pre-emptive adjustments and fine-tuning in structural adjustment. The PBC carried out flexible open market operations and used short-term liquidity operations (SLO) to make adjustments in both directions. A medium-term lending facility (MLF) was created and MLF operations were carried out to guide market interest rates while keeping aggregate liquidity at an adequate volume in order to reduce the costs of financing for the real economy. The parameters of the macro-prudential policy were adjusted, the credit policy to support central bank lending and discounts was enhanced, and the role of credit policy was tapped to guide structural adjustments in encouraging financial institutions to allocate more credit resources to the agricultural sector, rural areas, and farmers, and small and micro enterprises. The market-based interest-rate reform and the RMB exchange-rate regime reform were furthered while the foreign exchange administration reform was deepened.

In general, the various policies have gradually produced effects. Liquidity in the banking system was adequate, and growth of money, credit, and all-system financing aggregates was stable. The structure of lending continued to improve. Market interest rates declined, and loan interest rates offered by financial institutions generally moved downward, reducing financing costs for the corporate sector. At the end of September 2014, broad money M2 was up 12.9 percent year on year. Outstanding RMB loans were up 13.2 percent year on year, registering an increase of 7.7 trillion yuan from the beginning of 2014, 404.5 billion yuan more than the increase in the corresponding period of 2013. The growth of both small and micro enterprise loans and agro-related loans exceeded the growth of total loans. In the first three quarters of 2014, all-system financing aggregates totaled 12.84 trillion yuan. In September, the weighted average loan interest rate offered to non-financial enterprises and other sectors was 6.97 percent, a reduction of 0.12 percentage point from August and a reduction of 0.23

percentage point from December 2013. At end-September, the central parity of the RMB against the US dollar was 6.1525 yuan per dollar, an appreciation of 3 basis points from end-June.

The global economy has been undergoing a profound rebalancing after the global financial crisis. The Chinese economy is switching gears and undergoing structural adjustments while at the same time absorbing the effects of the stimulus policy adopted during the previous period. Thus it is necessary to observe and analyze the performance of the economy based on the trends in economic development and from the perspective of the new normal. In the short term, adjustments in the real estate market, the treatment of environmental pollution, and the moderating growth in the manufacturing sector will have some impact on the growth of the economy. However, with progress in the new industrialization, the application of information technology, urbanization and the modernization of the agricultural sector, the transformation of the growth pattern, and innovations and improvements in macro-economic management, the Chinese economy is expected to achieve more sustainable and higher-quality growth in the medium and long run. While structural adjustments are progressing, the economy still might face stronger downward pressures and increased potential risk exposures during certain periods, thus making the adjustment of the economic structure and the transformation of the growth pattern all the more imperative.

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, while adopting flexible micro policies, striking a balance among preserving growth, promoting reform, adjusting the economic structure, improving the welfare of the people, 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 the objectives of macro-economic management, adopt measures based on our own initiative, conduct fine-tuning and preemptive adjustments when necessary in response to developments in the fundamentals, and make adjustment measures more flexible, targeted, and effective, in order to provide a stable monetary and financial environment for structural adjustments, transformation, and an upgrading of the economic structure and to 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 appropriate volumes and to realize the 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 reform measures 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. In view of the financial deepening and innovations in the financial markets, the conduct of monetary policy, including that of its transmission mechanism, will be further improved. Supplies will be increased and competition will be enhanced to improve the quality of financial services, the efficiency of the financial sector, and the capacity of the financial to provide services to the real sector. A number of measures will be taken to reduce financing costs in the real economy. A comprehensive set of measures will be put in place to safeguard the bottom line to prevent the emergence of either systemic financial risks or regional financial risks.

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Part 1 Money and Credit Performance

In the third quarter of 2014 liquidity in the banking system was sufficient, money, credit, and all-system financing aggregates grew in a stable manner, and the credit structure improved further.

I. The growth of money supply stabilized

At end-September 2014, outstanding broad money (M2) stood at 120.2 trillion yuan, up 12.9 percent year on year, an acceleration of 0.1 percentage point from the end of August but a deceleration of 1.8 percentage points from the end of June. Outstanding narrow money (M1) stood at 32.7 trillion yuan, up 4.8 percent year on year, and a deceleration of 4.1 percentage points from the end of June. Currency in circulation (M0) stood at 5.9 trillion yuan, up 4.2 percent year on year, and a deceleration of 1.1 percentage points from the end of June. In the first three quarters, net cash injections totaled 27.4 billion yuan, 156 billion yuan less than net cash injections during the same period of the previous year. Growth of money supply has moderated during the recent period due to the impacts on money of structural adjustments, contractions in off-balance-sheet financing, the slowing expansion in some sectors with soft budget constraints, and stricter regulation of the inter-bank business.

As of end-September, outstanding base money stood at 28.5 trillion yuan, up 8.4 percent year on year, and an increase of 1.4 trillion yuan from the beginning of the year. The money multiplier stood at 4.21, which was 0.11 lower than that at end-June. The excess reserve ratio of financial institutions was 2.3 percent and that of rural credit cooperatives was 4.9 percent.

Box 1 Recent Changes in the Growth of Money

Since the third quarter of 2014, year-on-year growth of broad money (M2) has moderated. Year-on-year growth of M2 in July and August was down from the previous month by 1.2 and 0.7 percentage points respectively. On a comparable basis, M2 had grown 12.9 percent year on year at end-September, up 0.1 percentage point from the previous month, but it was down 1.8 and 0.7 percentage points from end-June and the end of last year respectively. Changes in the growth of money supply have been the subject of many debates. For some, it is simply regarded as a reflection of the slowdown in economic growth. Nevertheless, from a structural perspective, we can obtain a more comprehensive and objective understanding of the problem.

M2 is an aggregate indicator, and any change in M2 depends on changes in the various money creation channels, which in turn reflect adjustments and changes in the economic structure. When banks underwrite loans, make securities investment, buy foreign exchange, or conduct inter-bank business, new deposits will be created to increase money supply. Conversely, when banks issue bonds or equities to replenish their capital, both deposits and money supply will decrease. Therefore, we should observe the changes in the channels that affect money supply. In terms of the money-creation channels, since the beginning of 2014 credit extensions were generally stable. From January to September, new RMB loans posted 7.68 trillion yuan, representing an acceleration of 404.5 billion yuan year on year. Therefore, this was not a major factor contributing to the moderation in growth. Comparatively, the main reasons for the declining M2 growth were the large contractions in the inter-bank financing, capital replenishments by banks, and, to a lesser extent, decreases in the RMB equivalent of foreign exchange purchases. During the past two years, against the backdrop of a buoyant demand for financing, commercial banks have provided a large amount of financing to the real estate sector, sectors with soft budget constraints, and areas with restrictive policies, by means of under-regulated inter-bank businesses, securities investments, and so forth. As the pace of structural adjustments accelerated, the demand for financing in these sectors witnessed some changes. In addition, supervision of the inter-bank business was strengthened. As a result, since the third quarter the demand for financing in the aforementioned sectors declined and money creation also decreased. Furthermore, during recent periods supervision over the degree of deposit deviations of the commercial banks was strengthened, and the occurrence at the end of each month of abrupt increases in the deposits of commercial banks to meet performance assessments decreased. Furthermore, with implementation of Basel III, commercial banks have worked to replenish their capital. Larger increases in the banks' capital during the third quarter reduced money supply in the real economy. With the change in the balance of payments position, the growth of RMB equivalents of foreign exchange purchases decelerated. During the third quarter, the RMB equivalents of foreign exchange purchases increased by 7.8 billion yuan, representing a deceleration of 121.4 billion yuan year on year and helping to drive down growth in money supply. The slower growth in money supply was consistent with the changes in the all-system financing aggregates. During the third quarter of 2014, the amount of off-balance-sheet financing (including trust loans, entrusted loans, and undiscounted bankers' acceptance bills) declined by 310.6 billion yuan on a net basis, a deceleration of 1.5 trillion yuan year on year, and accounting for 97 percent of the deceleration in the all-system financing aggregates.

Overall, the changes in M2 growth during recent periods were caused by structural adjustments, contraction of off-balance-sheet financing, slower expansion in some sectors with soft budget constraints, and strengthened regulatory requirements. However, contractions in the under-regulated inter-bank business and slowdowns in the abrupt increase in deposits at the end of each month to meet performance evaluations are positive developments. This will not only help eliminate loopholes in the financial system and enhance financial stability, but will also help curb the rapid rise in overall leveraging in the society. In a sense, this is the intended effect of the macro-economic management. As the tertiary industry accounts for a larger share of the economy and its financing intensity is significantly lower than that of the secondary industry, demand for funding will decline accordingly. In terms of the performance of commercial banks, since the beginning of 2014 both the pace of write-offs of bad loans and the growth of non-performing loans have rebounded. In the meantime, the risk appetite of commercial banks has tended to decrease and commercial banks have provided less financing to sectors with high risks or soft budget constraints. This will help promote structural adjustments, optimize financial resource allocations, guide more funds to sectors with better growth prospects, and reduce the financing costs in the real economy. Nevertheless, if there is an abrupt decline in total lending, it may have a negative impact on the real economy.

It is worth noting that current M2 growth is higher than nominal GDP growth by more than 4 percentage points, and it is substantially higher than the average differential between 2000 and 2013 (averaging about 1.5 percent, after excluding the extraordinary circumstances in 2009). As outstanding M2 is over 120 trillion yuan and the ratio of M2/GDP is about 200 percent, growth of money supply is not slow. Unlike fiscal expenditures, money will not disappear after being injected into the real economy by the central bank. The stock of money will accumulate and continue to play a role in the economy. The key is to improve the efficiency of monetary turnovers. Otherwise, the stock of money will pile up to a high level and will negatively affect inflation and the real economy. It should also be noted that with the deepening of the market as well as accelerated financial innovations, factors affecting money supply have become more complicated, the volatility of money supply has increased, and it is more difficult to compile accurate monetary statistics. Furthermore, the signaling effect of monetary indicators and the stable relationship between the monetary indicators and economic growth and inflation is gradually changing. Therefore, we should not over-interpret the short-term changes in money supply.

Against the background of accelerated financial development and innovation, we should observe and assess monetary and financial conditions from the perspective of market interest rates. In September, the weighted average interest rates of inter-bank borrowings and bond-pledged repos posted 2.97 percent and 2.93 percent respectively, down 0.20 and 0.18 percentage point month on month and down 1.19 and 1.34 percentage points from December 2013. Meanwhile, the yields of government securities and corporate bonds and of loan interest rates have declined to various extents. In general, with the strengthened preemptive adjustments and the fine-tunings in view of the changes in the fundamentals, monetary policy has maintained a neutral and appropriate monetary condition.

II. The growth of deposits of financial institutions moderated

At end-September, outstanding deposits of domestic and foreign currencies in all financial institutions (including foreign-funded financial institutions, the same hereafter) posted 116.4 trillion yuan, up 10.0 percent year on year. This represented a deceleration of 3.1 percentage points from the end of June, an increase of 9.2 trillion yuan over the beginning of the year, and a deceleration of 2.3 trillion yuan year on year. In particular, outstanding RMB deposits posted 112.7 trillion yuan, up 9.3 percent year on year. This represented a deceleration of 3.3 percentage points from the end of June, an increase of 8.3 trillion yuan over the beginning of the year, and a deceleration of 3.0 trillion yuan year on year. It was mainly due to a notable deceleration in deposit growth. In the third quarter, RMB deposits decreased by 950.4 billion yuan quarter on quarter, with the decline being 3.1 trillion yuan larger year on year. In particular, contractions of under-regulated inter-bank borrowings and moderation of abrupt deposit growth to meet performance assessments at the end of each month were the main reasons for the slower creation of deposits. Outstanding deposits in foreign currencies posted USD605.3 billion, up 34.9 percent year on year. This represented an increase of USD140.2 billion from the beginning of the year, an acceleration of USD101.7 billion year on year, and flat with the growth during the corresponding period of 2012. It is worth noting that by the end of the third quarter, the volatility of RMB deposits had declined significantly. On the last day of September, RMB deposits had increased by 699.8 billion yuan, representing a deceleration of 434.2 billion yuan year on year. Stricter regulation in the degree of deposit deviations has produced positive results.

Broken down by sectors, the growth of deposits in all sectors declined. At end-September, outstanding household deposits in financial institutions posted 49.8 trillion yuan, up 9.1 percent year on year. This represented a deceleration of 2.9 percentage points from the end of June, an increase of 3.7 trillion yuan over the beginning of the year, and a deceleration of 1.3 trillion yuan year on year. Outstanding deposits of non-financial enterprises registered 37.0 trillion yuan, up 5.5 percent year on year. This represented a deceleration of 4.2 percentage points from the end of June, an increase of 1.1 trillion yuan over the beginning of the year, and a deceleration of 1.3 trillion yuan year on year. Outstanding fiscal deposits posted 4.1 trillion yuan, representing an increase of 1.1 trillion yuan from the beginning of the year and a deceleration of 342.7 billion yuan year on year. Outstanding deposits of non-deposit-taking financial institutions posted 8.5 trillion yuan, up 58.7 percent year on year. This represented a deceleration of 7.5 percentage points from the end of June, an increase of 2.7 trillion over the beginning of the year, and an acceleration of 2.2 trillion yuan year on year.

III. Loans of financial institutions increased in a stable manner

At end-September, outstanding loans in domestic and foreign currencies of all financial institutions registered 84.7 trillion yuan, up 13.0 percent year on year. This represented a deceleration of 0.7 percentage point from the end of June, an increase of 8.1 trillion yuan over the beginning of the year, and an acceleration of 413.8 billion yuan year on year. In particular, outstanding RMB loans stood at 79.6 trillion yuan, up 13.2 percent year on year. This growth was flat with that during the previous two months and 0.8 percentage point lower than that at the end of June. It represented an increase of 7.7 trillion yuan over the beginning of the year and an acceleration of 404.5 billion yuan year on year.

In terms of the loan structure, RMB loans to the household sector moderated from an elevated level, while the growth of loans to non-financial businesses and other sectors remained stable. At end-September, outstanding loans to the household sector registered 22.5 trillion yuan, up 17.2 percent year on year. This represented a deceleration of 2.1 percentage points from the end of June, but it was higher than the growth of total loans. It also represented an increase of 2.7 trillion yuan over the beginning of the year and a deceleration of 415.5 billion yuan year on year. In particular, home mortgage loans increased by 1.2 trillion yuan from the beginning of the year, flat with the growth during the same period of the last year. The share of new home mortgage loans remained at an elevated level. In the first three quarters of 2014, the share of new home mortgage loans of total new loans was 16.0 percent, which was above the average between 2010 and 2013. At end-September, outstanding RMB loans to non-financial businesses and other sectors posted 56.9 trillion yuan, up 11.8 percent year on year. This represented an acceleration of 0.2 percentage point from both the end of July and the end of August, a deceleration of 0.3 percentage point from the end of June, an increase of 5.0 trillion yuan from the beginning of the year, and an acceleration of 818.3 billion yuan year on year.

