China Monetary Policy Report, Quarter Two

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Monetary Policy Analysis Group of

the People’s Bank of China

Executive Summary

Overall, in the first half of 2012 Chinese economic growth was within the expected range of macro-economic management and overall performance remained stable but decelerating. The outlook for the agricultural harvest was good; growth of the industrial sector declined slightly; consumption and fixed-asset investments expanded steadily; growth of exports and imports rebounded moderately; price level growth declined further; and the employment situation remained stable. In the period under review, GDP increased 7.8 percent year on year to 22.7 trillion yuan; the consumer price index was up 3.3 percent year on year; and 6.94 million new job opportunities were created in urban areas.

Since the beginning of 2012, the PBC has followed the overall arrangements of the State Council, continued to implement a sound monetary policy, increased the strength of fine-tunings and pre-emptive adjustments in response to the deceleration of growth, the moderation of inflation, and other changes in economic conditions and it has made policy measures more targeted, flexible, and forward looking. The deposit required reserve ratio was cut twice, by 0.5 percentage points on each occasion, and reverse repo operations were intensified to keep liquidity at a reasonable volume. The dynamic adjustment mechanism of the deposit required reserve ratio was used as a counter-cyclical tool to enhance coordination between credit policy and industrial policy, to encourage financial institutions to optimize the credit structure, and to boost credit support to small and micro enterprises, the agricultural sector, farmers, rural areas, and on-going and follow-up key national projects. The benchmark deposit and loan interest rates were lowered on two occasions, with their floating range expanded to guide financial institutions to improve the pricing mechanism, to reduce the financing costs of enterprises, and to enhance financial services to the real sector. The reform of financial institutions continued to make progress, and the flexibility of the RMB exchange-rate regime was increased as the floating range of spot trading of the RMB against the US dollar on the interbank market was widened from ±0.5 percent to ±1 percent.

The appropriate and stable growth of money and credit aggregates provided strong support for economic development. At end-June 2012, the outstanding balance of broad money M2 increased 13.6 percent year on year to 92.5 trillion yuan; the outstanding balance of RMB loans was up 16.0 percent year on year and registered an increase of 4.86 trillion yuan from the beginning of 2012, 683.3 billion yuan more than the growth in the first half of 2011. In the first half of 2012, all-system financing aggregates posted 7.78 trillion yuan. The lending interest rates of financial institutions declined further. In June, the weighted average lending rate offered to non-financial enterprises and other sectors posted 7.06 percent, a reduction of 0.56 percentage points and 0.95 percentage points from March and the beginning of 2012 respectively.

In the first half of 2012, the RMB depreciated 0.38 percent against the US dollar and the real effective exchange rate of the RMB appreciated 0.85 percent.

At the current stage, the fundamentals remain basically unchanged to support stable and fairly rapid growth in China. With the adoption of fine-tuning measures and pre-emptive adjustment policy measures, the Chinese economy is expected to continue its steady growth. Yet as the global recovery remains in difficulty, the tasks of making domestic structural adjustments and boosting domestic consumption remain arduous. Given the overall size of the Chinese economy, the declining growth of the labor force year after year, and the stronger resource and environmental constraints, it is imperative to pay more attention to the quality and sustainability of growth while also maintaining economic growth.

In the period ahead, the PBC will continue to implement the overall arrangements of the State Council, continue to follow the principle of making progress with stability, and attach more importance to the goal of stable growth. The sound monetary policy will continue and macroeconomic management measures will become more targeted, flexible, and forward-looking. Fine-tunings and pre-emptive adjustment measures will be taken as appropriate. The effectiveness of monetary policy will be improved and structural tensions in the supply and demand of credit will be resolved through effective measures to improve financial services to the real sector. Efforts will be made to promote stability in overall price levels and steady economic growth and to create a stable and neutral monetary and financial environment. A mix of monetary policy instruments will be employed, and the macro-prudential policy will continue to play a counter-cyclical role in guiding the stable and reasonable growth of money and credit, to keep aggregate financing at a reasonable volume, and to optimize credit allocations. The market-based interest-rate reform will be advanced to guide financial institutions to use interest rate floating autonomy to properly price their products. The RMB exchange-rate regime will be advanced and the flexibility of the RMB exchange rate will be increased in both directions. Measures will be taken to facilitate the sound development of financial markets and to enhance the role of direct financing to meet diverse financing needs. Effective measures will be adopted to deepen the reform of financial institutions, to prevent systemic financial risks, and to maintain stability in the financial system.

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Part 1 Monetary and Credit Performance

In the first half of 2012 the Chinese economy stabilized amidst moderate growth. Liquidity in the banking sector was abundant. Money, credit, and all-system financing aggregates grew at a reasonable pace and the credit structure improved further.

I. Money supply registered stable and moderate growth

At end-June 2012, outstanding M2 registered 92.5 trillion yuan, up 13.6 percent year on year. This growth was 0.2 percentage points higher than that at the end of March 2012, and it was basically flat with the growth at the end of the last year. Outstanding M1 stood at 28.8 trillion yuan, an increase of 4.7 percent year on year. Growth accelerated by 0.3 percentage points compared with end-March 2012, and decelerated by 3.2 percentage points compared with end-2011. Currency in circulation M0 totaled 4.9 trillion yuan, up 10.8 percent year on year. This pace was 0.2 percentage points higher than that at end-March 2012, and 3.0 percentage points lower than growth at end-2011. In the first half of 2012, the net amount of cash withdrawn from circulation posted 146.5 billion yuan, 135.5 billion yuan more year on year.

Money supply rebounded due to implementation of a mix of monetary policy instruments, including open market operations, the reserve requirement ratio, and interest rate and counter-cyclical macro-prudential management. At end-June 2012, M2 growth was 0.8 and 0.4 percentage points higher than that at end-April and end-May respectively, while M1 growth went up by 1.6 and 1.2 percentage points respectively in comparison with end-April and end-May. M1 growth was subdued as the economy stabilized amidst moderate growth, with production and operations of enterprises at a relatively stable stage. The gap between M1 and M2 growth was basically a result of the slowdown in economic activities and the diversion of corporate demand deposits to wealth management products. In general, monetary conditions were appropriate, thereby facilitating the balance between maintaining stable and relatively rapid economic growth, keeping price stability, and preventing financial risks.

At end-June 2012, outstanding base money registered 22.8 trillion yuan, up 12.1 percent year on year and 344.5 billion yuan more than that at the beginning of 2012. The money multiplier stood at 4.06, which was 0.27 higher than that at end-2011, indicating robust money expansion. The excess reserve ratio of financial institutions stood at 2.1 percent and that of rural credit cooperatives (RCCs) stood at 3.6 percent.