In terms of the maturity brackets of RMB loans, growth of medium- and long-term loans picked up, while growth of short-term loans moderated. At end-September, outstanding medium- and long-term loans registered 44.4 trillion yuan, up 13.4 percent year on year. This represented an increase of 4.5 trillion yuan from the beginning of the year and an acceleration of 663.2 billion yuan year on year. New medium- and long-term loans accounted for 59.2 percent of the total new loans, up 5.8 percentage points from the corresponding period of the last year. In particular, fixed-asset loans accounted for a larger share of the total new loans. During the first three quarters, new fixed-asset loans posted 2.3 trillion yuan, an acceleration of 509.9 billion yuan year on year. The growth of new fixed-asset loans at end-September was 12.3 percent, an acceleration of 1.3 percentage points year on year. This was an important factor in bolstering investment. At end-September, outstanding short-term loans stood at 31.2 trillion yuan, an increase of 11.1 percent year on year and a deceleration of 4.3 percentage points from the end of June. Bill financing increased by a large margin. During the first three quarters, the amount of bill financing posted 738.3 billion yuan, an acceleration of 727.9 billion yuan year on year. Since the second quarter, as liquidity in the banking system was relatively abundant and the rate of bill discounts rate had declined, the amount of bill financing increased rapidly. Broken down by financial institutions, loans of large Chinese-funded national and local banks reported larger year-on-year growth.

Table 1 RMB Loans by Financial Institutions during the First Three Quarters of 2014

Unit: 100 million yuan

	First three quarters of 2014		First three quarters of 2013	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded large-sized national banks ①	36,628	3,410	33,218	2,174
Chinese-funded small- and medium-sized national banks ②	20,951	-1,982	22,933	4,426
Chinese-funded small- and medium-sized local banks ③	12,987	3,438	9,550	-373
Small-sized rural financial institutions ④	11,864	-203	12,067	1,069
Foreign-funded financial institutions	436	182	253	-306

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 end-September, outstanding foreign currency loans of financial institutions posted USD838.3 billion, up 9.5 percent year on year. This was USD61.5 billion more than that at the beginning of the year and a deceleration of USD20.8 billion year on year. In terms of the loan structure, short-term operational loans increased by USD32.4 billion, an acceleration of USD15.3 billion year on year. Outward loans increased by USD22.3 billion, at par with the amount during the same period of the last year. Foreign currency denominated loans have provided greater support to the trade sector and the "going global" strategy.

IV. The amount of all-system financing aggregates remained at an appropriate level and the financing structure was further optimized

According to preliminary statistics, during the first three quarters of 2014, all-system financing aggregates reached 12.84 trillion yuan, representing a decrease of 1.12 trillion yuan year on year, the second highest decrease in history. In particular, during the third quarter all-system financing aggregates posted 2.31 trillion yuan, a decline of 1.51 trillion yuan from the same period of the last year.

In terms of the financing structure, all-system financing aggregates during the first three quarters of 2014 were characterized by the following: First, RMB loans registered a larger increase and their share of all-system financing aggregates rose significantly. During the first three quarters of 2014, new RMB loans accounted for 59.8 percent of all-system financing aggregates, up 7.7 percentage points over the same period of the last year. Second, the amount of trust loans and undiscounted bankers' acceptance bills shrank significantly, and the growth of off-balance-sheet financing registered a notable year-on-year deceleration. With progress in structural adjustments and stricter regulatory requirements, the demand for funding in industries with soft budget constraints and in areas with restrictive policies that originally received funding from off-balance-sheet channels underwent some changes. As this part of financing activities contracted, some off-balance-sheet businesses moved to the balance sheet. During the first three quarters of 2014, the combined financing via entrusted loans, trust loans, and undiscounted bankers' acceptances amounted to 2.27 trillion yuan, representing a decline of 1.78 trillion yuan year on year and accounting for 17.6 percent of all-system financing aggregates, down 11.4 percentage points from the same period of the last year. Third, both debt and equity financing increased notably, and the amount and share of direct financing reached historical highs. During the first three quarters, the combined amount of financing via debt and equity issuances on the domestic market posted 2.12 trillion yuan, an increase of 427.1 billion yuan year on year. This accounted for 16.6 percent of all-system financing aggregates, up 4.4 percentage points year on year. The rising share of direct financing indicated that the financing structure was being optimized, helping to lower the financing costs of enterprises. In addition, the amount of new foreign currency denominated loans was less than that during the same period of the last year.

Table 2 All-system Financing Aggregates during the First Three

Quarters of 2014

Unit: 100 million yuan

	All-system financing aggregates①	Of which:						
		RMB loans③	Foreign currency denominated (RMB equivalent)	Entrusted loans	Trust loans	Undiscounted bankers' acceptances	Enterprise bonds	Financing by domestic institutions via the domestic stock markets
First three quarters of 2013	139,681	72,787	5,165	18,200	15,856	6,361	15,323	1,625
First three quarters of 2014②	128,441	76,832	3,756	17,871	3,602	1,188	18,186	3,033

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. The lending rates of financial institutions declined, and the costs of loans were lowered somewhat

In August, the General Office of the State Council issued *Guidance on Taking Measures to Alleviate the High Financing Costs of Businesses* (State Council General Office Document [2014] No.39). The PBC, jointly with other departments, has taken a number of measures and has urged commercial banks to implement the *Guidance*. A mix of monetary policy tools was utilized to maintain reasonable credit growth and to improve the credit structure. Market liquidity was adjusted in both directions. While total market liquidity remained at an appropriate level, efforts were made to increase agro-supporting central bank lending. The Medium-term Lending Facility (MLF) was employed to provide lending support to commercial banks that complied with the macro-prudential requirements, while Pledged Supplementary Lending (PSL) was tapped to provide stable longer-term and cost-effective funding support to development financial institutions in their efforts to promote renovations of shantytowns. The indicator system for macro-prudential management was further improved to gradually expand the room for local small and medium legal-person financial institutions and for relatively large financial institutions that have supported shantytown renovation and for the foreign trade sector to increase lending. Where appropriate, price levers were used to guide the downward movement of market interest rates. The 14-day reverse repo rate was cut on three occasions, respectively in July, September, and October, by a total of 40 basis points. Starting from September, the PSL rate was lowered slightly. Financial institutions were urged to improve their appraisal system, to clean up and rectify unreasonable financial service charges, and to improve efficiency in their loan approvals and underwriting. Moreover, greater efforts were made to develop direct financing and to regulate inter-bank business and wealth management business.

With the joint efforts by the relevant departments and financial institutions, the high costs of corporate financing were alleviated to some extent. At the end of September, the yield-to-maturity of 3-year and 7-year enterprise bonds (rated AA) on the inter-bank market posted 5.78 percent and 6.62 percent respectively, down 1.57 and 0.84 percentage points from the end of the last year. In September, the weighted average lending rate offered to non-financial businesses and other sectors was 6.97 percent, down 0.12 percent point from August 2014 and down 0.23 percent point from December 2013. In particular, the weighted average interest rate of loans was 7.33 percent, down 0.11 percentage point from August; the weighted average bill financing rate was 5.22 percent, at par with that in August. The weighted average home mortgage rate was 6.96 percent, down 0.05 percentage point from August.

Since the beginning of 2014, the share of loans with interest rates higher than the benchmark rate rose slightly. On the one hand, this was related to the rising funding costs of banks as a result of the rapid development of the wealth management business and other financial innovations, and, on the other hand, it was related to the rising risk premium due to the declining quality of credit assets in some regions and sectors in the midst of economic restructuring. With the gradual implementation of measures aimed at reducing corporate financing costs, in September the share of loans with lending rates lower than or flat with the benchmark rate rose, whereas the share of loans with lending rates higher than the benchmark rate declined. In September the share of loans with interest rates lower than or flat with the benchmark rate was 8.31 percent and 20.43 percent respectively, up 0.81 and 1.63 percentage points from August, and the share of loans with interest rates higher than the benchmark rate was 71.26 percent, down 2.44 percentage points from August. However, it is worth noting that there are many reasons for the high financing costs, among which the high debt ratio and the rising risk premiums were the two main factors. To deal with the issue of the high financing costs, we need to address both their symptoms and the root causes, and to accelerate the pace of structural adjustments and reform.

Table 3 Shares of Loans with Rates at, above, and below the Benchmark Rate, January through September 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
July	8.23	19.68	72.09	19.35	27.78	12.46	9.69	2.81
August	7.50	18.80	73.70	18.28	29.35	13.21	9.81	3.05
September	8.31	20.43	71.26	19.01	28.18	12.29	9.00	2.78

Source: The People's Bank of China.

The deposit and lending rates of foreign currencies declined somewhat from June due to the movement of interest rates on international markets and changes in the supply and demand of foreign currencies in China. In September, the weighted average interest rate of US dollar demand deposits and US dollar deposits with maturities of less than 3 months registered 0.14 percent and 0.83 percent respectively, down 0.08 and 1.16 percentage points from August. The weighted average interest rates of US dollar loans with maturities of less 3 months and of 3 to 6 months (including 3 months) posted 2.53 percent and 2.51 percent respectively, down 0.34 and 0.52 percent point from August.

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

Unit:%

Month	Large-value deposits						Loans				
	Demand Deposits	Within 3 months	3-6 months (including 3 months)	6-12 months (including 6 months)	1 year	Above 1 year	Within 3 months	3-6 months (including 3 months)	6-12 months (including 6 months)	1 year	Above 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
July	0.21	1.59	2.72	2.96	3.47	2.48	2.73	2.97	3.32	3.24	3.72
August	0.19	1.09	2.13	2.77	3.06	2.16	2.61	2.66	3.01	2.89	3.39
September	0.14	0.83	1.76	2.30	2.40	1.18	2.53	2.51	2.67	2.74	3.55

Source: The People's Bank of China.

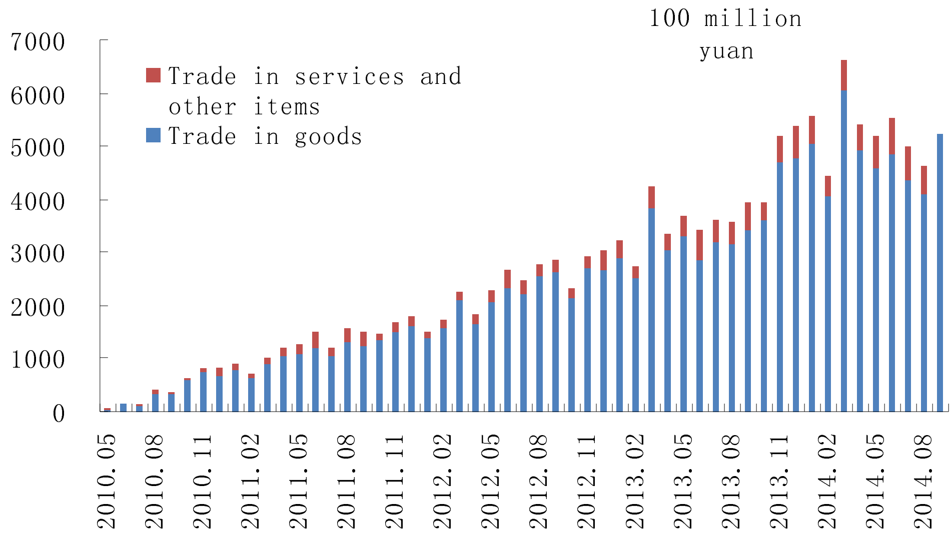
VI. The flexibility of the RMB exchange rate was strengthened

In the third quarter, the RMB exchange rate remained basically stable and moved in both directions, with stronger flexibility and stable expectations. At end-September, the central parity of the RMB against the US dollar was 6.1525 yuan per dollar, representing an appreciation of 3 basis points, or 0.005 percent, from the end of June. From the reform of the RMB exchange-rate regime in 2005 to end-September 2014, the RMB registered a cumulative appreciation of 34.52 percent against the US dollar. According to calculations by the BIS, in the third quarter the NERR and REER of the RMB appreciated by 4.50 percent and 4.97 percent respectively, and from the RMB exchange-rate regime reform in 2005 to September 2014, the NEER and REER of the RMB appreciated by 34.11 percent and 43.36 percent respectively.

VII. Cross-border RMB business continued to grow steadily

According to preliminary statistics, in the third quarter of 2014, commercial banks processed 1.53 trillion yuan in RMB settlements of cross-border trade,[1] up 36.7 percent year on year. In particular, settlements of trade in goods registered 1.24 trillion yuan and settlements of trade in services and other items under the current account registered 0.29 trillion yuan. Actual RMB receipts and payments from cross-border trade registered 651.12 billion yuan and 882.56 billion yuan respectively, resulting in a receipt-payment ratio of 1:1.36. Bank settlements of cross-border direct investments in RMB totaled 250.96 billion yuan, up 68.4 percent year on year. Specifically, outward direct investments settled in RMB totaled 47.21 billion yuan, up 56.1 percent year on year, and foreign direct investments settled in RMB totaled 203.75 billion yuan, up 71.6 percent year on year.

[1] Beginning from August, the statistics on entrepôt trade without custom declarations and clearance were adjusted from trade in services to trade in goods. Consequently, the statistics on trade in goods increased, whereas those on trade in services decreased. The historical data were adjusted accordingly.



Source: The People's Bank of China.

Figure 1 RMB Settlements of Cross-border Trade

Box 2 A Five-Year Retrospective of Cross-border RMB Business

China's rapid economic growth, expansion of foreign trade, and opening-up of the financial sector have gradually generated demand for RMB in the rest of the world. The RMB began to circulate beyond the Chinese border, though in the initial stages it was mainly in the border areas. In 2004, cross-border RMB business first began in Hong Kong and Macao. The business volume grew rapidly, though still at a low level. After the outbreak of the global financial crisis in 2008, the US dollar and other major reserve currencies fluctuated within a large margin, and enterprises both at home and abroad had a strong demand for RMB settlements of cross-border trade. Local governments in Shanghai and Guangdong as well as other areas applied to the State Council for permission to carry out RMB settlements of cross-border trade on a pilot basis. Against this backdrop and with the approval of the State Council, the PBC took the lead in launching a pilot program for RMB settlements of cross-border trade. Enterprises in the domestic pilot regions were allowed to carry out RMB settlements of cross-border trade, and subsequently the overseas areas designated for the pilot program were expanded to the entire world. During the last five years, the PBC, together with other departments, has abided by the principle of "acting in a low-profile and pragmatic manner, responding to the market demand, advancing the pilot program gradually in due order, and keeping risks controllable," and gradually established a policy framework and regulatory mechanism for the cross-border use of RMB.

First, efforts were made to fully facilitate settlements and use of RMB in cross-border trade. With the approval of the State Council, in July 2009 the pilot program of RMB settlements of cross-border trade was conducted in Shanghai and in four cities in Guangdong Province (i.e., Guangzhou, Shenzhen, Zhuhai, and Dongguan). The pilot program was expanded in June 2010 and again in August 2011. As a result, the domestic pilot areas were expanded to the entire country, and domestic enterprises engaged in trade in goods, services, and other items under the current account were able to select RMB as the pricing, billing, and settlement currency, while individuals engaged in trade in goods and services could also use RMB as the settlement currency. The relevant agencies have also gradually used RMB as the billing currency for the statistics, accounting, and management of cross-border trade, investments, balance of payments, and so forth. From the start of the cross-border RMB business to the third quarter of 2014, the volume of RMB settlements of cross-border transactions was more than 4.8 trillion yuan. The RMB has become the second most-used currency for cross-border payments and receipts of Chinese entities, accounting for 25 percent of the total cross-border payments and receipts. The share of RMB settlements in the total volume of settlements of trade in goods was more than 15 percent. RMB receipts and payments have taken place between China and 174 countries. Due to the availability of the cross-border RMB business, enterprises are able to hedge exchange-rate risks and to reduce financial costs. Banks now provide a greater variety of financial products and services to enterprises to support their cross-border trade and investment activities. Both enterprises and banks have benefited from the development of the cross-border RMB business. In general, the cross-border use of RMB covers all items in the current account and is supported by adequate facilitation.

Second, RMB settlements and use in cross-border direct investments have been actively carried out. To support the pilot program of RMB settlements of cross-border trade, in January 2011 domestic institutions were allowed to make outbound investments with RMB. In October 2011, overseas institutions were allowed to make direct investments in mainland China with RMB. In September 2013, overseas institutions were allowed to invest in domestic financial institutions. The amount of RMB overseas investments and outbound direct investments totaled 1.67 trillion yuan.

Third, RMB-denominated cross-border financial investments were promoted in a stable and orderly way. In August 2010, overseas institutions were allowed to invest in China’s inter-bank bond market. In December 2011, the pilot scheme for RMB Qualified Financial Institutional Investors (RQFII) was launched. Overseas institutions were encouraged to issue RMB-denominated bonds in China’s inter-bank market and the reflow channel for RMB was expanded to create a beneficial cycle for the RMB outflow and inflow mechanism. As of September 2014, 177 overseas institutions were granted access to the domestic inter-bank bond market; an investment quota of 740 billion yuan was approved under the RQFII scheme; and 86 overseas institutions were qualified to participate in the pilot scheme, making total investments of 283.3 billion yuan.

Fourth, supportive arrangements were established to promote the development of offshore RMB centers in an orderly way. With the approval of the State Council, in addition to Hong Kong, Macao, and Taiwan, RMB clearing arrangements have been established in Singapore, London, Frankfurt, Seoul, Paris, and Luxemburg, and a Chinese-funded bank has been designated as the clearing bank for the local RMB business. The channels and mechanisms for offshore RMB use and flows were expanded to support the RMB to gradually become a regional invoice investment and financing currency.

Fifth, international cooperation with respect to the use of local currency was continuously deepened. In parallel with the progress in the cross-border RMB business, between 2009 and October 31, 2014, the PBC signed local currency swap agreements with 26 monetary authorities and central banks, amounting to a total volume of about 2.9 trillion yuan. Direct trading has been launched between the RMB on the one hand, and the euro, Japanese yen, British pound sterling, Australia dollar, New Zealand dollar, Singapore dollar, Malaysian ringgit, and Russian ruble on the other hand. Some central banks and monetary authorities have held RMB in their foreign exchange reserves while more central banks and monetary authorities are planning to do so in the future. The RMB has become the 7th largest reserve currency in the world. Local currency cooperation is playing an increasing role in deepening international economic, trade, and financial ties, and in maintaining the stability of the international financial system.

Part 2 Monetary Policy Operations

In the third quarter of 2014, in accordance with the overall arrangements of the Party Central Committee and the State Council, the PBC continued its sound monetary policy and took measures to respond to the downward pressures and the moderation in price inflation, while remaining focused on the goal of macro-economic management and taking initiatives as called for. The PBC has made innovations in the approach and methodology of macro-economic management, diversifying policy instruments, optimizing the combination of policy measures, dealing with salient issues in economic performance, and carrying out pre-emptive adjustments and fine-tunings of the structural adjustments to keep aggregate liquidity at an adequate volume and to maintain stable market interest rates, to guide reasonable credit growth and structural optimization, and to beef up credit support to small and micro enterprises, the agricultural sector, rural areas, and farmers, and the central and western regions. The above measures have played an important role in the development of the real economy.

I. Flexible open market operations were conducted

The PBC continued to use open market operations to conduct preemptive adjustments and fine-tunings. In view of the changing liquidity situation during the various periods, the PBC properly managed the intensity and pace of reverse operations and successfully dealt with volatility in short-term liquidity caused by a number of complex factors. In the third quarter, a total of 438 billion yuan of reserve repo operations was conducted, while the maturity and variety of open market operations were optimized. Due to the changed supply and demand for short-term liquidity, the maturity of reverse repo operations was shortened from 28 days to 14 days to make liquidity management more targeted and effective.

Analysis and monitoring of the market environment and market interest-rate movements were strengthened. Responding to changes in market-rate trends, the flexibility of open market operations was enhanced when appropriate. In the third quarter, the interest rate of 14-day reverse open operations was lowered on two occasions, by 10 and 20 basis points respectively, which helped to guide market expectations and to promote stable market operations. At end-September, the interest rate of 14-day reverse repo was 3.5 percent, down 30 basis points from the second quarter. In October, it declined further by 10 basis points.

State treasury cash management operations were conducted in an appropriate manner. In the third quarter, a total of 160 billion yuan of state treasury funds was deposited in commercial banks in three separate operations, including 110 billion yuan in three-month deposits, and 50 billion yuan in six-month deposits.

II. The Medium-term Lending Facility (MLF) was launched and MLF operations were conducted

Currently, liquidity management in the banking system must respond to shocks from changes in capital flows, fiscal expenditures, and IPOs in the equity market, but also must undertake the task of improving the price-based macro-economic management framework, guiding the movement of market interest rates, and so forth. To maintain the liquidity in the banking system at an appropriate volume and to support the reasonable growth of money and credit, the PBC must continuously enrich and improve the mix of instruments based on the specificity of the demand for liquidity, the party in need, and the use of the liquidity, so as to make macro-economic management more flexible, targeted, and effective. Based on these considerations, the PBC launched the Medium-term Lending Facility (MLF) in September 2014. The MLF is a policy instrument to provide medium-term base money to commercial banks and policy banks that comply with the macro-prudential requirements. The MLF is provided with government bonds, central bank bills, policy financial bonds, high-grade debenture bonds, and other high-quality bonds as eligible collateral.

In September and October, the PBC provided, in the form of MLF 500 billion yuan and 269.5 billion yuan of base money with a maturity of 3 months and an interest rate of 3.5 percent respectively to state-controlled commercial banks, joint-stock commercial banks, relatively large city commercial banks, and rural commercial banks. In addition to providing liquidity, the MLF rate has acted as a medium-term policy interest rate, guiding commercial banks to lower lending rates and social financing costs to support the growth of the real economy. In general, while the pace of providing base money via the purchase of foreign exchange has moderated, the MLF has helped to bridge the liquidity gap and to maintain liquidity at an appropriate volume.

Given the overall liquidity situation in the money market, in the third quarter the PBC did not conduct Standing Lending Facility (SLF) operations and kept the balance of SLFs at zero.

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 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 has recalibrated the parameters of the dynamic adjustment mechanism for the differentiated reserve requirement. In the third quarter, the PBC further adjusted the policy parameters in the implementation of the credit policy for small and micro enterprises and agro-linked loans to encourage financial institutions to ramp 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.

Box 3 Desirability Lending

The so-called "desirability lending" that has been frequently covered in recent media reports is in fact the differentiated reserve requirement dynamic adjustment mechanism. The purpose of this mechanism is to help financial institutions to match their credit extensions with their capital levels and the reasonable demands for economic growth. In particular, capital requirements include not only the minimum capital requirement of 8 percent, but also macro prudential requirements, such as counter-cyclical capital buffers, capital surcharges for systemically important institutions, and capital reserves. The essence of this mechanism is that the growth of overall credit should be aligned with the projected rate of economic growth. The faster credit expands, the worse its misalignment is with the desirability level and the more risks that are likely to build up. Therefore, it is necessary to impose a higher capital requirement to mitigate the pro-cyclical fluctuations of credit expansion, prevent the build-up of systemic risks, and make sure that the financial system will support the real sector in a sustainable way. Thus, desirability lending is a transparent, rule-based macro-prudential policy tool based on capital requirements. It is different from administrative controls on the lending quota.

Given the current environment of macro-economic management, the desirability lending tool is a reasonable choice as a new macro-prudential instrument to absorb the effects of the stimulus policy adopted during the previous period. The choice of the macro-economic management framework has to take into account various constraining factors and must be consistent with the level of economic development. After observing that the package of stimulus measures had an effect in addressing the global financial crisis and the recovery of the Chinese economy solidified, the PBC started to guide monetary conditions to return to normal in accordance with the overall arrangements of the State Council. However, at that time, there were different views among the various parties market pressures were intense. Since interest rates and the reserve requirement provide strong signals, it is necessary to adopt macro-prudential measures to guide commercial banks to operate on a sound basis and to refrain from excessive expansion. Over the years the PBC has focused on shifting to an indirect, market-based approach, and has increased the role of liquidity management and price instruments. However, the use of price instruments is affected by many factors, such as the existence of liquidity constraints, resistance to large interest-rate adjustments, lack of sensitivity to interest rates at the micro level, the ongoing exchange-rate regime reform, and so forth. Therefore, it is necessary for the macro-prudential tools to play a role in macro-economic management. As the situation evolves and the reform deepens, naturally there will be other choices in terms of instruments.

Desirability lending has the feature of being transparent and rule-based, and it is capable of dynamic adjustment. Using an established formula and the relevant parameters, financial institutions can calculate the desirability growth of lending and better understand the stance and orientation of the macro-economic policy. This limits to a maximum extent the room for discretionary judgment, and differentiates desirability lending from the traditional lending quota. Of course, complex factors are involved in its implementation. For example, some rural credit cooperatives have a capital adequacy ratio far below the regulatory requirements or even at negative levels. If the rules of desirability lending were to be strictly followed, it would require that lending be reduced, and would have large repercussions on local economic activities in the under-developed regions where financial services are scarce. Also, for newly established financial institutions, including township and village banks, historical data are unavailable. These situations call for a flexible approach in the use of desirability lending. The dynamic adjustment feature of desirability lending makes it possible to reflect the changes in the macro-economic situation and in the business operations of financial institutions in a timely manner. On the one hand, changes in the capital adequacy ratio and other indicators of financial institutions will cause desirability lending to move; on the other hand, the central bank may also adjust the parameters of the macro-prudential policy based on the changes in the macro-economic situation. In general, since the adoption of macro-prudential tools, credit extensions have been in appropriate volumes and have been consistent with the demands of economic development, and the credit structure has improved as well.

The growth of desirability lending is usually the annual growth of lending, whereas the pace of credit extensions within a year is determined by the financial institutions based on their liquidity situation, business strategy, and the actual demand for loans in the real sector. In general, desirability lending is to be achieved based on the principle of seeking an overall balance without drastic fluctuations, combined with flexibility to meet the actual demand for loans in the real economy. In particular, rural financial institutions can manage the pace of credit extensions in a flexible way based on the seasonal demands from the agricultural cycles. In general, in the case of many rural financial institutions, a very large proportion of lending takes place in the first several quarters, usually in line with the agricultural cycles.

The relationship between desirability lending and targeted reductions of the reserve requirements should be viewed in the proper context. Under the precondition of preserving macro-economic stability and maintaining reasonable growth of money and credit, the PBC, since the beginning of 2013, has adjusted the indicators of the macro-prudential regulatory framework on several occasions in view of the changes in the economic situation and has expanded the room for desirability lending. As a result, the subsequent increase in lending was larger than that released by the targeted reduction of the reserve requirements. Some financial institutions have limited room for credit expansions due to a lack of capital strength. The targeted reduction of the reserve requirements mainly sends out a signal and aims to establish a positive incentive mechanism to optimize the credit structure and to guide financial institutions to beef up the share of agro-related loans and lending to small and micro enterprises. It is not a measure designed to expand aggregate credit. Many financial institutions have the potential to further increase lending to small and micro enterprises and the agricultural sector by improving the structure of the stock of assets. Without an expansion in total lending, other categories of loans may be reduced and a larger share of the principal and interest payments for loans and of new loans can be used to support small and micro enterprises, the agricultural sector, rural areas, and farmers. The targeted reduction in the reserve requirement can play a supportive role, but it cannot replace the role of the market in determining fund flows. At a fundamental level, measures should be taken to increase the willingness and capacity of financial institutions to lend to small and micro enterprises, agricultural sectors, rural areas, and farmers, such as adopting preferential tax treatments for small and micro enterprises, building the capital strength of small and medium-sized financial institutions, establishing small and medium-sized banks with private capital, and preventing entities with soft budget constraints from abusing an excessive volume of resources.

IV. Central bank credit policy lending was used to encourage financial institutions to provide more loans to the agricultural sector, rural areas, and farmers, and to small and micro enterprises

To implement the requirements of the Executive Meeting of the State Council on increasing agro-supporting and small and micro enterprise supporting central bank lending and discounts, increasing the capacity of the financial industry to serve the weak links in the economy, such as the agricultural sector, rural areas, and farmers, and small and micro enterprises, in the third quarter of the year the PBC increased agricultural-supporting central bank lending and discounts, and guided financial institutions to step up credit support to the agricultural sector, rural areas, and farmers, and to small and micro enterprises. Meantime, the PBC continued to improve the management of agricultural-supporting central bank lending and discounts, and required that the average interest rates of loans underwritten by rural financial institutions by using the proceeds of the agricultural-supporting central bank loans be lower than those of other agro-linked loans with the same maturities. In addition, the PBC gave priority to agro-linked and small and micro enterprise bills in its discount window and offered a discount rate lower than the average interest rate of discounts with the same maturities so as to lower the social financing costs. For agricultural-supporting and small and micro enterprise supporting loans extended by financial institutions to earthquake-stricken Ludian county by using central bank loans, the lending rates were one percentage point lower than those of normal agricultural-supporting and small and micro enterprise supporting loans so as to support the reconstruction of the earthquake-stricken areas. At end-September, outstanding agricultural-supporting central bank loans posted 214.8 billion yuan, an increase of 46.4 billion yuan from the beginning of the year; outstanding small and micro enterprise supporting central bank loans posted 46.5 billion yuan, an increase of 46.5 billion from the beginning of the year; and outstanding central bank discounts posted 125.7 billion yuan, an increase of 12 billion yuan from the beginning of the year.

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, conducted assessments of credit policy guidance, and encouraged banking financial institutions to make innovations in terms of organizations, mechanisms, products, and service models and to optimize the credit structure. A number of measures were adopted to upgrade financial services to small and micro enterprises. Continual efforts were made to improve institutional building in the inter-bank bond market, expand the direct financing channels for small and medium enterprises, and support eligible commercial banks to issue financial bonds earmarked for lending to small and micro enterprises. Efforts were also made to increase financial support to new types of agricultural entities, such as family farms and the modern agricultural sector. Consumer finance was further developed. Financial services were improved to better the livelihood of the people, in areas such as job creation, students in need, ethnic minorities, rural migrant workers, and college-graduates who become village officials, and to promote poverty alleviation, economic development, and balanced regional development. Credit inputs were increased to advanced manufacturing industries with good market prospects, strategic emerging industries, modern IT industries and information consumption, the cultural industry, the service industry, the transformation and upgrading of traditional industries, and industries promoting green and environmentally friendly growth. The reasonable funding needs of key ongoing and follow-up projects were satisfied and efforts were made to support major infrastructure and livelihood projects, such as the reconstruction of shanty dwellings, construction of railways and underground pipe networks, in order to help improve the quality and efficiency of growth. The financial services coordination mechanism for 14 contiguous poverty-stricken areas was further improved to effectively improve financial services for poor areas. Efforts were made to guarantee financial services for post-quake reconstruction in Ludian county. Financial services were improved to address problems of excess capacity. For enterprises that sought to consolidate their excess capacity, targeted credit was provided to support mergers and acquisitions. A differentiated approach was adopted toward profit-making enterprises in industries with excess capacity. The pilot program of credit securitization was expanded to help financial institutions better manage the stock of credit assets.