II. Deposits of financial institutions increased significantly by the end of the second quarter

At end-June 2012, outstanding deposits in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, the same hereinafter) stood at 90.9 trillion yuan, up 13.2 percent year on year. Such growth represented an acceleration of 0.2 percentage points over end-March 2012 and a deceleration of 0.3 percentage points compared with end-2011. The outstanding value was 8.2 trillion yuan more than that at the beginning of 2012, an acceleration of 707.2 billion yuan year on year. Outstanding RMB deposits registered 88.3 trillion yuan, up 12.3 percent year on year. Such growth was 0.2 and 1.2 percentage points lower than that at end-March 2012 and end-2011 respectively. The outstanding value was 7.4 trillion yuan more than that at the beginning of 2012, an acceleration of 42.5 billion yuan year on year. New deposits in March and June reached 3.0 trillion yuan and 2.9 trillion yuan respectively, accounting for 40.0 percent and 38.8 percent of total new deposits in the first half of 2012. Outstanding deposits in foreign currency posted USD405.1 billion, an increase of 58.0 percent year on year, or USD130.1 billion over that at the beginning of 2012, representing USD99.4 billion more year on year.

Broken down by sectors, the growth of household deposits was relatively rapid, whereas that of non-financial institutions was flat. At end-June 2012, outstanding household deposits stood at 39.1 trillion yuan, up 17.2 percent year on year. This was 4.2 trillion yuan more than that at the beginning of 2012 and represented an acceleration of 927.7 billion yuan year on year. Outstanding RMB deposits of non-financial institutions totaled 31.1 trillion yuan, up 5.7 percent year on year. This represented a rise of 1.1 trillion yuan compared with that at the beginning of 2012, constituting a deceleration of 518.4 billion yuan year on year. At end-June, outstanding fiscal deposits reached 3.2 trillion yuan, up 531.4 billion yuan from the beginning of 2012 and representing a deceleration of 443.4 billion yuan year on year.

III. The growth of loan extensions by financial institutions picked up

At end-June 2012, outstanding loans in domestic and foreign currencies of all financial institutions reached 63.3 trillion yuan, up 15.9 percent year on year. This growth was 0.4 percentage points higher compared with that at end-March 2012 and 0.2 percentage points lower than that at end-2011. It marks an increase of 5.1 trillion yuan compared with that at the beginning of 2012 and an acceleration of 709.3 billion yuan year on year.

The growth of RMB loans accelerated. At end-June 2012, outstanding RMB loans stood at 59.6 trillion yuan, up 16.0 percent year on year. This growth represented a rebound of 0.3 percentage points compared with that at end-March and end-May 2012. The outstanding value was 4.86 billion yuan more than that at the beginning of 2012, representing an acceleration of 683.3 trillion yuan year on year. New loans extended from April through June registered 681.8 billion yuan, 793.2 billion yuan, and 919.8 billion yuan respectively, indicating a month-on-month rising trend month. In general, financial institutions are still strongly motivated to provide loan extensions, with credit providing robust support for economic growth.

The overall credit structure continued to improve, with a remarkable rise in medium- and long-term loans and robust credit support to small and micro-sized enterprises, agriculture, rural areas, and farmers. At end-June 2012, loans to the household sector increased 16.6 percent year on year, which was 1.1 trillion yuan more that that at the beginning of 2012. Loans to non-financial institutions and other sectors grew by 15.9 percent year on year, an increase of 3.7 trillion yuan compared with the beginning of 2012 and representing an acceleration of 1.0 trillion yuan year on year. Broken down by maturities, medium- and long-term loans rose by 1.6 trillion yuan compared with the beginning of 2012, representing a deceleration of 716.6 billion yuan. At end-June 2012, medium- and long-term loans grew by 9.3 percent year on year, up 0.2 percentage points compared with that at the end of May and marking the first rebound since 2012. As in May, new medium- and long-term loans in June accounted for more than 30 percent of the total newly extended loans of all maturities. Newly extended medium- and long-term loans in June registered 278.3 billion yuan, an acceleration of 68.7 billion yuan year on year. Short-term loans including bill financing went up 3.1 trillion yuan from the beginning of 2012, an acceleration of 1.3 trillion yuan year on year. Credit support extended to small- and micro-sized enterprises and agriculture, rural areas, and farmers remained robust. At end-June, outstanding RMB loans extended by major financial institutions, rural cooperative financial institutions, urban credit cooperatives, and foreign-funded banks to small- and micro-sized enterprises rose 21.4 percent year on year, 10.1 and 5.9 percentage points more than those extended to large- and medium-sized enterprises. In the first half of 2012, domestic and foreign currency-denominated rural loans and agricultural loans extended by major financial institutions, rural cooperative financial institutions, urban credit cooperatives, village and township banks, and financial companies increased by 1.4 trillion yuan and 258.9 billion yuan respectively, accelerating by 88.2 billion yuan and 63.3 billion yuan year on year. New loans to rural households registered 364.5 billion yuan, basically flat with the same period of the last year. Broken down by institutions, loan growth of Chinese-funded large banks operating nationwide, Chinese-funded small and medium local banks, and rural cooperative financial institutions accelerated significantly year on year.

Table 1 RMB loans of financial institutions in the first half of 2012

Unit: 100 million yuan

	First Half of 2012		First Half of 2011	
	New loans	Acceleration year on year	New loans	Acceleration Year on year
Chinese-funded Large Banks Operating Nationwide①	22,145	1,902	20,243	-4,039
Chinese-funded Small and Medium Banks Operating Nationwide②	13,271	-365	13,636	994
Chinese-funded Small and Medium Local Banks③	6,808	4,240	2,567	-233
Rural Cooperative Financial Institutions④	8,590	1,559	7,031	-571
Foreign-funded Financial Institutions	289	5	284	-491

Note: ①Chinese-funded large banks operating nationwide refer to banks with assets denominated in foreign and domestic currencies equivalent to no less than 2 trillion yuan (according to the amount of total assets of the financial institutions in both domestic and foreign currencies at end-2008).

② Chinese-funded small and medium banks operating nationwide refer to banks that operate across different provinces with assets of less than 2 trillion yuan denominated in domestic and foreign currencies.

③ Chinese-funded small and medium local banks refer to banks that have total assets of less than 2 trillion yuan and that operate within a single province.