In terms of the effectiveness of the credit policy, the credit structure has shown positive results and has provided greater support to priority areas, such as the agricultural sector, rural areas, and farmers, and small and micro enterprise. First, the growth of small and micro enterprise loans outpaced the growth of total loans. At end-September, outstanding RMB loans to small and micro enterprises stood at 14.55 trillion yuan, up 13.5 percent year on year. This growth was 4.1 and 1.8 percentage points higher than that to large and medium enterprises respectively, and 0.3 percentage point higher than the growth of total loans. Second, the growth of agro-linked loans continued to outpace the growth of total loans. At end-September, outstanding RMB and foreign currency denominated agro-linked loans increased 13.7 percent year on year to 22.92 trillion yuan, outpacing the growth of total loans by 0.7 percentage point. Third, credit funds were tilted to the western region, and the credit imbalance among the various regions was continuously alleviated. At end-September, the balance of RMB and foreign currency denominated loans to the western region increased 15.9 percent year on year, outpacing the growth of loans to the eastern and central regions by 4.7 and 1.1 percentage points respectively.

VI. Further improvements in the RMB exchange-rate regime

The RMB exchange-rate regime was further improved in a self-initiated, controllable, and gradual manner. Focusing on the role of market demand and supply 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 third quarter, the central parity of the RMB against the US dollar peaked at 6.1425 yuan per dollar and reached a trough of 6.1707 yuan per dollar. It appreciated on 27 out of 65 trading days and depreciated on the remaining 38 trading days, with the largest day-to-day appreciation at 0.30 percent (or 187 points) and the sharpest day-to-day depreciation at 0.10 percent (or 61 points).

The RMB exchange rate moved in both directions against the euro, Japanese yen, and other major currencies. At end-September, the central parity of the RMB against the euro and the Japanese yen registered 7.8049 yuan per euro and 5.6242 yuan per 100 yen, representing an appreciation of 7.56 percent and 8.13 percent respectively from the end of June. Beginning from the reform in 2005 to end-September 2014，on a cumulative basis the RMB appreciated 28.31 percent and 29.90 percent against the euro and the Japanese yen respectively.

To facilitate bilateral trade and investment, on September 30, 2014, direct trading between the RMB and the euro was launched on China's inter-bank foreign exchange market. Meanwhile, direct trading between the RMB and other currencies on the inter-bank foreign exchange market was brisk and market liquidity increased notably, which helped to lower the currency conversion costs for economic entities. In the third quarter of 2014, direct market trading between the RMB and the euro registered 49.51 billion yuan.

Table 5 Trading Volume of the RMB against Other Currencies on the Inter-bank Foreign Exchange Spot Market during the Third Quarter 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	56,722.0	495.1	1,110.4	558.3	571.9	301.6	47.7	4.8	2.0	26.6	0.75

Source: China Foreign Exchange Trade System.

In the third quarter, based on the bilateral local currency swap agreements with the PBC, overseas monetary authorities conducted a total of 294 billion yuan of currency swap transactions with the PBC. These transactions played an active role in promoting bilateral trade and investment.

VII. Deepening the reform of financial institutions

The transformation and reform of asset management companies were advanced. On August 28, China Huarong Asset Management Co. Ltd. signed cooperation agreements with eight strategic investors, i.e., China Life (Group), U.S. Warburg Pincus, CITIC Securities International, Khazanah Nasional Berhad of Malaysia, China International Capital Corporation (CICC), China National Cereals, Oils, and Foodstuff Corporation (COFCO), Fosum International, and Goldman Sachs. China Life (Group) increased its shareholding in China Huarong Asset Management Co., and seven other strategic investors made a total of 14.54 billion yuan of investments, accounting for 21.0 percent of the equity of China Huarong Asset Management Co. after its capital increase.

The reform of the rural credit cooperatives (RCCs) proceeded smoothly. The asset quality of the RCCs continued to improve, and agro-linked loans provided by the RCCs increased rapidly. As of the end of September, the NPL ratio of the RCCs across the country was 3.9 percent, down 0.2 percentage point from the end of 2013; the capital adequacy ratio of the RCCs was 10.8 percent, up 0.4 percentage point from the end of 2013. Outstanding loans of the RCCs across the country stood at 10.4 trillion yuan, accounting for 13.0 percent of the total loans provided by all kinds of financial institutions during the same period, up 0.3 percentage point from the end of 2013. Outstanding agro-linked loans and loans to farmers posted 6.9 trillion and 3.4 trillion yuan, up 11.6 percent and 12 percent respectively from the end of 2013. The reform of the ownership structure of the RCCs was pushed ahead. Further progress was made in clarifying the ownership structure, improving the corporate governance, and strengthening the internal management, and the management and performance of the RCCs improved. At end-September, there were 1,574 RCCs, 574 rural commercial banks, and 106 rural cooperative banks with legal-person status at the county (city) level.

Since the beginning of 2014，business performance in some areas and industries declined, and some enterprises encountered difficulties in their operations, weighing on the quality of bank credit assets. As of the end of June, outstanding non-performing loans (NPLs) of commercial banks posted 694.4 billion yuan, up 102.4 billion yuan from the end of 2013; the NPL ratio stood at 1.08 percent, up 0.08 percentage point from the end of 2013. The rebound in NPLs of commercial banks was due to the accelerated economic structuring and the declining profits of some enterprises. However, the NPL ratio of commercial banks in China is still at a low level compared with that of other major economies in the world. In addition, their profitability, capital adequacy ratio, and provisioning levels remain fairly good. In the first half of 2014, total profits of commercial banks posted 858.3 billion yuan, up 14.0 percent year on year; at end-June the weighted average of the tier-one capital adequacy ratio of commercial banks was 10.1 percent, up 0.2 percentage point from the end of 2013, and the weighted average of the capital adequacy ratio was 12.4 percent, up 0.2 percentage point from the end of 2013; the provisioning coverage ratio was 262.9 percent, down 19.8 percentage points from the end of 2013; the loan provisioning ratio was 2.8 percent, at par with the level at the end of 2013. Overall, commercial banks had a relatively strong capacity in terms of managing risks and absorbing losses as they developed some potential to absorb credit-asset losses, and their credit risks were generally controllable.

VIII. Reform of the foreign exchange administration was deepened

The reform of the foreign exchange administration was advanced to promote facilitation of trade and investment. First, reform of foreign exchange administration in trade was deepened. Reform of foreign exchange administration under trade in goods and services was deepened to promote the healthy development of foreign trade. Second, RMB convertibility under the capital account was advanced. A pilot program was conducted to allow foreign-invested enterprises to sell their foreign currency denominated capital funds to banks on a voluntary basis to facilitate operations and fund management of foreign-funded enterprises; the foreign exchange administration of overseas investments and financing for domestic residents was reformed so as to expedite the administrative procedures and expand the channels for capital flows.

The supervisory system for cross-border payments and receipts was strengthened. First, monitoring of cross-border capital flows and international financial markets was strengthened, contingency plans were further improved, and the package of policy toolkits was enriched. Second, system building was optimized and foreign exchange regulatory information and data sharing were enhanced to lay a solid foundation for strengthening the capacity of ex-post supervision, 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 of false transit trade foreign exchange surrender by enterprises and forward buying of foreign exchange by banks. By the end of the third quarter, 85 enterprises were found to be involved in illegal activities, with the related funds totaling USD851 million, and the amount of the administrative fines posted 106 million yuan.

Part 3 Financial Market Analysis

In the third quarter of 2014, China's financial market functioned in a stable manner. Transactions on the money market expanded rapidly while market rates declined; the amount of bond issuances increased significantly and bond issue rates fell; stock indices rose and trading on the stock markets increased rapidly.

I. Financial market analysis

1. Transactions on the money market increased rapidly while market interest rates declined

Repo transactions on the inter-bank market continued to increase rapidly, while the decline in inter-bank borrowing moderated. In the first three quarters of 2014, the turnover of bond repos on the inter-bank market totaled 157.1 trillion yuan, with an average daily turnover of 835.7 billion yuan, up 33.6 percent year on year and representing an acceleration of 15 percentage points from the first half of the year. The turnover of inter-bank borrowing reached 27.5 trillion yuan, with an average daily turnover of 146.3 billion yuan, down 3.1 percent year on year and representing an increase of 15 percentage points in year-on-year growth compared with the first half of the year. In terms of the maturity structure, overnight products still dominated bond repo and inter-bank borrowing transactions, accounting for 79.1 percent and 80.1 percent of their respective turnovers during the first three quarters of 2014, down 1.5 and 2.6 percentage points from the first half of 2014. The turnover of government securities repos on the stock exchanges rose 39.6 percent year on year to 64 trillion yuan, with growth 11.6 percentage points lower than that during the first half of the year.

The flow of funds among financial institutions displayed 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 three quarters of 2014, the amount of net lending by large banks increased 60.2 percent year on year, representing an acceleration of 30.9 percentage points from the first half of the year. Second, securities and fund management companies and small- and medium-sized banks were net fund borrowers, with their net borrowings increasing by 80.8 percent and 94.3 percent respectively year on year, up 13.1 and 64.6 percentage points from the first half of the year. Third, net borrowings of other financial institutions and products declined 20 percent year on year.

Table 6 Fund Flows among Financial Institutions during the First Three Quarters of 2014

Unit: 100 million yuan

	Repos		Inter-bank borrowing	
	First three quarters of 2014	First three quarters of 2013	First three quarters of 2014	First three quarters of 2013
Domestic-funded large banks①	-548,416	-341,606	-46,217	-29,584
Domestic-funded small- and medium-sized banks②	208,022	114,220	-29,173	-22,159
Securities and fund management companies	208,135	115,445	55,994	30,679
Insurance companies	67,006	44,073	142	0
Foreign-funded financial institutions	24,655	11,950	1,727	4,340
Other financial institutions and vehicles③	40,598	55,918	17,527	16,723

Notes: ①Domestic-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.
②Domestic-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.

In the first three quarters of 2014, the aggregate notional principal of RMB interest-rate swaps amounted to 2656.26 billion yuan. In particular, in the third quarter the aggregate notional principal of RMB interest-rate swaps amounted to 957.61 billion yuan, up 63.4 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 738.91 billion yuan, accounting for 77.2 percent of the total. In terms of the reference rate, the base rate of the floating end of the RMB interest-rate swaps mainly included the 7-day fixing repo rate and the Shibor, and their notional principals accounted for 79.4 percent and 20.0 percent of the total respectively. In the third quarter, the yield curves of interest-rate swaps showed an overall downward trend.

Table 7 Transactions of Interest-rate Derivatives during the Third Quarter of 2014

	Interest-rate swaps	Bond forwards	Forward-rate agreements

	Transactions (lots)	Amount of notional principal (100 million yuan)	Transactions (lots)	Transactions (lots)	Amount of notional principal (100 million yuan)	Transactions (lots)
In the Third quarter of 2013	5,816	5,860.5	0	0.0	1	0.5
In the Third quarter of 2014	11,150	9,576.1	—	—	—	—

Source: China Foreign Exchange Trade System.

The issuance and transactions of inter-bank CDs were increasingly brisk. Since the launch of the inter-bank CDs, the scope of issuers has expanded in an orderly manner and the number of investors has gradually increased. As of end-September 2014, 66 financial institutions disclosed their inter-bank CDs issuance plans, and 63 financial institutions completed their issuances on the inter-bank market. Issuances and transactions of inter-bank CDs were increasingly brisk. In the first three quarters, a total of 427 CDs was issued, with an aggregate amount of 407.2 billion yuan, while the transaction volume on the secondary market registered 184.5 billion yuan. The pricing of CDs issuances and transactions was based on the Shibor rates. The steady growth in the issuance and trading of inter-bank CDs provided a basis for quoting the medium- and long-end Shibor rates.

Money-market rates declined steadily. In the middle and end of July, money-market rates increased due to the freezing of a large amount of liquidity by IPOs and payments of reserve requirements by some financial institutions. The PBC used a number of policy instruments to provide liquidity and lowered the central bank reverse repo rates in July and September to guide the steady decline in the market rates. In September, the weighted average interest rate of inter-bank borrowings and bond-pledged repos posted 2.97 percent and 2.93 percent respectively, down 50 and 56 basis points year on year.

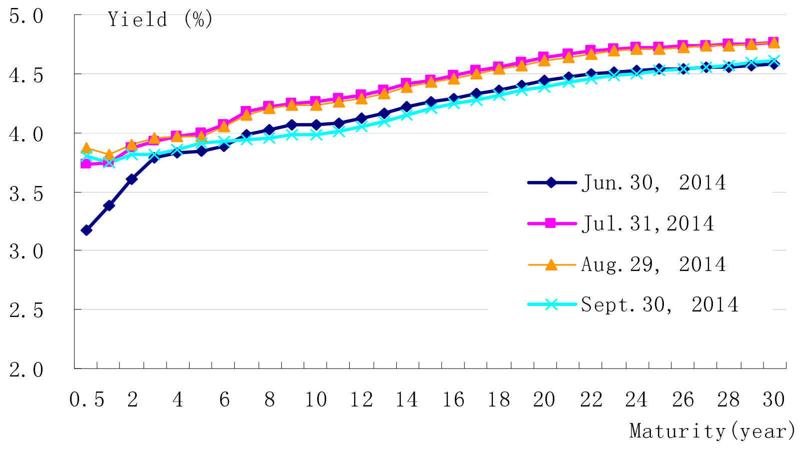
2. Bond issuances expanded rapidly and the issuance rates declined

The decline in the turnover of spot bond transactions on the inter-bank market continued to moderate year on year. In the first three quarters, a total of 28.6 trillion yuan of bonds was traded, with a daily average of 152.1 billion yuan, down 21.5 percent year on year and the decline narrowing by 24.3 percentage points from the first half of the year. A total of 1.76 trillion yuan of spot government securities was traded on the stock exchanges, up 40.8 percent year on year and an acceleration of 8.1 percentage points from the first half of the year.

In terms of trading products, in the third quarter the turnover of spot government securities was 1.76 trillion yuan, accounting for 15.9 percent of the total spot transactions on the inter-bank market; the turnover of spot financial bonds and spot corporate debenture bonds was 5.11 trillion yuan and 4.15 trillion yuan respectively, accounting for 46.2 percent and 37.5 percent of the total. In terms of trading entities, Chinese-funded small and medium-sized banks were mainly net bond sellers, with total net spot bond sales of 338.2 billion yuan, while other financial institutions and foreign-funded financial institutions and products, making net bond purchases of 171 billion yuan and 95.2 billion yuan respectively.

Bond indices continued to rise. In the third quarter, the China Bond Composite Index (net price) rose from 99.48 points at end-June to 99.97 points at end-September, up 0.49 percent, whereas the China Bond Composite Index (full price) rose from 111.84 points to 112.62 points, up 0.70 percent. The Government Securities Index on the stock exchanges rose from 142.02 points at end-June to 143.60 points at end-September, up 1.11 percent.

The yield curves of government securities on the inter-bank market moved downward after moving upward for a while, with yield curves at the short-end rising and those at the long-end declining. At end-September, the yield of 1-year government securities was 3.74 percent, up 36 basis points from end-June, and the yield of 10-year government securities was 3.98 percent, down 8 basis points from end-June. From July to early September, due to the large volatility in macro-economic and financial data, the yields of government securities rose and the yield curve showed an overall flattening and upward trend. Starting from late September, the yields of government securities fell notably and the yield curves shifted downward, with government securities at the short-ends showing a moderate decline.



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

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

The volume of bond issuances expanded significantly year on year. In the first three quarters of 2014, a total of 8.45 trillion yuan of bonds (including central bank bills) was issued, 1.51 trillion yuan more than that issued during the same period of the last year. In particular, issuances registered 3.07 trillion yuan in the third quarter, 385 billion yuan more than issuances in the same period of the last year. The issuance of financial bonds and corporate debenture bonds registered a larger year-on-year increase, while debt-financing instruments issued by non-financial enterprises increased significantly. At end-September, outstanding bonds of all kinds posted 34.2 trillion yuan, up 17.3 percent year on year and representing an acceleration of 2.7 percentage points from end-June. Municipal project revenue notes were newly launched, issued by project companies with the operating cash flow used as the primary source of repayment. The first municipal project revenue note was issued on July 14, 2014. The launch of municipal project revenue notes will help to build a transparent and regulated investment and financing mechanism for urban construction, effectively controlling and resolving the debt risks of local governments and providing funding for urban construction.

Table 8 Issuance of Major Bonds during the First Three Quarters of 2014

Type of bond	Issuance (100 million yuan)	Year-on-year growth (100 million)
Government securities①	16,585	946
Central bank bills	0	-5,148
Financial bonds②	28,380	8,410
Of which: Financial bonds issued by the China Development Bank and policy financial banks	19,094	3,710
Corporate debenture bonds③	39,530	10,930
Of which: Debt-financing instruments of non-financial enterprises	31,269	8,605
Enterprise bonds	7,345	2,878
Corporate bonds	691	-557
Total	84,495	15,137

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.

In general, bond issuance rates declined. The interest rate of 10-year financial bonds issued by the China Development Bank in September 2014 was 4.68 percent, down 22 basis points from those of the same maturity issued in June 2014. The average interest rate of short-term financing bills (rated A-1) issued by AAA-rated enterprises was 5.04 percent, up 5 basis points from June; the average rate of 5-year medium-term notes (rated AAA) issued by AAA rated enterprises was 5.49 percent, down 10 basis points from June; the average rate of 7-year bonds (rated AA+) issued by AA+ rated enterprises was 6 percent, down 77 basis points from June. The Shibor played a greater role in bond pricing. In the first three quarters, 2 floating-rate bonds were based on the Shibor, with a gross issuance volume of 8 billion yuan; 510 fixed-rate enterprise bonds were all based on the Shibor, with a gross issuance volume of 613.5 billion yuan; and a total of 818.7 billion yuan of fixed-rate short-term financing bills was issued based on the Shibor, accounting for 98 percent of all fixed-rate short-term financing bills.

3. The volume of bill financing continued to increase and bill-financing rates showed a downward trend

In the first three quarters of 2014, commercial bills discounted by financial institutions totaled 42.5 trillion yuan, up 22.8 percent year on year; the outstanding balance of bill discounts posted 2.7 trillion yuan, up 31.1 percent year on year. At end-September, the outstanding amount of bill financing had grown by 738.3 billion yuan from the beginning of the year and 495 billion yuan from the end of June; the share of outstanding bill financing in the total outstanding loans stood at 3.4 percent, up 0.5 percentage point year on year. Affected by a number of factors, such as the guidance of the central bank discount rate, the money-market rates, and changes in demand and supply on the bill market, the bill-financing rates showed a downward trend.

Growth of the bill acceptance business moderated. In the first three quarters of 2014, commercial bills issued by enterprises totaled 16.2 trillion yuan, up 6.9 percent year on year; outstanding commercial bills at end-September posted 9.7 trillion yuan, up 8.8 percent year on year. At end-September, outstanding bankers’ acceptance bills had increased by 686.1 billion yuan from the beginning of the year and had declined by 478 billion yuan from the end of June. In terms of the issuing entities, outstanding 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.

4. The stock indices and the turnover both rose rapidly, and financing on the equity market registered a larger increase

The stock indices rallied across the board. At end-September, the Shanghai Stock Exchange Composite Index closed at 2,364 points, gaining 248 and 316 points respectively from the end of 2013 and the end of June 2014; the Shenzhen Stock Exchange Component Index closed at 1,334 points, gaining 276 and 237 points respectively from the end of 2013 and the end of June 2014; the Growth Enterprise Board (GEB) Index (Chinext Price Index) closed at 1,541 points, gaining 236 and 136 points respectively from the end of 2013 and the end of June 2014. The weighted average P/E ratio on the A-share market of the Shanghai Stock Exchange rose from 11.0 times at end-2013 to 11.5 times at end-September 2014, while that of the Shenzhen Stock Exchange rose from 28 times to 32 times.

Turnover on the stock market increased rapidly. In the first three quarters, turnover on the Shanghai and Shenzhen stock exchanges totaled 40.7 trillion yuan, up 18.1 percent year on year, and the daily turnover averaged 221.3 billion yuan, up 13.6 percent year on year. In particular, turnover in the third quarter increased significantly, with the daily turnover averaging 293.3 billion yuan, up 40.6 percent year on year. In the first three quarters, the volume of transactions on the GEB amounted to 5.3 trillion yuan, up 53.8 percent year on year. At end-September, the combined market capitalization of the Shanghai and Shenzhen stock exchanges posted 24.3 trillion yuan, up 21.9 percent year on year; market capitalization of the GEB amounted to 1.4 trillion yuan, up 75.8 percent year on year.

The amount of equity financing increased rapidly. In the first three quarters, a total of 382.7 billion yuan was raised by enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, additional offerings, rights issuances, and warrant exercises, representing an increase of 113.9 billion yuan year on year. In the third quarter, equity financing on the A-share market amounted to 121.2 billion yuan, 56 billion yuan more than that during the same period of the last year.

5. Growth of assets in the insurance industry accelerated

In the first three quarters, total premium income in the insurance industry amounted to 1.59 trillion yuan, representing year-on-year growth of 18.6 percent, a deceleration of 2.2 percentage points from the first half of the year; total claim and benefit payments amounted to 523.8 billion yuan, representing year-on-year growth of 16.2 percent. Specifically, total claim and benefit payments in the property-insurance sector increased 12.3 percent, while those in the life-insurance sector increased 20.4 percent.

The growth of insurance assets accelerated. At end-September, total assets in the insurance industry posted 9.61 trillion yuan, representing year-on-year growth of 19.3 percent and an acceleration of 0.4 and 2.6 percentage points respectively from the end of June and the end of 2013. Among this total, bank deposits increased 9.7 percent year on year, while investment-linked assets increased 22 percent.

Table 9 Use of Insurance Funds, End-September 2014

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-September 2014	End-September 2013	End-September 2014	End-September 2013
Total assets	96,076	80,530	100	100
Of which: Bank deposits	25,095	22,879	26.1	28.4
Investments	62,582	51,280	65.1	63.7

Source: China Insurance Regulatory Commission.

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

In the third quarter, the turnover of RMB/foreign exchange spot transactions totaled USD970.8 billion, representing a decrease of 8.6 percent year on year. The turnover of RMB/foreign exchange swap transactions totaled USD1.24 trillion, representing an increase of 37.7 percent year on year. Among this total, overnight RMB/USD swap transactions amounted to USD668.4 billion, accounting for 54 percent of the total. The turnover on the RMB/foreign exchange forward market totaled USD14.5 billion, representing an increase of 302.6 percent year on year. The turnover of foreign currency pair transactions amounted to USD15 billion, a decline of 6 percent year on year. In particular, USD/HKD transactions accounted for the lion's share, or 48.4 percent of the total.

The number of participants on the foreign exchange market increased further. At end-September，there were 442 members on the foreign exchange spot market, 96 members on the foreign exchange forward market, 95 members on the foreign exchange swap market, 84 members on the currency swap market, and 36 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 price of gold consolidated at a subdued level

The volume of transactions on the gold market declined. In the first three quarters of 2014, the turnover of all sorts of precious metals on the Shanghai Gold Exchange amounted to 3.7 trillion yuan, down 9.7 percent year on year, and the decline was 2.2 percentage points larger than that in the first half of the year. Specifically, the trading volume of gold was 11,000 tons, an increase of 22.6 percent year on year, and turnover posted 2.7 trillion yuan, an increase of 9.8 percent year on year. The trading volume of silver was 238,000 tons, a decline of 30.9 percent year on year, and turnover posted 989.84 billion yuan, a decline of 38.9 percent year on year. The trading volume of platinum was 51.1 tons, a decline of 21.5 percent year on year, and turnover posted 15.24 billion yuan, a decline of 24.4 percent year on year.

In the third quarter, the price of gold consolidated at a subdued level. In the middle of July, the price of gold witnessed a new round of corrections on the international market. At end-September, the morning spot fixing price of gold on the London Gold Market slumped to USD1,216.5 per ounce, a decline of 7.5 percent from the end of June. The price of gold on the domestic market also fluctuated at a subdued level due to the impact of the international market. In the third quarter, the highest price of gold on the Shanghai Gold Exchange (AU9999) was 266.89 yuan per gram, and the lowest price of gold was 239.03 yuan per gram. At end-September, the price of gold closed at 241.24 yuan per gram, down 7.87 percent from the end of June.

II. Institutional building in the financial market

1. Improving institutional arrangements in the securities market

The trading rules for the pilot Shanghai Hong Kong Stock Connect Scheme were further clarified. On September 26，the Shanghai Stock Exchange issued the *SSE Measures for the Pilot Program of the Shanghai Hong Kong Stock Exchange Connect Mechanism (PHSECM)*, defining the basic models and relevant requirements for the pilot program, including margin trading, the investor suitability requirement, measures to deal with abnormal trading, and so forth, so as to lay a solid foundation to regulate the pilot program.

Regulatory measures for private equity funds were released. On August 21, the CSRC issued the *Provisional Administrative Rules for Private Equity Funds*. The *Administrative Rules* clarify the full-coverage registration and filing system and the qualified investor system for private equity funds, regulate the fund-raising and operations of private equity funds, and display the policy intentions of the differentiated industrial self-discipline and regulation so as to promote the sound development of various kinds of private equity funds and the construction of a multi-tiered capital market system.

Efforts were made to promote innovation and development in the futures industry. On September 16，the CSRC issued the *Opinions on Further Promoting Innovation and Development of Futures Companies*. The *Opinions* clarify the development objectives for the futures industry and the supporting policy measures for the next stage based on eight points, i.e., increasing the competitiveness of the futures companies, relaxing market access of the industry when appropriate, gradually promoting the opening-up of the futures companies, strengthening investor protection, and so forth, so as to promote innovation and development of the futures industry and to enhance its role in the development of the real economy, structural adjustments, and upgrading.

2. Improving institutional arrangements in the insurance market

The top-level design of the insurance industry was strengthened. On August 10, the State Council issued *Several Opinions on Accelerating the Development of Modern Insurance Services*. The *Opinions* propose improvements to the insurance financial compensation mechanism, strengthening the core function of risk management and increasing the allocation efficiency of insurance funds so as to build a competitive, innovative, and vibrant modern insurance service industry. It is projected in the *Opinions* that by 2020 the insurance penetration (the insurance premiums as a percentage of GDP) will be 5 percent, and the insurance density (the ratio of the insurance premiums to the total population) will be 3,500 yuan per person.

Self-regulation of the insurance industry was promoted. On September 4, the China Insurance Asset Management Association was established in Beijing. The Association will act as a bridge between the insurance regulatory authority and the insurance market, promoting rapid and healthy development of insurance asset management, strengthening industry self-regulation, and preventing risks. The specific functions of the Association include: to promote the development of insurance asset management; to provide product registration, custody, and trading services; to encourage innovation, and to promote the market-oriented transformation of insurance asset management; to conduct market monitoring and to signal risks to members; and to maintain market order, develop self-regulatory conventions, and regulate member behavior.

3. Steadily promoting innovation and development of the gold market and the foreign exchange market

On September 19, 2014, the international gold board was launched in the China (Shanghai) Pilot Free Trade Zone by the Shanghai Gold Exchange as a step to further promote the opening-up of the domestic gold market.

Efforts were made to develop the foreign exchange market and to improve the market-based RMB exchange-rate regime. First, limitations on the margin of banks' quotations of RMB/USD buying and selling rates to clients were lifted and banks can now price their quotation rates independently. As a result, the remaining limitations on the banks' quotation rates to clients were all lifted so as to further improve the RMB exchange-rate regime. Second, self-regulation of the foreign exchange market was advanced. The *Guidelines on the Code of Conduct and Conventions in the Inter-bank Foreign Exchange Market* were issued to foster a fair and competitive market order and to promote a new foreign exchange administrative framework based on industrial self-regulation and supplemented by government regulation and supervision.

Part 4 Macro-economic Analysis

I. Global economic and financial developments

In the third quarter of 2014, the momentum of the world economic recovery further diverged. The U.S. economy steadily recovered, with improved conditions in the labor market. Growth in the euro area was weak, and there were tremendous downward pressures on inflation. In Japan, the economic situation was not stable, thus the Bank of Japan faced difficulties in achieving the inflation targets. The performance of the emerging market economies diverged, and some countries experienced a large volume of capital outflows.

1. Economic development in the major economies

The economic recovery in the U.S. was generally steady. The annualized GDP growth in the third quarter posted 3.5 percent. Though lower than the second quarter growth of 4.6 percent, it still beat market expectations. Corporate activity was high and the Purchasing Managers Index (PMI) averaged 57.6 for the third quarter, much higher than the threshold of 50. The labor market improved, with the unemployment rate dropping to 5.9 percent and the problem of the idle labor force gradually being addressed. Consumer confidence was strengthened. The University of Michigan's Consumer Sentiment Index climbed to 86.9 in October, hitting a new high since August 2007. Inflation remained at a low level, with the September CPI growing by 1.7 percent year on year. The fiscal deficit declined considerably. The federal budget deficit posted USD486 billion in the 2014 fiscal year (as of end-September), representing a year-on-year decrease of USD195 billion. However, according to the sectoral GDP data in the third quarter, the growth of commercial investments, housing, and consumer expenditures was lower than that in the second quarter, indicating a moderation in domestic demand.

The economy in the euro area posted weak growth. The annualized GDP growth in the second quarter was merely 0.1 percent. The unemployment rate remained at a high level, registering 11.5 percent in September. The manufacturing industry was sluggish, and the PMI stood at 50.3 in September, representing a new low during the past 14 months. Downward pressures on inflation mounted. In October, the Harmonized Index of Consumer Prices (HICP) grew by 0.4 percent year on year. Though it was higher than the September figure of 0.3 percent, core inflation (excluding energy and food prices) unexpectedly dropped to 0.7 percent, implying that the weakness in energy and food prices might spread to the other sectors of the economy.

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

Country	Index	2013Q3			2013Q4			2014Q1			2014Q2			2014Q3		
		Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.
United States	Real GDP Growth Rate (annualized quarterly rate, %)	4.5			3.5			-2.1			4.6			3.5 (primary estimate)		
	Unemployment Rate (%)	7.3	7.2	7.2	7.2	7.0	6.7	6.6	6.7	6.7	6.3	6.3	6.1	6.2	6.1	5.9
	CPI (YOY, %)	2.0	1.5	1.2	1.0	1.2	1.5	1.6	1.1	1.5	2.0	2.1	2.1	2.0	1.7	1.7
	DJ Industrial Average (closing number)	15500	14810	15130	15546	16086	16577	15699	16322	16458	16581	16717	16827	16563	17098	17043
Euro zone	Real GDP Growth Rate (annualized quarterly rate, %)	0.5			1.2			0.9			0.1			…		
	Unemployment Rate (%)	12.0	12.0	12.0	11.9	11.9	11.8	11.8	11.7	11.7	11.6	11.6	11.5	11.5	11.5	11.5
	HICP (YOY, %)	1.6	1.3	1.1	0.7	0.9	0.8	0.8	0.7	0.5	0.7	0.5	0.5	0.4	0.4	0.3
	EURO STOXX 50 (closing number)	2699	2670	2776	2878	2901	2919	2853	2968	2916	2978	3033	3014	2979	3044	3067
Japan	Real GDP Growth Rate (annualized quarterly rate, %)	1.8			0.5			6.0			-7.1			…		
	Unemployment Rate (%)	3.9	4.1	4.0	4.0	3.9	3.7	3.7	3.6	3.6	3.6	3.5	3.7	3.8	3.5	3.6
	Core CPI (YOY, %)	0.7	0.8	0.7	0.9	1.2	1.3	1.3	1.3	1.3	3.2	3.4	3.3	3.3	3.1	3.0
	NIKKEI225 (closing number)	13668	13389	14456	14328	15662	16291	14915	14841	14828	14304	14632	15162	15621	15425	16174

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

Affected by the hike in the consumption tax rate, the Japanese economy suffered a setback. The quarter-on-quarter annualized GDP growth posted -7.1 percent, representing a new low since the first quarter of 2009. In September, the trade deficit (not seasonally adjusted) reached 960.6 billion yen, marking the 27th successive month of a trade deficit. Deflation conditions eased. In September, the core CPI grew by 3.0 percent year on year, or by 1 percent after adjusting for the hike in the consumption tax rate. The PMI in the manufacturing and service sectors rebounded modestly. The PMI in the manufacturing sector rose to 52.2 in August and fell to 51.7 in September. The PMI in the service sector rose from 46.4 in April to 52.5 in September.