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

Source: People's Bank of China

Foreign currency-denominated loans grew steadily. At end-June 2012, outstanding foreign-currency loans of financial institutions reached USD582.3 billion, up 16 percent year on year. This was USD43.8 billion more than that at the beginning of 2012, a deceleration of USD7.5 billion year on year. Trade financing increased by USD18 billion, accounting for 41 percent of new loans denominated in foreign currencies. Overseas loans and medium- and long-term loans climbed by USD19.9 billion, accounting for 45 percent of the total new loans denominated in foreign currencies.

IV. All-system financing aggregates went up slightly year on year

It is estimated that in the first half of 2012 all-system financing aggregates registered 7.78 trillion yuan, up 13.5 billion yuan year on year. Among this total, RMB loans increased by 4.86 trillion yuan, representing an acceleration of 683.3 billion yuan. Foreign currency-denominated loans increased by the equivalent of 276.5 billion yuan, representing a deceleration of 59.6 billion yuan year on year. New entrusted loans rose by 482.7 billion yuan, representing a deceleration of 220.1 billion yuan year on year. Trust loans increased by 343.2 billion yuan, representing an acceleration of 251.9 billion yuan year on year. Undiscounted bankers' acceptances grew 608.9 billion yuan year on year, representing a deceleration of 717.8 billion yuan. Net financing via corporate bond issuances registered 824.4 billion yuan, representing an acceleration of 165.6 billion yuan compared with the same period of 2011. A total of 149.5 billion yuan was raised by domestic non-financial institutions via the stock market, down 118.2 billion yuan year on year.

Table 2 All-system financing aggregates since the beginning of 2002

Unit:100 million yuan

Year	All-system financing aggregates①	Among this total						
		RMB loans③	Foreign currency-denominated loans (RMB equivalent)	Entrusted loans	Trust loans	Undiscounted bankers' acceptances	Corporate bonds	Financing by domestic non-financial institutions via the stock market
2002	20,112	18,475	731	175	——	-695	367	628
2003	34,113	27,652	2,285	601	——	2010	499	559
2004	28,629	22,673	1,381	3,118	——	-290	467	673
2005	30,008	23,544	1,415	1,961	——	24	2,010	339
2006	42,696	31,523	1,459	2,695	825	1,500	2,310	1,536
2007	59,663	36,323	3,864	3,371	1,702	6,701	2,284	4,333
2008	69,802	49,041	1,947	4,262	3,144	1,064	5,523	3,324
2009	139,104	95,942	9,265	6,780	4,364	4,606	12,367	3,350
2010	140,191	79,451	4,855	8,748	3,865	23,346	11,063	5,786
2011	128,286	74,715	5,712	12,962	2,034	10,271	13,658	4,377
First half of 2012②	77,775	48,551	2,765	4,827	3,432	6,089	8,244	1,495

Note:

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

② Data for the current period are preliminary.

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

④ "——" indicates that the data are not available or can be omitted due to a negligible transaction volume.
Sources: The People's Bank of China, National Development and Reform Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission, China Government Securities Depository Trust and Clearing Co. Ltd., National Association of Financial Market Institutional Investors, etc.

The structure of financing took on the following features. First, RMB loans accounted for a much larger share, while the share of foreign-currency denominated loans declined. In the first half of 2012, new RMB loans constituted 62.4 percent of total financing, up 8.7 percentage points year on year. The RMB equivalent of foreign currency-denominated loans accounted for 3.6 percent of all-system financing aggregates, which was 0.7 percentage points lower year on year. Second, the volume of financing via corporate bonds was quite large, accounting for an enhanced share of the total. In the first half of 2012, financing via corporate bonds took up 10.6 percent of all-system financing aggregates, which was 2.1 percentage points higher year on year. Third, due to the much slower year-on-year growth of undiscounted bankers' acceptances, off-balance sheet financing provided to the real economy via financial institutions was significantly less than that during the same period of the last year. In the first half of 2012, financing via undiscounted bankers' acceptances, entrusted loans, and trust loans accounted for 18.4 percent of all-system financing aggregates, representing a deceleration of 9.0 percentage points year on year.

V. The lending rates of financial institutions generally declined

As the PBC lowered the benchmark RMB deposit and lending rates of financial institutions and adjusted the floating band of deposit and lending rates, the lending rates of financial institutions to non-financial institutions and other sectors generally declined. In June, the weighted average lending rate stood at 7.06 percent, down 0.56 percentage points compared with end-March 2012. The weighted average interest rate of ordinary loans registered 7.55 percent, which was 0.42 percentage points lower than that at end-March 2012. The weighted average bill financing rate posted 5.07 percent, down 1.14 percentage points compared to end-March. The weighted average residential mortgage rate edged down to 6.68 percent in June, down 0.75 percentage points compared to end-March 2012.

The share of loans with interest rates higher than the benchmark constituted a smaller share. In June, the share of loans with interest rates higher than, lower than, and flat with the benchmark stood at 66.99 percent, 7.92 percent, and 25.08 percent respectively, marking a decrease of 3.44 percentage points, an increase of 3.30 percentage points, and an increase of 0.13 percentage points respectively compared with end-March 2012.

Table 3 Shares of loans with rates floating at various ranges of the benchmark

rate, January through June 2012

unit：%

	Lower than the benchmark	At the benchmark	Higher than the benchmark						
	[0.9，1）	1	Sub-total	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2
January	4. 79	26. 22	69. 00	22. 33	25. 51	8. 76	9. 22	3. 17
February	5. 53	27. 59	66. 88	23. 12	23. 76	7. 98	8. 61	3. 40
March	4. 62	24. 95	70. 43	21. 12	26. 99	9. 48	9. 41	3. 43
April	5. 03	23. 06	71. 91	20. 76	28. 92	10. 10	8. 98	3. 16
May	5. 35	24. 08	70. 57	20. 51	28. 90	9. 73	8. 31	3. 12
June	7. 92	25. 08	66. 99	19. 94	27. 87	8. 90	7. 66	2. 63

Source: The People's Bank of China

Affected by factors like the change in domestic fund supply and demand, the demand deposit interest rate and the weighted average interest rate of less than 3-month large-value US dollar deposits registered 0.26 percent and 2.07 percent respectively, marking a decline of 0.01 percentage points and 0.85 percentage points respectively compared with the rates at end-March 2012. The weighted average interest rate of less than 3 month and 3 month (inclusive) to 6 month US dollar loans posted 3.38 percent and 3.74 percent respectively, down 0.18 percentage points and 0.27 percentage points compared with the rates at end-March.

Table 4 The average interest rates for large-value deposits and loans denominated in US dollars, January through June 2012

Unit: %

month	Large-value deposits						Loans				
	Demand deposits	Within 3 months	Demand deposits	Within 3 months	Demand deposits	Within 3 months	Demand deposits	Within 3 months	Demand deposits	Within 3 months	Demand deposits
January	0. 34	3. 29	4. 24	4. 73	5. 46	5. 87	3. 78	4. 35	4. 81	4. 47	4. 27
February	0. 29	3. 16	3. 93	4. 34	4. 64	4. 50	3. 51	4. 08	4. 35	4. 28	4. 29
March	0. 27	2. 91	3. 61	4. 34	4. 76	5. 35	3. 56	4. 00	4. 36	4. 03	3. 53

April	0.21	2.69	3.54	3.97	4.40	3.32	3.54	3.96	4.44	4.07	3.99
May	0.26	2.37	3.33	3.92	4.12	4.16	3.50	4.11	4.27	4.21	3.90
June	0.26	2.07	2.93	3.39	4.07	4.36	3.38	3.74	3.72	4.02	4.10

Source: The People's Bank of China

VI. The flexibility of the RMB exchange rate increased significantly

Since the beginning of 2012, the RMB exchange rate remained basically stable, with movements in both directions and with greater flexibility. Expectations regarding the RMB exchange rate were generally stable. At end-June 2012, the central parity of the RMB against the US dollar was 6.3249 yuan per US dollar, down 240 basis points or 0.38 percent over end-2011. From the reform of the RMB exchange-rate regime in 2005 to end-June 2012, the RMB has appreciated by a cumulative 30.86 percent against the US dollar. The BIS estimates that in the first half of 2012, the nominal effective RMB exchange rate appreciated 1.62 percent and the real effective exchange rate appreciated 0.85 percent; from the beginning of the exchange-rate reform in 2005 to June 2012, the nominal effective exchange rate of the RMB appreciated 23.12 percent and the real effective exchange rate appreciated 30.40 percent.

Part 2 Monetary Policy Operations

In the first half of 2012, the PBC continued its prudent monetary policy in line with the overall arrangements of the State Council. In response to the slowing economy and the moderated rise in prices, the PBC intensified policy efforts by making policies better targeted, more flexible, and more forward-looking while also making fine-tunings and taking pre-emptive measures. As a result, the PBC kept liquidity at a reasonably ample level, used interest rates as a leverage in guiding stable money and credit growth, ensured proper aggregate financing to the economy, encouraged financial institutions to improve the credit structure, enhanced the flexibility of the RMB exchange rate, and promoted the reform of financial institutions, thereby contributing to sound economic and financial performance.

I. Flexible open market operations

Open market operations in both directions were conducted in a flexible manner, supported by closer monitoring of liquidity in the banking system and complemented by reserve requirement adjustments. This enabled the PBC to moderate the fluctuations in liquidity supply and demand caused by seasonal factors and market developments, ensuring that liquidity in the banking system remained stable. In the first half of 2012, the PBC conducted 944 billion yuan of repos and 566 billion yuan of short-term reverse repos.

The direction of liquidity movements was properly managed by a carefully designed mix of open market operations tools. Against the backdrop of the volatile global economic and financial environment, the PBC made liquidity management better targeted, more flexible, and more forward-looking by carefully designing the maturity, timing, and frequency of repos with maturities of less than 91 days and of short-term reverse repos with maturities of less than 14 days, leveraging the role of open market operations as a tool for pre-emptive adjustments and fine-tunings to properly manage the direction of liquidity management in response to changes in the supply and demand gap in the banking system.

Interest rates of open market operations became more flexible. Based on intensified monitoring of market interest rate developments, the PBC enhanced the flexibility of interest rates of open market operations as a complement to adjustments to the benchmark deposit and lending rates. The strengthened flexibility, as reflected in the decline by various degrees across the interest rates of operations of all maturities since the beginning of 2012, facilitated the guiding of market expectations and supported a greater role for market interest rates to balance liquidity supply and demand. At end-June, interest rates for 28-day and 91-day repo operations recorded 2.75 percent and 3.05 percent respectively.

The PBC properly conducted state treasury cash management operations. In the first half of 2012, in six separate operations, the PBC deposited 320 billion yuan of state treasury funds in commercial banks, including 60 billion yuan of 3-month deposits, 200 billion yuan of 6-month deposits, and 60 billion yuan of 9-month deposits. Interest rates of all deposits remained on a downward path.

II. Cuts in the deposit reserve requirement ratio on two occasions and the differentiated reserve requirement mechanism as a counter-cyclical tool

As less RMB liquidity was created in the purchase of foreign currencies in the first half of 2012 compared with the previous year due to weak external demand and other factors, the PBC used the reserve requirement for liquidity adjustments while reducing sterilization through open market operations. Following a cut of 0.5 percentage points on December 5, 2011, the PBC further lowered the reserve requirement ratio on February 24 and May 18, 2012, each time by 0.5 percentage points, to keep liquidity in the banking system at a proper level.

The PBC improved the differentiated reserve requirement mechanism to allow the macro-prudential instrument to play a counter-cyclical role in supporting lending to small and micro-sized enterprises, agriculture, rural areas, and farmers, and other weak links in the economy, as well as to key ongoing projects. In addition, measures were also taken to flexibly manage the pace of credit supply according to actual demand. In response to the decline in some economic indicators, the parameters of the adjustments were adjusted in a timely fashion.

III. Cuts in the benchmark deposit and lending rates

As inflationary expectations moderated, the PBC cut the benchmark deposit and lending rates on June 8 and July 6, lowering the 1-year benchmark deposit rate from 3.50 percent to 3.00 percent and the 1-year benchmark lending rate from 6.56 percent to 6.00 percent, down by 0.50 percentage points and 0.56 percentage points respectively on a cumulative basis. Simultaneously, the floating bands of deposit and lending rates were adjusted, with the ceiling for deposit rates raised to 110 percent of the benchmark deposit rate, and the floor for lending rates lowered to 70 percent of the benchmark lending rate. These timely interest rate cuts and adjustments in the floating band were expected to promote a decline in interest rates and to create a more favorable policy environment for reducing borrowing costs for companies. Financial institutions will also be encouraged to further improve their financial services in market competition as they enjoy more discretionary pricing power.

Box 1 Expanding the interest rate floating band

Since the beginning of 2012, in response to domestic and global economic and financial developments, the PBC continued to implement a sound monetary policy and made timely pre-emptive adjustments, and fine-tunings through a combination of various monetary policy tools. The PBC cut the benchmark deposit and lending rates on June 8 and July 6 and simultaneously adjusted the floating band of deposit and lending rates. Financial institutions were allowed to offer deposit rates from the previous 100 percent to 110 percent of the benchmark deposit rate and to offer lending rates from the previous 90 percent to 80 percent of the benchmark lending rate on June 8 and to 70 percent on July 6.