Recovery in the emerging market economies diverged. Growth in the emerging market economies in Asia moderated slightly, but remained at a relatively high level. Due to geopolitical risks, slowing growth of external demand, fluctuations in commodity prices, and structural factors, some CIS and Latin American countries faced increasing downward pressures on their economies. Capital flows into the emerging market economies slowed down. According to estimates of the International

Institute of Finance (IIF), net capital inflows into the stock and bond markets of the emerging market economies posted USD12 billion and USD18 billion in August and September respectively, much lower than the monthly average of USD37 billion between May and July.

2. Developments in the global financial markets

The U.S. financial market performed well, and the European market was generally stable. Supported by the additional monetary easing measures, the Japanese stock market rallied. Performance of the financial markets in the emerging market economies was generally stable, and stock indices rose modestly.

The US dollar appreciated, and most of the major currencies depreciated against the US dollar by a relatively large margin. On September 30, the exchange rate of the USD/EUR closed at 1.26 dollar per euro, a depreciation of 7.7 percent from end-June. The exchange rate of the GBP/USD and the JPY/USD closed at 1.62 dollar per pound and 109.64 yen per dollar respectively, representing a depreciation of 5.2 percent and 7.6 percent respectively from end-June. At the same time, most of the emerging market currencies depreciated. Among them, the Russian ruble, the Brazilian real, the Chilean peso, and the South African rand depreciated by 14.2 percent, 10.4 percent, 7.6 percent, and 6.1 percent respectively.

The USD Libor edged up, whereas the euro Euribor declined markedly. Driven by the expectation of monetary policy normalization by the U.S. Federal Reserve, the 1-year dollar Libor posted 0.5786 percent at end-September, an increase of 3.4 basis points from end-June. After the interest rate cut by the ECB, the Euribor declined markedly. At end-September, the 1-year Euribor registered 0.338 percent, a decrease of 15 basis points from end-June.

Government bond yields in the major developed economies dropped. At end-September, the 10-year government bond yields in the U.S. and Japan closed at 2.51 percent and 0.53 percent respectively, down by 1 and 4 basis points respectively compared with end-June. The yield of 10-year government bonds in Germany closed at 0.95 percent, down 31 basis points from the end of June.

The stock indices in the major advanced economies and most emerging market economies rallied. At end-September, the Dow Jones Industrial Average Index and the STOXX50 Index closed at 17,043 and 3,067 points respectively, up by 1.3 percent and 1.8 percent respectively from end-June; the Nikkei 225 Index closed at 16,174 points, up by 6.7 percent from end-June, and it rose further by 1.5 percent after the Bank of Japan announced an additional easing of its monetary policy. Stock markets in most emerging market economies went up. In the third quarter, Argentina’s MERV Index surged by 59.1 percent, and both Indonesia’s Jakarta Composite Index and the Mexican MXX Index rose by 5.3 percent.

3. Monetary policies in the major economies

The monetary policies in the major advanced economies diverged further. The Federal Reserve is steadily normalizing the stance of its monetary policy. After the regular meetings in July and September respectively it announced it would make further measured reduction in the pace of its asset purchases, i.e. by USD10 billion. In its October meeting, it decided to conclude its asset-purchase program this month. In addition, in the statement released after the October meeting, the FOMC used, for the first time, such optimistic expressions as “the under-utilization of labor resources is gradually diminishing" and "the likelihood of long-term inflation remaining at 2 percent of less has diminished somewhat since early this year." The European Central Bank (ECB) further relaxed its monetary policies. In September, the ECB announced it would lower the interest rates on the main refinancing operations (MROs), the marginal lending facility, and the deposit facility by 10 basis points respectively to 0.05, 0.3, and -0.2 percent, and from the fourth quarter of 2014 it would launch a two-year asset-purchase plan to buy asset-backed securities (ABS) and covered bonds. The Bank of England (BOE) maintained its policy rate of 0.5 percent and the scale of its asset purchases at 375 billion pounds. In a surprise move, the Bank of Japan expanded the scale of its quantitative and qualitative easing monetary policy. On October 31 it stated that it will conduct monetary operations so that the monetary base will increase at an annual pace of about 80 trillion yen (an addition of about 10-20 trillion yen compared with the past), purchase Japanese government bonds (JGB) so that their amount outstanding will increase at an annual pace of about 80 trillion yen (an addition of about 30 trillion yen compared with the past), extend the average remaining maturity of JGB purchases to about 7 to 10 years (an extension of a maximum of about 3 years compared with the past), and increase the purchase of exchange-trade funds (ETFs) and Japan real estate investment trusts (J-REITs) by a large margin.

The monetary policies in the emerging market economies have diverged as well. Under inflationary and currency depreciation pressures, some emerging economies increased their policy rates. On July 10, the Bank Negara Malaysia raised its benchmark rate by 25 basis points to 3.25 percent, the first rate hike in three years. On July 16, the National Bank of Ukraine raised its policy rate from 9.5 percent to 12.5 percent. On July 17, the South African Reserve Bank raised the policy rate by 25 basis points to 5.75 percent. The Central Bank of the Philippines raised the overnight lending rate on two occasions, on July 31 and September 11 respectively, by a total amount of 50 basis points to 4 percent. The Central Bank of Russia raised the benchmark rate by 50 basis points to 8 percent on July 25, and again by 150 basis points to 9.5 percent on October 31, 50 basis points higher than market expectations. In order to boost economic growth, some emerging market economies relaxed their monetary policies. The Central Bank of Chile lowered the policy rate on three occasions, i.e., on July 15, August 14, and September 11 respectively, by a total amount of 75 basis points to 3.25 percent. On July 18, the Central Bank of the

Republic of Turkey lowered the 1-week repo rate by 50 basis points to 8.25 percent. On July 22, the National Bank of Hungary decided to lower the policy rate by 20 basis points to a record low of 2.10 percent. The Bank of Korea lowered its benchmark rate by 25 basis points to 2.25 percent on August 14, and by another 25 basis points to 2 percent on October 15. On August 5, the Reserve Bank of India reduced the statutory liquidity ratio (SLR) of scheduled commercial banks by 50 basis points to 22 percent.

In addition, some emerging market economies intervened in the foreign exchange market. In response to depreciation pressures, the Central Bank of Brazil strengthened foreign exchange market intervention, announcing on September 24 it would increase the daily auction of US dollar foreign exchange swap contracts by USD750 million. Affected by the sanctions and the downward movements of international oil prices, the Russian ruble lost 21 percent against the US dollar between early July and late October, the largest decline among all currencies in the world. To ease the ruble's downward trend, the Central Bank of Russia Federation intervened in the foreign exchange market on a massive scale, selling approximately USD29.3 billion in October. In the meantime, it enlarged the floating band of the ruble against US dollar and stated that a free-floating exchange-rate system would be adopted in 2015 as planned.

4. The world economic outlook and the major risks

Overall, the global economy continues to recover slowly. However, structural problems and uncertain factors still exist and may pose the following risks to the global economy:

First, there are still uncertainties in the economic growth and monetary policy outlook in the U.S. The Federal Reserve (FED) provided an optimistic assessment of the employment and inflation situations, but it has retained the forward guidance of maintaining low policy rates for a considerable time, indicating its cautious attitude towards raising interest rates. More recently, market investors began to worry more about the slowdown in the global economy that could increase the external risks to the U.S. economy. The FED is also concerned about the downward pressures on domestic prices as a result of the appreciation of the US dollar. If the key economic data of the U.S. experiences ups and downs and market expectations sway regarding the timing of interest rate hike by the FED, volatility in the international financial market may increase.

Second, the euro zone still faces considerable downward and deflation risks. Though sovereign credit risk has eased, the euro zone have to address longer-term and structural problems, such as the slowing economic growth in Germany and France, the weakening credit demand in the real economy, and the deleveraging in the banking sector. The ECB has implemented a negative rate policy and has increased the volume of asset purchases, but it faces constraints, such as capital outflows caused by the depreciation of the euro, the lack of depth in the debt instruments, and the credit risks of the SMEs. It is still uncertain whether the ECB balance sheet can be expanded to the anticipated level and whether credit can be effectively increased to the real economy. It will not be an easy task for the euro zone to change the current situation of sluggish growth and high unemployment.

Third, the Japanese economy is facing downward pressures, with the outlook for inflation remaining unclear. Japan has not completely eliminated the impact of the consumption tax hike in April, and faces challenges resulting from the approaching time window for the next decision-making on the consumption tax reform. Rather than effectively boosting exports, the depreciation of the yen raised the costs of imports for enterprises. The recent policy to further monetary easing has caused large devaluation of yen, raising concerns both at home and abroad that it will be difficult for the central bank, with an excessively large balance sheet, to make an orderly exit in the future. Given the protracted structural problems, including high level of government debt, the aging population, the weak financing demand in the real economy, and the slow progress in structural adjustments, dependence on the strong stimulus of easing monetary policies may not be a sustainable option in the long run.

Fourth, some emerging market economies face short-term downside risks. Domestically, in response to the global financial crisis, some emerging market economies have taken unconventional measures to spur the economy, leading to rapid credit expansions and higher leveraging. Internally, there is a lack of endogenous drivers to support economic growth. Externally, uncertainties in the diverging monetary policy of major advanced economies and investor concerns about the outlook of emerging markets may have negative impacts on exchange rates, financial markets, and capital flows in some of the emerging markets.

Moreover, geopolitical risks and other factors have aggravated market uncertainties. The tensions between Russia and Ukraine, the mutual sanctions between Russia on the one hand, the U.S. and European countries, on the other, and the potential panic in the spread of the Ebola epidemic might take its toll on market confidence and have adverse effects on trade and financing activities.

II. Analysis of China’s macro-economic performance

The Chinese economy continued to perform within a reasonable range. Consumption registered stable growth, and exports and imports improved quarter by quarter. Investment and price levels grew at a more moderate pace, while structural adjustments made accelerated progress. In the first three quarters of 2014, China’s Gross Domestic Production (GDP) stood at 42.0 trillion yuan, increasing by 7.4 percent year on year. Specifically GDP grew by 7.4 percent, 7.5 percent, and 7.3 percent year on year respectively in the first, second, and third quarters, and by 1.5 percent, 2.0 percent, and

1.9 percent quarter on quarter. The Consumer Price Index (CPI) rose 2.1 percent year on year. The trade surplus posted USD231.6 billion.

1. Consumption registered stable growth, and exports and imports improved quarter by quarter

The income of urban and rural residents continued to rise. In general, consumption growth was stable, while online and other new types of consumption registered more rapid growth. In the first three quarters of 2014, the per capita disposable income of urban residents stood at 22,044 yuan, increasing by 9.3 percent year on year in nominal terms and 6.9 percent in real terms. The per capita cash income of rural residents posted 8,527 yuan, growing by 11.8 percent in nominal terms and 9.7 percent in real terms. As indicated by the third quarter Urban Depositors' Survey conducted by the People's Bank of China, the current income sentiment of urban residents registered 49.2 percent, which was 0.9 percentage points higher than that in the previous quarter. Consumption sentiment remained basically stable, with residents inclined to consume more accounting for 18 percent, which was 0.4 percentage point lower than that in the second quarter. Sentiment for automobile purchases for the next three months registered 16.7 percent, increasing by 0.8 percentage point quarter on quarter. Sentiment for buying big-ticket items (electronic appliances, furniture, high-order goods, etc.) posted 26.4 percent, rising by 1.6 percentage points compared with the previous quarter. In the first three quarters, retail sales of consumer goods totaled 18.9 trillion yuan, up 12.0 percent year on year in nominal terms and 10.8 percent in real terms. Specifically, retail sales of consumer goods in urban areas was 16.3 trillion yuan, increasing by 11.9 percent, while retail sales of consumer goods in rural areas stood at 2.6 trillion yuan, growing by 13 percent year on year. Online retail sales in China registered 1.8 trillion yuan, up by 49.9 percent year on year.

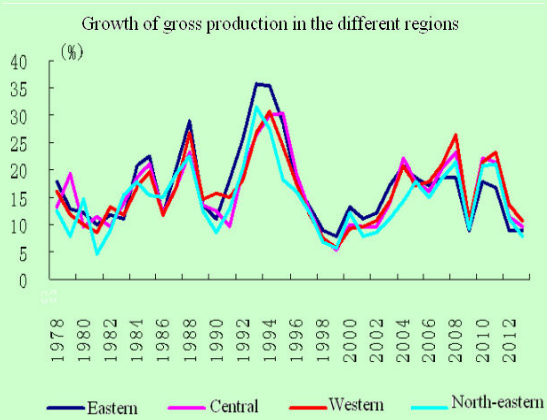
Growth of fixed-asset investments slowed down. In the first three quarters, fixed-asset investments (excluding by rural residents) reached 35.8 trillion yuan, growing by 16.1 percent in nominal terms and 15.3 percent in real terms, which was 1.2 percentage points slower than growth during the first half of the year. Broken down by industries, investment in the primary, secondary, and tertiary industries registered rapid, basically stable, and slower growth respectively, with year-on-year growth rates of 27.7 percent, 13.7 percent, and 17.4 percent. Planned investments for on-going construction projects totaled 85.5 trillion yuan, up by 12.5 percent year on year, while planned investments for new projects rose 14.4 percent, reaching 30.4 trillion yuan.

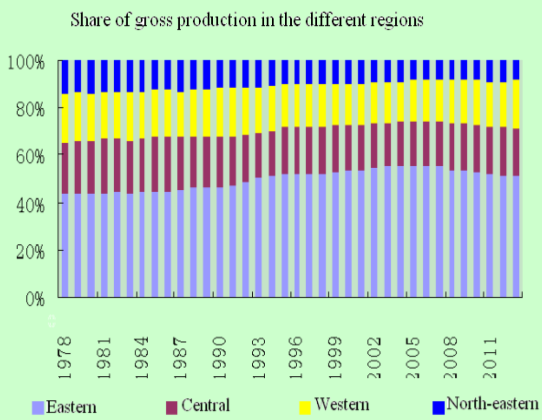
Imports and exports rebounded quarter by quarter. In the first three quarters of this year, imports and exports totaled USD3.2 trillion, up 3.3 percent year on year, an acceleration of 2.1 percentage points from the first two quarters. In RMB terms, exports and imports totaled 19.4 trillion yuan in the first three quarters, increasing by 1.8 percent year on year. Among this total, exports declined by 6.1 percent in the first quarter, but rebounded by 3.4 percent and 12.8 percent respectively in the second and third quarters. Imports dropped by 1.2 percent in the first quarter, while they remained flat and grew by 0.9

percent respectively in the second and third quarters. As a result of the plummet in the price of commodities in international markets, imports of energy and resources grew in volume but declined in value. In the first three quarters, the average import price of iron ore, crude oil, soybeans, and copper declined by 17.9 percent, 1.4 percent, 4.6 percent, and 6.3 percent respectively, while the volume of imports grew by 16.5 percent, 8.3 percent, 15.3 percent, and 10.5 percent respectively. The trade structure continued to improve. In the first three quarters, general trade grew in a stable manner while processing trade increased slightly. Foreign trade in the central and western regions maintained a robust momentum of growth. In the first three quarters of 2014, actually utilized foreign direct investments declined by 1.4 percent year on year to USD87.36 billion; domestic investors invested in 4,475 overseas enterprises in 152 countries and regions, and cumulative non-financial outbound direct investments rose 21.6 percent to reach USD74.96 billion.