After the initial pricing reviews and adjustments following the policy moves on June 8, the deposit rates offered by banks stabilized and became quite differentiated. First, instead of hiking their deposit rates to the ceiling, banks chose to set the deposit rates at various levels. With respect to the deposit rates, three groups of banks can be identified according to their size, with the first group including large commercial banks, which generally offered higher rates for short-term deposits. These banks increased the rates for deposits with a maturity of or shorter than 1 year shortly after the policy announcement, with the rates for demand deposits up by 10 percent and that for time deposits up by 7 or 8 percent. Interest rates offered for time deposits with a maturity of longer than 1 year were the same as the benchmark deposit rate. The second group includes medium-sized commercial banks, which floated the short-term deposit rates up to the ceiling. On the day of the policy announcement, medium-sized banks continued to offer the benchmark deposit rate but soon followed the larger banks by increasing the short-term deposit rates. Rates for deposits with a maturity of or shorter than 1 year were set at 110 percent of the benchmark deposit rate whereas rates for deposits with longer maturities were set at the benchmark rate. The third group, including most local banks with legal-person status and other small financial institutions, increased rates for deposits of all maturities to 110 percent of the benchmark deposit rate, though a few later adjusted the rates downward for long-term time deposits in line with their own operational performance and due to competitive considerations. Second, some banks developed more specified pricing policies based on the maturities of deposits and the customer structure. For example, a number of medium-sized regional banks set different rates for different amounts of deposits and customers, while some foreign-funded banks offered lower rates for long-term deposits on top of this differentiated policy. After the PBC further cut the benchmark deposit rate while keeping the floating band for deposit rates unchanged on July 6, large banks quickly adapted their pricing strategy by setting rates for demand deposits at the benchmark level instead of at 110 percent, while medium-sized banks and local banks with legal-person status generally continued their existing deposit-rate policy.

Financial institutions strengthened their lending pricing ability as they improved corporate governance and enhanced hard financial discipline in the financial reform during recent years. They developed lending pricing polices based on the expanded floating band by calculating their equilibrium lending-rate levels, and they further improved internal management by building a pricing mechanism that features multi-level authorizations under centralized management. After the PBC's adjustment of the benchmark lending rate and floating band, the weighted average interest rate of new lending to non-financial corporations and other sectors dropped to 7.06 percent in June from the 7.61 percent in March.

In general, adjustments to the benchmark deposit and lending rates as well as to the floating band helped reduce the costs of financing to the real economy and release effective investment demand, thereby promoting sound and rapid economic growth. Moreover, the adjustments provided financial institutions with greater room for pricing. This will encourage financial institutions to accelerate improvements in pricing mechanism, enhance independent pricing ability, and promote differentiated competition, thus facilitating diversification of the current homogenous operation models. It will also give banks more incentives to serve SMEs through greater financial support, which in turn will help improve financial sector support to the development of the real economy.

IV. Strengthened window guidance and credit policy guidance

The PBC continued to enhance and improve window guidance of financial institutions. It encouraged better coordination between credit policy and industrial policy, and guided financial institutions to properly manage the credit structure and the lending pace to improve financial services to the real economy and to the people's livelihood by pursuing a differentiated credit policy, thereby accelerating economic restructuring and a shift in the economic development pattern. The PBC increased credit support to key projects and small and micro-sized enterprises, agriculture, rural areas and farmers, facilitated by the issuance of the *Opinion of the State Council on Further Supporting the Healthy Development of Small and Micro-sized Enterprises* to address the SMEs' financing difficulties. It promoted innovation in rural financial products and services to enhance financial support for the development of modern agriculture and upgrading of irrigation, especially for the development of farmland irrigation and other infrastructure. The PBC continued to urge full compliance with the policies to support the supporting emerging strategic industries, tourism, the cultural industry, services outsourcing and logistics, as well as energy conservation and environmental protection programs. The PBC continued to strictly implement the differentiated mortgage policies by supporting the development of affordable housing and small and medium-sized ordinary residential commercial property as well as purchases by first-time home buyers while restricting speculative house purchase. Moreover, the PBC continued to improve financial services designed to regulate local government financing platforms and to rein in lending to industries with heavy energy consumption, high emissions, and excessive capacity.

V. Development of cross-border use of RMB

The use of RMB in settling cross-border trade transactions was promoted comprehensively. In accordance with the *Notice on Issues regarding Qualifications for RMB Settlement in Goods Exports*, which was released in March 2012, in June the PBC and five other government agencies issued a list of enterprises that will be put under special supervision, and, in line with their mandate, they will strengthen management of these enterprises as they settle exports of goods in RMB. With this development, all Chinese enterprises qualifying for imports and exports are allowed to use RMB as the currency for settling exports of goods in accordance with the law, which will further facilitate trade and promote the use of RMB in cross-border trade and investment.

RMB settlement of cross-border trade and investment grew steadily. In the first half of 2012, RMB settlement of cross-border trade recorded 1251.95 billion yuan, up 31 percent year on year. This included 868.65 billion yuan in trade of goods and 383.3 billion yuan in exports of services and other items under the current account. Actual RMB receipts and payments in the first six months totaled 1212.18 billion yuan, bringing the receipt-to-payment ratio from 1:1.7 in 2011 to 1:1.4. In the first half of 2012, RMB settlement of cross-border direct investments reached 110.55 billion yuan, including 18.74 billion yuan of outbound direct investments and 91.81 billion yuan of foreign direct investments.

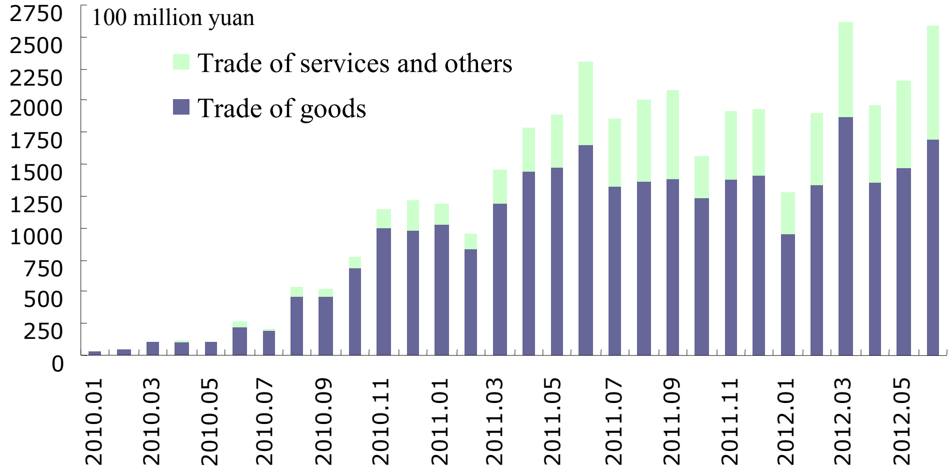


Figure 1 RMB settlement of cross-border trade

Source: The People's Bank of China

VI. Improvements in the RMB exchange-rate regime

The PBC further improved the RMB exchange-rate regime reform in line with the principle of making it a self-initiated, controllable, and gradual process. Focusing on the role of market supply and demand and adjustments with reference to a basket of currencies, the PBC enhanced the flexibility of the RMB exchange rate and kept it basically stable at an adaptive and equilibrium level. In the first half of 2012, the central parity of the RMB against the US dollar peaked at 6.2670 yuan per dollar and reached a trough of 6.3359 yuan per dollar. It appreciated on 56 out of the 117 trading days in the first six months of the year, and depreciated on the remaining 61 trading days, with the largest intraday appreciation at 0.26 percent (or 162 points), and the sharpest intraday depreciation at 0.33 percent (or 209 points).

The RMB exchange rate moved in both directions against the euro, the Japanese yen, and other major international currencies. At end-June, the central parity of the RMB against the euro registered 7.8710 yuan per euro, an appreciation of 3.70 percent from end-2011, and the central parity of the RMB against the Japanese yen stood at 7.9648 yuan per 100 Japanese yen, an appreciation of 1.83 percent from end-2011. Beginning from the reform of the RMB exchange-rate regime in 2005 to end-June 2012, on a cumulative basis the RMB appreciated 27.23 percent against the euro and depreciated 8.27 percent against the Japanese yen. In the first half of 2012, the interbank foreign exchange spot market recorded 10736.35 billion yuan of transactions in RMB against the US dollar, 37.15 billion yuan in RMB against the euro, 83.43 billion yuan in RMB against the Japanese yen, 44.26 billion yuan in RMB against the Hong Kong dollar, 2.54 billion yuan in RMB against the pound sterling, 2.12 billion yuan in RMB against the Australian dollar, 100 million yuan in RMB against the Canadian dollar, 490 million in RMB against the Malaysian ringgit, 1.52 billion yuan in RMB against the Russian ruble, and 1.39 billion yuan in RMB against the Thai baht.

Direct trading between the RMB and the Japanese yen was introduced in due time in an effort to support the growing economic and financial ties between China and Japan and as a follow-up to the proposal in the cooperation agreement reached by the leaders of the two countries. With the introduction of direct market makers that improve the way of developing the central parity between the RMB and the Japanese yen, direct trading was initiated in the inter-bank foreign exchange market on June 1, 2012. Trading was brisk, with markedly narrowed spreads in quotes and increased liquidity, and banks also narrowed the spread between bidding and asking prices at counters, making it easier for businesses and households to use Japanese yen.

Box 2 Expanding the floating band of the RMB exchange rate against the US dollar in the foreign exchange market

On April 16, 2012, the PBC expanded the floating band of RMB trading prices against the US dollar on the inter-bank spot foreign exchange market from 0.5 percent to 1 percent around the central parity, and expanded the spread between the RMB/USD selling and buying prices offered by designated foreign exchange banks from 1 percent to 2 percent. The PBC also adjusted foreign exchange operations and significantly reduced foreign exchange interventions.

As China's foreign exchange market grew rapidly with increasing trading volume and products in recent years, market participants developed a stronger risk management ability and an increasing willingness for discretionary pricing. In line with the developments in the foreign exchange market, the RMB exchange rate should have a wider band of floating. At the same time, China made much progress in restructuring its economy. China's BOP became more balanced, with the current account surplus as a share of GDP dropping steadily and reaching 2.8 percent in 2011. As the gap between foreign exchange supply and demand narrowed, expectations regarding exchange rate movements began to diverge, and the RMB exchange rate was closer to its equilibrium level, making it the right time to expand the RMB exchange rate floating band.

Since the policy was adopted on April 16, the foreign exchange market generally remained stable. The market was in a better position to move toward an equilibrium level, and market supply and demand played a dominant role in the development of the RMB exchange rate. First, the RMB exchange rate became more flexible. In 50 percent of the trading days during the period between April 16 and end-June, the RMB exchange rate fluctuated above 0.5 percent around the central parity, with the sharpest fluctuation reaching 0.98 percent or 619 basis points. With the expanded floating band and enhanced flexibility, the RMB exchange rate was more resilient against supply and demand shocks. Second, there was more consistency between trading prices. The spread between the opening price and the previous day's closing price averaged 33 basis points during the period between April 16 and end-June, compared with an average of 47 basis points during the period between the beginning of the year and April 16, suggesting market supply and demand played an increasingly fundamental role. Third, the selling and buying prices offered at bank counters remained stable. Spreads between spot buying and selling prices at major banks were close to the level before the policy was introduced, reflecting the banks' enhanced ability to independently develop pricing and to manage risks.

Going forward, the PBC will continue to promote the RMB exchange-rate regime reform in view of domestic and global economic and financial developments and in accordance with the principle of making the reform a self-initiated, controllable, and gradual process. As the market plays a greater role, the PBC will enhance the RMB exchange rate flexibility in both directions and keep the exchange rate basically stable at an adaptive and equilibrium level. Moreover, the PBC will continue to improve foreign exchange administration, expand the foreign exchange market, and encourage innovations in foreign exchange products.

VII. Deepened reform of financial institutions

Significant progress was made by large commercial banks to expand overseas business, and the reform at the ABC to build a dedicated division for rural financial services made concrete achievements. In May, applications by the Industrial and Commercial Bank of China (ICBC) to acquire the Bank of East Asia (US), by the Agricultural Bank of China (ABC) to set up a branch in New York, and by the Bank of China (BOC) to open a branch in Chicago were approved by the US regulatory authorities, while the ICBC's application to open a Brazilian subsidiary was approved by the Brazilian National Currency Committee. To provide county-level branches greater incentives in serving agriculture, rural areas, and farmers, the ABC released the *Notice on Regular Clearing of Returns on Preferential Reserves for Financial Services for Agriculture, Rural Areas, and Farmers* in May, which allows the distribution a certain portion of returns on preferential reserves to county-level branches with the best performance in agro-linked financial services.