Box 4 Regional Economic Development in China

As China has a vast territory, the different regions vary in terms of their economic development. Since the 1980s, the CPC Central Committee and the State Council have launched development strategies targeting the different regions, namely strategies for prioritized development in the eastern coastal region, development of the western region, revitalization of the old industrial base in the northeastern region and a rising strategy in the central region. In terms of gross output, the gaps among the different regions have been narrowing in the recent decade. Economic growth in the eastern region has remained relatively stable, accounting for more than one-half of gross output, but its share has been on the decline; the central and western regions registered faster growth, accounting for a larger share of national output, reaching more than 40 percent by end of 2013; output in the northeastern region was relatively small, with the growth rate and its share of GDP both declining by a small margin (see Figure 3). β convergence and σ convergence study based on data from the different provinces reveals that economic growth in the different regions has converged in recent years, indicating more balanced development.



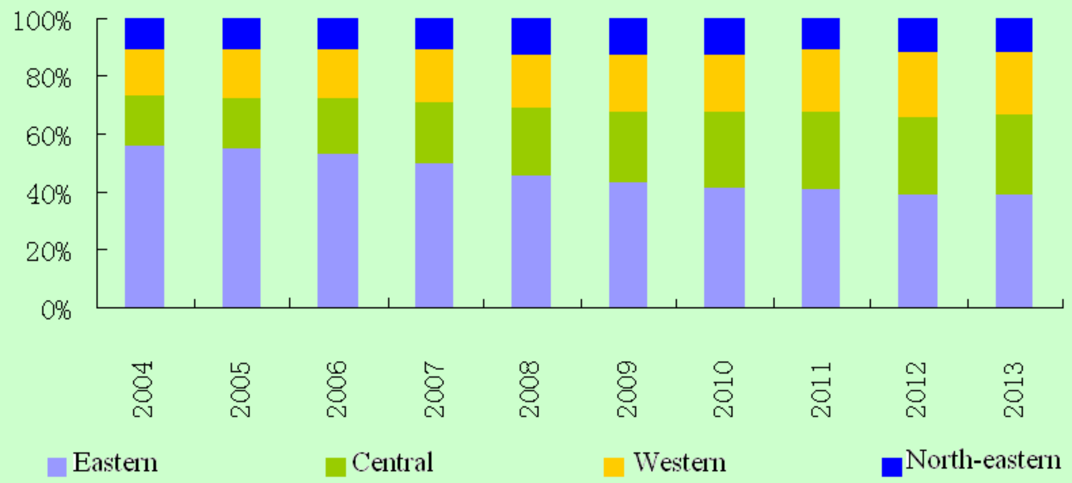


Source: CEIC, PBC staff calculations.

Figure 3 Growth and Shares of Gross Production in the Various Regions

As the forerunner in development, the eastern region is more resilient and thus has been playing a leading role in restructuring. In the 1980s and 1990s, the eastern region grew rapidly, driven by high investment. In addition, the eastern region was the first to begin a structural transformation, with the growth of investment, particularly investment in secondary industry, much lower than that of the other regions since 2004. In addition, the share of secondary industry registered a steady decline, while tertiary industry posted faster growth to reach 47 percent by the end of 2013, exceeding the share of secondary industry for the first time in history. The economy in the eastern region is more market-based and more resilient. Though negatively impacted by this round of the global financial crisis as a result of its high degree of openness, the eastern region pursued adjustment policies ahead of the other regions by shifting away from processing and compensation trade and labor-intensive industries, and by promoting rapid development of the services industry and the hi-tech industry. The various economic indicators were stable. From 2008 to 2013, the coefficient of variation (a measure of dispersion, which is defined as the ratio of the standard deviation to the mean of a data series) in the value and growth of fixed-asset investments in the eastern region was significantly lower than that in the other regions; final consumption of the household sector in the eastern region accounted for more than 50 percent of the total and remained stable; the structure of foreign trade improved, with the share of general trade increasing while that of processing trade declining in the recent two years in a number of provinces. In the process of eliminating overcapacity, developing the emerging industries, and reallocating resources, the eastern region could be exposed to considerable economic and financial risks, which should be viewed from a long-term perspective in a rational manner.

Tapping on their latecomer advantage, the central and western regions were the destination of the industrial relocation from the eastern region and picked up their pace of development. Since 2004, investment growth in the central and western regions has been higher than that in the eastern region, and the share of secondary industry in gross output has registered stable growth, reaching about 50 percent by the end of 2013 (see Figure 4). With greater growth potential and less exposure to the shock of the global financial crisis, and benefiting from the stimulus measures designed to mitigate the impact of the crisis, the central and western regions witnessed faster growth than the national average in terms of the major economic indicators. As the recipients of processing trade and labor-intensive industries transferred from the eastern region due to lower costs, the central and western regions surpassed the eastern region in terms of growth of imports and exports. However, the central and western regions rely on an extensive investment-driven growth model. More easily affected by government policies, the economic indicators in the western region reveal more fluctuations. There remains much to be done in order to improve the growth pattern in the western region.



Source: CEIC, PBC staff calculations.

Figure 4 Shares of Investment in Secondary Industry in the Various Regions

The northeastern region maintained its strength in agricultural production, but it had difficulties in promoting structural adjustments and it suffered from weaker performance of the major economic indicators. At the end of 2013, the weighted average fixed-asset investments in the northeastern region decreased by approximately 19 percentage points from that in 2006 and remained in a negative range since the beginning of 2014. Meanwhile, export growth was not satisfactory and remained in a negative range since the beginning of 2014. Compared with the central and western regions, per capita income in the northeastern region was higher and the income gap between urban and rural residents was narrower, contributing to the maintenance of stable consumption growth.

Looking at development trends in China over the past decade and more, the adjustment of the industrial structure has been a dynamic process whereby industries have been moving to regions that have a comparative advantage for development, and the gap between the different regions has been narrowing. According to industry relocation theory, such a relocation from developed to developing regions promotes the development of the entire economy. The economies of the different regions in China are complementary and there is large space for inter-regional relocation, indicating a great growth potential for the national economy. However, when shifting to a higher gear of development, the eastern, central, and western regions have all relied heavily on investment and have developed in a way that imposes greater pressures on resources and on the environment. A resource-efficient and environmentally friendly growth model should be adopted to enhance both the quality and quantity of development. At present, China's structural adjustment has reached a critical stage in which the focus should be on adjusting the economic structure, promoting reform, and upgrading the growth model to further release the reform dividend and the development potential. In this process, the various regions should deepen cooperation based on their comparative advantages and local circumstances so as to promote balanced and sustainable development of the Chinese economy.

2. Agricultural production was in good shape, and performance of the industrial sector was stable

The value-added growth of the tertiary industry outpaced that of the secondary industry. The value-added of the tertiary industry during the first three quarters of the year posted 3.8 trillion yuan, 18.6 trillion yuan. and 19.6 trillion yuan respectively, up 4.2 percent, 7.4 percent, and 7.9 percent respectively year on year. The value-added of the three industries accounted for 9.0 percent, 44.2 percent, and 46.7 percent of total GDP respectively, with the share of the tertiary industry rising by 1.2 percentage points from the same period of the last year, and 2.5 percentage points higher than that of the secondary industry.

Agricultural output was in good shape, supported by a bumper harvest of summer grain. Total output of summer grain rose 3.6 percent year on year to 137 million tons. In addition, a big crop is expected this autumn. In the first three quarters of this year, combined output of pork, beef, mutton, and poultry increased by 2.0 percent year on year to 59.75 million tons, among which pork production climbed up by 3.3 percent to reach 39.72 million tons.

Industrial production remained stable. In the first three quarters of 2014, the value-added of statistically large enterprises, if calculated at comparable prices, grew by 8.5 percent year on year but decelerated by 0.3 percentage point compared with the first half of the year; specifically, it grew 8.0 percent in September, an acceleration of 1.1 percentage points from August. The sales ratio of products of industrial enterprises was 97.7 percent, increasing by 0.2 percentage point from the first half of the year. In the first three quarters of 2014, statistically large enterprises realized total profits of 4.4 trillion yuan, up 7.9 percent year on year. Among the 41 industrial sectors, 33 saw year-on-year growth in profits. Specifically, the manufacturing of computers, communications and other electronic equipments, the production and supply of electricity and heat industry, manufacturing in the automobile industry, and the manufacturing in the electric machinery and equipment industry were the top gainers, growing by 27.5 percent, 21.3 percent, 21.0 percent, and 19.6 percent respectively. Though facing headwinds, enterprises managed to expand trade and enhance their profitability. According to the PBC Survey of 5,000 Industrial Enterprises in the third quarter, the business climate index was 54.9 percent, down 0.5 percentage point from the previous quarter; the profit index edged up by 0.9 percentage point quarter on quarter to 55 percent; the export order index stood at 49.9 percent, up 0.2 percentage point from the previous quarter.

3. Overall price levels remained stable

The growth of consumer prices moderated. In the third quarter, the CPI rose 2.0 percent year on year but narrowed by 0.2 percentage point from the previous quarter. The CPI in July, August, and September climbed by 2.3 percent, 2.0 percent, and 1.6 percent respectively. Both food and non-food items saw smaller price increases. In particular, food prices rose by 3.0 percent year on year, which was 0.4 percentage point less than the increase in the previous quarter and it accounted for about 1.0 percentage point of CPI growth; the price of non-food items increased by 1.5 percent year on year, which was 0.1 percentage point less than the increase in the previous quarter and it accounted for about 1.0 percentage point in the CPI growth. Prices of consumer goods and services experienced moderated growth. The price of consumer goods edged up by 1.8 percent year on year, easing by 0.2 percentage point from the previous quarter; the price of services picked up by 2.4 percent year on year, decelerating by 0.3 percentage point compared with the second quarter.

Producer prices continued to tumble. The year-on-year producer price indices dropped by 0.9 percent, 1.2 percent, and 1.8 percent respectively in July, August and September respectively, averaging 1.3 percent. The average monthly decrease in the third quarter was 0.2 percentage point less than that in the second quarter. Of these, the price of capital goods decreased by 1.8 percent year on year, narrowing by 0.2 percentage point compared with the decline during the previous quarter. The price of consumer goods ticked up by 0.2 percent year on year, accelerating by 0.1 percentage point from the previous quarter. In the third quarter, producer purchasing prices declined by 1.5 percent year on year, moderating by 0.4 percentage point from the previous quarter. The corporate goods price index (CGPI) fell again, down by 1.6 percent year on year and flat with the second quarter. Specifically, the prices of primary commodities slumped and the prices of investment goods fell more than the prices of consumer goods. In the third quarter, the prices of major agricultural products went up by 0.3 percent year on year, which was the same level as that in the previous quarter. The price index of agricultural capital goods decreased by 0.8 percent year on year, but the decline slowed by 0.3 percentage point from the previous quarter.

As a result of the overall slide in commodity prices in international markets, the slump in imported prices expanded further. In the third quarter, the average price of Brent Crude oil futures on the Intercontinental Exchange dropped by 5.7 percent quarter on quarter, in contrast with a quarter-on-quarter increase of 1.7 percent in the last quarter. From July to September, import prices dropped by 2.0 percent, 2.0 percent, and 1.0 percent year on year respectively, averaging -1.7 percent, and the average monthly decline expanded by 0.6 percentage point from the last quarter. Export prices grew by -0.8 percent, 0.5 percent, and 2.1 percent year on year respectively in July, August, and September, averaging 0.6 percent, compared with the -0.2 percent year-on-year growth in the previous quarter.

The GDP deflator remained stable. In the first three quarters, the GDP deflator (the ratio of nominal GDP to real GDP) was 1.0 percent, down by 0.6 percentage point from the same period of the last year and the same as that in the first half of the year.

The price reform continued. In a notice released on July 10, the NDRC decided to liberalize four service fees for construction projects that are not invested or commissioned by the government, i.e. fees for preliminary work consulting, engineering survey and design, tender agents, and project supervision of construction projects. These prices will be market-determined. On September 1, the NDRC and the relevant government ministries jointly released a notice on adjusting the surcharges on the emission of flue gas and wastewater. All provinces (regions and municipalities) are required to raise the surcharge on flue gas to above 1.2 yuan per pollution equivalent and the surcharge on wastewater emissions to more than 1.4 yuan per pollutant before June 30 2015. On October 9, the Ministry of Finance and the relevant agencies announced that an ad valorem coal resource tax would enter into effect on December 1, 2014 on a nationwide basis, while coal-related funds and charges would be cleaned up.

4. The growth of fiscal revenue and expenditures picked up

In the first three quarters of 2014, fiscal revenue posted 10.6 trillion yuan, up 8.1 percent year on year, which was 0.5 percentage point less than that during the same period of 2013. Fiscal expenditures reached 10.4 trillion yuan, up 13.2 percent year on year, an acceleration of 4.4 percentage points from those during the same period of 2013. Total revenue was 272.23 billion yuan more than expenditures, which was 413.44 billion yuan less than that during the same period of 2013.

In terms of the structure of fiscal revenue, non-tax revenue registered 1.6 trillion yuan, up 12.1 percent year on year, and tax revenue registered 9.1 trillion yuan, up 7.4 percent year on year. In terms of the various 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 7.5 percent, 6.3 percent, 1.4 percent, 8.1 percent, 6.9 percent, and 12.4 percent respectively. As for the structure of fiscal expenditures, fiscal expenditures for purchases and reserves of grain, affordable housing, and transportation grew relatively rapidly, increasing by 26.5 percent, 22.2 percent, and 21.4 percent respectively.

5. The employment situation was generally stable

In the first three quarters, the newly-employed in the urban areas reached 10.82 million, which was 160,000 more year on year. At the end of the third quarter, the registered unemployment rate in the urban areas posted 4.07 percent. In the third quarter, a statistical analysis by the China Human Resources Market Information Monitoring Center on market demand and supply information regarding public employment service agencies in 102 cities revealed that the overall labor supply and demand was in balance. The ratio of job seekers to job vacancies was 1.09, down 0.02 from the previous quarter and up 0.01 from the same period of the last year. Broken down by industry, demand in sectors such as public management and social organizations, education, finance, and international organizations increased compared with the second quarter, while demand in sectors such as leasing and business services, wholesale and retail trade, services to households and other services, construction and hotels and catering services decreased from the previous quarter. In terms of job seekers, there was a slight increase in the number of fresh college graduates. But the number of job seekers who were not able to find employment upon graduation, job seekers who were out of a job, and local rural residents declined. Market demand for professionals with medium or high skill levels and expertise continued to grow rapidly.

6. International payments and expenditures were generally balanced

Preliminary statistics indicated a current account surplus of USD162 billion, a capital and financial account deficit of USD14.1 billion, and growth of USD148.1 billion in reserve assets in the first three quarters of 2014. As for the third quarter alone, the current account registered a surplus of USD81.5 billion, the capital and financial account saw a deficit of USD81.6billion, and reserve assets decreased by USD430 million.