Reform of the rural credit cooperatives (RCC) went smoothly, and notable achievements were made. First, the RCCs' asset quality was strengthened significantly. Based on the five-category loan classification, outstanding NPLs at the RCCs at end-June dropped to 4.7 percent, down by 0.8 percentage points from end-2011, and the capital adequacy ratio increased 0.1 percentage points from end-2011 to 10.8 percent. Second, agro-linked lending by the RCCs grew markedly. At end-June, total RCC deposits posted 11.2 trillion yuan, up 10.8 percent from end-2011, while total RCC lending registered 7.5 trillion yuan, an increase of 12.9 percent from end-2011. In particular, outstanding agro-linked loans and loans to rural households reached 5.1 trillion yuan and 2.6 trillion yuan, up 10.7 percent and 11.0 percent respectively from end-2010. Third, steady progress was made in RCC property rights reform. As of end-June, a total of 1,858 RCCs with legal-person status at the county (city) level, 247 rural commercial banks, and 173 rural cooperative banks were established.

VIII. Deepened reform of foreign exchange administration

Institutional arrangements were set up to guard against shocks from cross-border capital flows. Regulatory responsibilities were defined and policy measures were developed to address potential risks and to guard against volatile cross-border capital flows. Momentum against irregular capital flows was maintained, while risk monitoring and risk warning on potential risks in the banking system were strengthened and special oversight programs were launched for some commercial banks. As of end-June, joint operations with the public security authorities had resulted in the cracking of 4 underground banking cases, 8 illegal foreign exchange selling and purchase cases, and one online foreign exchange speculation case, with total fines reaching over 16 million yuan.

Efforts were made to promote nationwide implementation of the reform of foreign exchange management for trade of goods. On June 27, the State Administration of Foreign Exchange (SAFE), the General Administration of Customs, and the State Administration of Taxation jointly announced that, effective August 1, the reform of foreign exchange management for trade in goods will be launched across the country to replace the existing case-by-case verification and writing-off policy for foreign exchange receipts and payments for trade in goods with a process that focuses on oversight over the aggregate amount and features continuous monitoring and category-specific supervision, which is expected to enhance risk prevention. It was also announced that, in an effort to make regulation and supervision more effective and efficient, measures will be taken to adjust the procedures for export declarations, streamline requirements for export rebates, and enhance joint supervision.

Actions were taken to facilitate trade and investment. Distribution of the short-term external debt quota in 2012 was refined in favor of banks in the central and western regions and small- and medium-sized banks so as to meet the demand for short-term external financing by Chinese-funded enterprises. The pilot reform that allows for surrender of foreign exchange capital by foreign-funded micro-credit companies was launched in Tianjin and another three provinces (municipalities) as part of the efforts to support small- and micro-sized enterprises. Policies were simplified to make it easier for companies to send back outbound direct investments and to lend in foreign currencies in overseas markets, and for individuals to make external guarantees in an effort to support private capital to go global.

Part 3 Financial Market Analysis

In the first half of 2012, China's financial market continued to perform in a stable manner. Transactions on the money market increased significantly, and interest rates moved down noticeably. Bond market indices went up by a small margin, and bond issuances were basically stable. Stock indices stabilized while financing on the stock markets declined substantially. Total assets in the insurance industry maintained steady growth, and the foreign exchange market traded briskly.

I. Financial market analysis

1. Transactions on the money market increased significantly, and interest rates moved down noticeably

Repo transactions and interbank borrowings on the money market were brisk, with the trading volume increasing significantly. In the first half of 2012, the turnover of bond repos totaled 70.2 trillion yuan, with an average daily turnover of 575.4 billion yuan, up 50.9 percent year on year. The turnover of interbank borrowings reached 23.7 trillion yuan, with an average daily turnover of 194.6 billion yuan, an increase of 63.3 percent year on year. Overnight products still dominated bond repo and interbank borrowing transactions, accounting for 80.5 percent and 88.4 percent of their respective turnover, up 3.7 and 1.7 percentage points from the same period of the previous year. The total turnover of government securities repos on the stock exchanges soared 111 percent year on year to 14.8 trillion yuan.

In terms of financing by financial institutions, the flow of funds among financial institutions in the first half of the year showed the following characteristics: first, domestically-funded large banks were the only net fund providers, and their net lending increased rapidly, with cumulative net lending of 32.4 trillion yuan in the first half of the year, representing growth of 18.6 trillion yuan from the same period of the previous year; second, other market participants, especially domestically-funded small and medium-sized banks and securities and fund management companies, were net fund borrowers due to their strong funding demand, and net borrowings by domestically-funded small and medium-sized banks, and securities firms and fund management companies were 14.1 trillion yuan and 8.0 trillion yuan respectively, representing growth of 9.8 trillion yuan and 4.7 trillion yuan from the same period of the previous year; third, in the interbank lending market, domestically-funded large banks changed from net borrowers during the same period of the previous year to net lenders, while domestically-funded small and medium-sized banks and foreign-funded financial institutions changed from net lenders to net borrowers.

Table 5 Fund flows among financial institutions in the first half of 2012

Unit: 100 million yuan

	Repo		Interbank borrowing	
	In the first half of 2012	In the first half of 2011	In the first half of 2012	In the first half of 2011
Domestically-funded large banks ①	-283,691	-143,767	-40,005	6,351
Domestically-funded small and medium-sized banks ②	134,390	60,211	6,789	-16,822
Securities and fund management companies	61,475	27,493	17,681	4,847
Insurance companies	25,709	11,893	-	-
Foreign-funded financial institutions	7,287	5,532	2,167	-4,108
Other financial institutions③	54,831	38,638	13,368	9,732

Notes: ①Domestically-funded large banks include the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, the China Construction Bank, the China Development Bank, the Bank of Communications, and the China Postal Savings Bank. ②Domestically-funded small and medium-sized banks include the China Merchants Bank and 16 other medium-sized banks, small-sized city commercial banks, rural commercial banks, rural cooperative banks, and village and township banks. ③Other financial institutions 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, other investment products, and so forth. ④A negative sign indicates net lending and a positive sign indicates net borrowing.

Source: China Foreign Exchange Trade System

Interest rates on the money market declined noticeably amid fluctuations. Due to a number of factors including the Spring Festival, in January interest rates witnessed their highest level of the year; as the PBC consecutively lowered the reserve requirement ratio and the benchmark deposit and lending rates and in a timely manner adjusted liquidity in the banking sector via open market operations, interest rates on the money market showed a gradually falling trend; although affected by seasonal factors such as end of quarter performance evaluations, at end-June interest rates on the money market increased somewhat; the monthly weighted average interest rates of bond-pledged repo and interbank borrowing at end-June posted 2.81 percent and 2.72 percent, down 56 and 61 basis points from the end of the last year, and down 213 and 184 basis points from the same period of the last year. At the end of June, the overnight and 7–day Shibor stood at 3.60 percent and 4.11 percent respectively, down 140 and 222 basis points from the beginning of the year; the 3-month and one-year Shibor registered 4.08 percent and 4.75 percent, down by 139 and 49 basis points from the beginning of the year.