The total external debt continued to grow. As of end-June 2014, the outstanding external debt posted USD907.2 billion, up 17.5 percent year on year. Among this total, the stock of the registered outstanding external debt posted USD579 billion, an increase of 25.2 percent year on year and accounting for 63.8 percent of the total; the outstanding short-term external debt posted USD715.9 billion, an increase of 19.6 percent year on year and accounting for 78.9 percent of the total.

7. Sectoral analysis

(1) The real estate sector

Nationwide turnover of commercial real estate continued to decline and more cities reported lower real estate prices. The growth of investment in real estate development slowed down, while growth in loans in the real estate sector moderated.

More cities reported lower real estate prices, but some saw smaller declines in prices. In September, the prices of newly-built commercial residential housing dropped in 69 out of 70 large- and medium-sized cities nationwide, 14 more cities than in June, and 8 cities reported a slower pace in price decline drop compared with that in June.

The prices of newly-built commercial residential housing fell year on year in 58 cities, representing an increase of 57 from June. All the cities reported a month-on-month decrease in the prices of pre-owned residential housing. Though 18 more cities reported such a decline than in June, 2 saw smaller fall in prices. Compared with the last year, the prices of pre-owned residential housing declined in 52 cities, compared with 8 cities in June.

Sales of commercial real estate continued to fall. In the first three quarters, the floor area of sold commercial real estate nationwide posted 770 million square meters, down 8.6 percent year on year, which was 2.6 percentage points more than the decline in the first half of the year. The sales value of commercial real estate declined 8.9 percent year on year to 4.9 trillion yuan, which was 2.2 percentage points more than the decline during the first half of the year. Among the total, the sold floor area and the sales value of commercial residential housing accounted for 87.7 percent and 82.3 percent respectively of the total sold floor area and the turnover in commercial real estate.

The growth of investment in real estate development decelerated. In the first three quarters of this year, nationwide investment in real estate development totaled 6.9 trillion yuan, up 12.5 percent year on year, a deceleration of 1.6 percentage points compared with the first half of the year. In particular, investment in residential housing posted 4.7 trillion yuan, registering year-on-year growth of 11.3 percent and accounting for 68 percent of total investment in real estate development. The floor area of newly started real estate projects declined 9.3 percent year on year to 1.31 billion square meters; the margin of the decline was 7.1 percentage points less than that in the first half of the year. The floor area of real estate projects under construction grew 11.5 percent year on year to 6.73 billion square meters, up 11.5 percent year on year, and the growth rate was 0.2 percentage point higher than that in the first half of the year. The floor area of completed real estate projects posted 570 million square meters, representing year-on-year growth of 7.2 percent, and the growth rate was down 0.9 percentage point from the first half of the year.

The growth in real estate loans slowed down. As of end-September, outstanding real estate loans of major financial institutions (including foreign-funded financial institutions) stood at 16.7 trillion yuan, up 18.2 percent year on year and down 1.0 percentage point from end-June. Outstanding real estate loans accounted for 21 percent of the total outstanding loans, which was 0.2 percentage point higher than that at the end of June 2014. In particular, outstanding mortgage loans rose 17.6 percent year on year to 10.2 trillion yuan, a deceleration of 0.9 percentage point from end-June; outstanding housing development loans gained 24.5 percent year on year to 3.2 trillion yuan, a deceleration of 2.4 percentage points from end-June; outstanding land development loans rose 12.7 percent year on year to 1.2 trillion yuan, an acceleration of 3 percentage points from end-June. In the first three quarters, new real estate loans registered 2112.7 billion yuan, accounting for 27.5 percent of all types of new loans and accelerating by 0.7 percentage point from the first half of the year.

More credit support was provided for the construction of welfare housing. At end-September 2014, outstanding loans for welfare housing development posted 1044 billion yuan, up 52.1 percent year on year, which was 32.1 percentage points higher than the growth of housing development loans. In the first three quarters, new welfare housing development loans posted 314.9 billion yuan, accounting for 48.5 percent of the total new real estate development loans. In addition, the pilot program of using housing provident fund loans to support the construction of affordable housing proceeded steadily. At end-September, 331 welfare housing projects in 79 cities passed loan approvals and received 70.9 billion yuan in loan disbursements based on the construction progress, and 27.3 billion yuan of the principal was repaid.

(2) Equipment manufacturing sector

The equipment manufacturing sector refers to all industries that provide technologies and equipment for the development of various economic sectors and national security. As the foundation of economic development, especially industrial development, equipment manufacturing is closely connected with other sectors, creates many jobs, and requires intensive technology and capital. It is a guarantee for industrial upgrading and technological advances and is a reflection of national comprehensive strength.

Against the background of stable economic development, deepening structural reform, and an accelerating transformation in the development pattern over the past several years, equipment manufacturing has prospered in China and has formed a sizable industrial system with various industrial categories and a high technical level. In 2013, China's equipment manufacturing realized a total output value of 20 trillion yuan, accounting for more than one-third of the global total and ranking first in the world. In the first half of 2014, the value-added of statistically large equipment manufacturing enterprises increased 11.2 percent year on year, up 2 percentage points from the same period of the last year. Total profits of these enterprises surged by 20.3 percent, up 8.9 percentage points from the same period of the last year. The operating margin of the main businesses stood at 6.9 percent, up 0.6 percentage point year on year. Furthermore, sunrise industries in this category made significant breakthroughs. Industries such as advanced rail transportation equipment, aerospace vehicles and equipment, intelligent manufacturing goods, marine equipment, new-energy vehicles and robots boomed and made great progress in terms of original design and core technologies.

However, China's equipment manufacturing industries, especially the high-end ones, were stuck in the situation of being big but not strong and they failed to turn around the tide. Major problems include: first, being the keys for the survival and development of equipment manufacturing, basic machinery parts, basic manufacturing techniques, and basic materials industries still lack a capability for independent innovation, reflected in weak technical skills, the absence of a generic technology research system, and insufficient research in basic and generic technologies; second, the industrial system is not sound and complete, reflected in an overcapacity in medium- and low-end products and an insufficient capacity in high-end products, homogeneous competition, lack of competitive international conglomerates, and few enterprises with expertise and specialty and renowned brands; third, the quality of growth is low. The rate of the current industrial value-added of China's equipment manufacturing is about 26 percent, which is 6 to 8 percentage points lower than the average in the advanced countries.

China is at a critical stage in its structural adjustment and transformation of the growth pattern. We should take advantage of the favorable conditions, seize the strategic opportunity of adjustments in the division of labor in the global economy, and facilitate the shift from Made in China to Created in China. The market should play a decisive role in allocating resources. Fiscal incentives and policy support should be provided to guide private capital and talent to become involved in industrial innovation. Efforts should be made to encourage enterprises, universities, and research institutions to collaborate more closely and to increase input in research and development so as to realize breakthroughs in core technologies.

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

I. Outlook for the Chinese economy

The global economy is undergoing a profound rebalancing after the global financial crisis and this process has not yet been completed. The Chinese economy is changing gears and undergoing structural adjustments while at the same time the effects of the stimulus policy adopted during the previous period are still being absorbed. Thus it is necessary to observe and analyze the performance of the economy based on the trends in economic development and in the context of the new normal. In the short term, the adjustment of the real estate market, the treatment of environmental pollution, and the moderated growth in the manufacturing sector will have some impact on the growth of the economy. However, in the medium to long run, with progress in urbanization and transformation of the growth pattern, the Chinese economy is expected to achieve more sustainable and higher-quality growth. Given the size of the economy and of the domestic market and the risk resilience of the economy, there is plenty of room for coordinated progress in the new type of industrialization, the application of information technology, and urbanization, and modernization of the agricultural sector, and the economy is quite resilient. While investment in infrastructure, real estate, and other sectors has slowed, mobile Internet, electronic information, network marketing, and other new areas have gathered pace, and fixed-asset investments in information technology, technology services, and leasing and business services have maintained relatively high growth of about 40 percent. The service industry has seen continuous rapid growth. Economic performance has displayed the typical features of structural adjustments. In terms of the 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 range of the management framework, as well as a combination of short-term demand management and the adoption of a series of policy measures to promote reform, adjust the economic structure, and improve people's welfare. As the services industry has a strong capacity to create jobs, and demographic changes are leading to a reduction in the working population, the employment elasticity of economic growth has increased. As a result, the employment situation has been relatively stable, and household income has maintained rapid growth. As indicated by the Urban Depositors' Survey conducted by the People's Bank of China in the third quarter, both the current income sentiment index and the future income sentiment index of urban residents went up by 0.9 percentage point from that of the previous quarter, the current employment sentiment index went up by 0.6 percentage point, and the future employment expectation index went up by 0.4 percentage point. In terms of the external environment, the momentum of the world economic recovery has further diverged. However, the global economy is still on the track of a mild recovery, and the external environment is generally stable.

However, the Chinese economy still faces many challenges and risks. Although the economic situation has been complicated and volatile in recent years, some old problems and conflicts remain. The endogenous growth drivers are yet to be strengthened, the high dependence of growth on indebtedness and investment is more prominent, and the resource and environmental constraints have grown more serious. While the structural adjustments are progressing, downward pressures and potential risk exposures may grow in certain periods. Energy-intensive industries may become more prominent in some localities as a result of the pursuit of high growth. In an environment of lax financial discipline and structural imbalances, the role of monetary policy and its transmission channels may be affected. Therefore, we need to take into account and tackle an increasing number of problems. On the one hand, efforts should be made to promote stable performance of the economy, and, on the other hand, we should avoid excessively loose policy measures to perpetuate the structural imbalances and increase inflation and indebtedness. From a global perspective, the macro-economic policies of the major economies have diverged. As the pace of adjustment of U.S. monetary policy accelerates, international capital flows and capital costs may be affected. These will add to the challenges of macro-economic management and its implementation. In general, in view of the complicated domestic and external situations, structural adjustments and the transformation of economic growth pattern are more urgent. We should properly manage and coordinate the priorities in the structural adjustments and the short-term demand management policy. It is necessary to maintain an aggregate balance and also to focus on structural optimization. We need to make plans to foster new growth points from a strategic development perspective and to address deep-rooted economic problems by deepening reform, promoting innovation and development, and further stimulating economic vitality and competiveness.

The hike in consumer prices moderated and the price situation was generally stable.

Currently, the external environment is relatively stable, while the domestic economic adjustments have a new momentum. The excess capacity in some industries is acute. In particular, due to the increased supply and strengthening of the US dollar, commodity prices in the international market continued to fall. These factors have depressed the hike in the price levels in China. According to the Urban Depositor's Survey conducted by the PBC in the third quarter, the household current price satisfaction index went up by 1.9 percentage points from the last quarter. However, due to supply-side changes, potential upward pressures in labor and service prices, and other factors, prices are generally very sensitive to changes in aggregate demand. It should also be noted that after the rapid rise in prices in earlier periods, the absolute level of prices is not low and the domestic prices of many goods are higher than those in foreign countries. Households still have strong feelings about prices and price expectations are not quite stable. The Urban Depositor's Survey in the third quarter indicated that households expected that the price index would continue to rise. Going forward, 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 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 while adopting 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 the objectives of macro-economic management, take initiatives as called for, conduct fine-tunings and preemptive adjustments when necessary in response to developments in the fundamentals, and make adjustment measures more flexible, targeted, and effective, in order to provide a stable monetary and financial environment for structural adjustments, transformation, and the upgrading of the economic structure, and to promote sustainable economic development. Moreover, the reform measures 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 resource allocations. In view of the financial deepening and innovation in the financial markets, the conduct of monetary policy will be improved, including its transmission. Supplies will be increased and competition will be enhanced to improve the quality of financial services, the efficiency of the financial sector, and the capacity of the financial sector to provide services to the real sector.

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 a reasonable volume 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, will be used flexibly, and the central bank collateral management framework will be improved to properly manage aggregate liquidity and to maintain a stable money market. Moreover, commercial banks will be guided to enhance liquidity and asset and liability management, to make good arrangements for liquidity at various time-points, to properly manage asset and liability aggregates 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 of the macro-prudential policy framework will be adjusted when necessary based on changes in economic performance, the soundness of the financial institutions, and implementation of the credit policy to guide financial institutions to support development of the real sector in a more targeted way.

Second, the stock of credit assets will be revitalized and the use of new loans will be optimized to support the structural adjustments, transformation, and upgrading of the economy. 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 ratio, tap the role of credit policy in 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 their organizational structure, institutional arrangements, and product and service models, and to support the 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 role of the financial sector will be enhanced to provide better financial services and to promote the reform and development of the railway, shipbuilding, and other key industries. In addition, there will be enhanced support to science and technology, culture, information consumption, the strategic emerging industries, and other key areas in the national economy. Implementation of the credit policy will be continuously improved to beef up financial services and to provide support for poverty alleviation, job creation, students in need, ethnic minorities, rural migrant workers, college graduates who become village officials, and other welfare-enhancing areas. Reasonable demands for funds will be satisfied from ongoing and follow-up projects and welfare projects. Lending to high energy-consuming and highly polluting industries and industries burdened with an overcapacity will be strictly controlled to promote the removal of excess capacity. A green credit mechanism will be established and improved to provide better financial services for energy conservation, a circular economy, reduction in air pollution, and so forth, and to enhance credit support for 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 area plans and reasonable home purchase for households, and to contain the 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, such as maintaining the reasonable growth of money and credit, improving the corporate governance of banks, cleaning up the unreasonable financial service charges, improving a multi-tier capital market, increasing the supply of financial services, deepening reform and structural adjustments, and so forth.

Third, the market-based interest-rate reform and the RMB exchange-rate regime reform will be deepened to improve efficiency in the 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 and 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 greater 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 adhere to the principle of financials serving the real economy, and 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 the RMB against other currencies will be promoted to provide better services for RMB settlements 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 structural adjustments and transformation, deepening reform and opening up, and preventing financial risks. The financial infrastructure and the institutional arrangements 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 better meet investor demands. The market-making mechanism will be improved to enhance liquidity in 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, the investor base, and financing intermediaries will be further promoted, and risk-sharing and market-discipline mechanisms will be strengthened. We will implement measures to promote direct financing and the development of a multi-tier 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, the reform of financial institutions will be deepened to improve financial services by increasing supply and enhancing competition. The reform of large commercial banks and other large financial institutions will furthered so as to continue to improve corporate governance, build effective mechanisms for decision making, execution, and checks and balances, and to translate the principle of corporate governance into daily operations and risk control behavior. The pilot reform program of the Rural Finance 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 customers in the counties. The reform of the Export-Import Bank of China and the Agricultural Development Bank of China will be accelerated by better defining 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. The reform of the China Development Bank will be deepened to further tap the role of development finance in priority areas and the weak links in the economy and at critical periods. The shift to market-based operations of asset management companies will be further promoted. Under the precondition of stronger supervision, the development of various kinds of financial institutions, financial service organizations, and intermediary agencies will be encouraged to build a financial eco-environment for fair competition with 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 the capacity for risk management, to safeguard the rights and interests of investors, and to promote the sound development of Internet finance.

Sixth, effective measures will be adopted to mitigate systemic financial risks and to preserve stability in the financial system. Macro-prudential regulation will be enhanced to guide financial institutions to operate on a sound basis and to encourage them to strengthen liquidity, internal controls, 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 of the 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, and monitoring and analysis of local government financing vehicles, shadow banking businesses, and mutual guarantees and joint peer 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 in enhancing risk monitoring and in regulatory coordination of cross-sector and cross-market products, in coordinating development of various financial markets and instruments, and in establishing a system of comprehensive financial statistics and an information-sharing mechanism. Efforts will be made 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 and regional financial risks.