Trading of RMB interest-rate swap and forward products decreased slightly. In the first half of the year, a total of 9,490 transactions were conducted, with an aggregate nominal principal of 1173.49 billion yuan, down 4.4 percent year on year. With respect to the term structure, RMB interest-rate swaps with a maturity of less than one year (inclusive) traded most briskly, and their aggregate notional principal accounted for 75.9 percent of the total. The base rates of the floating end of the RMB interest-rate swaps included the 7-day fixing repo rate and the Shibor, and their notional principal accounted respectively for 51.4 percent and 42.7 percent of the total. Transactions of bond forwards posted 16.04 billion yuan, representing a decrease of 64.4 percent year on year.

Table 6 Transactions of interest-rate derivatives in the first half of 2012

	Interest-rate swaps		Bond forwards		Forward-rate agreements	
	Transactions	Amount of notional principal (100 million)	Transactions	Amount of notional principal (100 million)	Transactions	Amount of notional principal (100 million)
2007	1,978	2,186.9	1,238	2,518.1	14	10.5
2008	4,040	4,121.5	1,327	5,005.5	137	113.6
2009	4,044	4,616.4	1,599	6,556.37	27	60.0
2010	11,643	15,003.4	967	3,183.43	20	33.5
2011	20,202	26,759.6	436	1,030.10	3	3.0
Q1 2012	4,317	4,913.7	45	144.57	——	——
Q2 2012	5,173	6,821.2	7	15.86	2	1.0

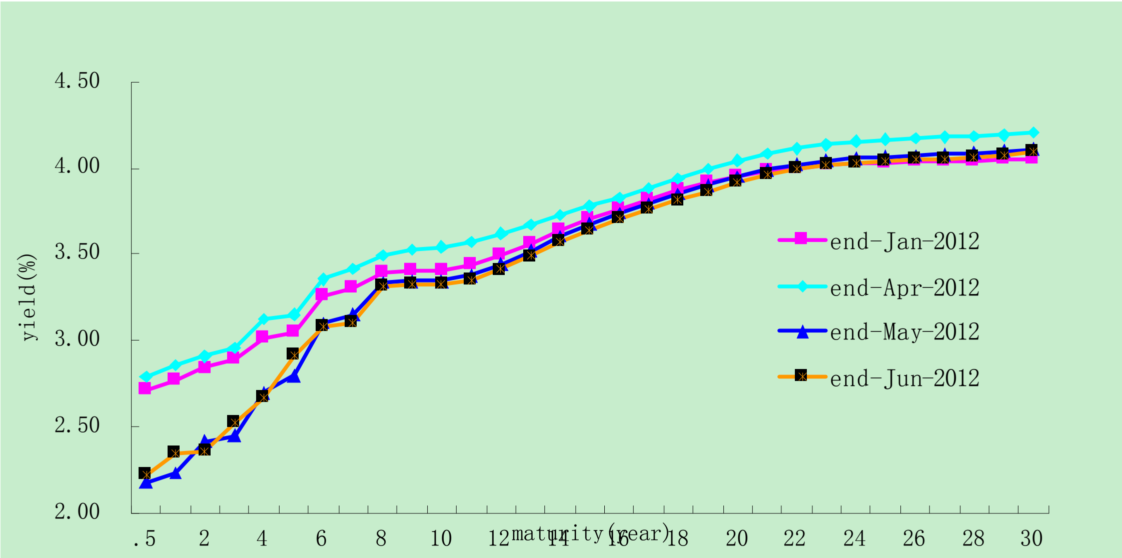
Source: China Foreign Exchange Trade System

2. Bond market indices climbed somewhat and bond issuances grew steadily

Turnover of spot bond transactions on the interbank market remained stable. In the first half of 2012, the turnover of spot bond trading totaled 33.6 trillion yuan, with a daily average of 275.7 billion yuan, up 9.5 percent year on year. In terms of trading entities, domestically-funded large banks and foreign-funded financial institutions were net purchasers on the interbank spot bond market, with net purchases of 195.5 billion yuan and 69.7 billion yuan respectively. Exchange-traded spot government securities transactions posted 47.8 billion yuan, 13.2 billion yuan less than that during the same period of the previous year.

Bond price indices moved up slightly. The China Bond Composite Index (net price) rose 1.03 percent from 101.23 points at the beginning of the year to 102.27 points at end-June, and the China Bond Composite Index (full price) rose 1.49 percent from 111.28 points at the beginning of the year to 112.94 points at end-June. The exchange-traded government securities index rose 1.73 percent from 131.44 points at the beginning of the year to 133.71 points at end-June.

In the first half of the year, the yield curve of government securities showed an overall downward trend. At end-June, the yields of 6-month, 5-year, 10-year, and 20-year government bonds were 49, 13, 8 and 4 basis points lower than those at the end of January, and the yield curves of government bonds steepened somewhat amid downward movements.



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

Figure 2 Yield curve of government securities on the interbank bond market

The volume of bond issuances was generally stable. In the first half of 2012, a total of 3.49 trillion yuan of bonds (excluding central bank bills) was issued, 302.2 billion yuan more than that during the same period of the last year. In particular, the volume of newly issued government securities, short-term financing bills, bank subordinate bonds and hybrid bonds posted 682 billion yuan, 350.3 billion yuan, and 56.6 billion yuan respectively, 155.8 billion yuan, 149.6 billion yuan, and 105.4 billion yuan less than that during the same period of the last year; the issuance volumes of super and short-term commercial paper and bank ordinary bonds were 192.5 billion yuan and 143 billion yuan more respectively than those during the same period of the last year. At end-June, a total of 22.0 trillion yuan of bonds was deposited with the China Government Securities Depository Trust and Clearing Co., Ltd., an increase of 7.4 percent year on year. Since securities companies reactivated the issuance of short-term bills in May, two such bonds have been issued on the interbank bond market, with total financing amount of 8 billion yuan.

Table 7 Issuance of bonds in the first half of 2012

Types of bonds	Issuance (100 million yuan)	Year-on-year growth (100 million yuan)
Government securities①	6820	-1558
Policy financial bonds issued by the China	11416	143

Development Bank and other policy banks		
Bank subordinated bonds and hybrid bonds	566	-1054
Bank ordinary bonds	1450	1430
Enterprise bonds②	14602	3966
Of which：Short-term financing bills	3503	-1496
Super and short-term commercial paper	1925	1925
Medium-term notes	3236	-59
Corporate bonds	1047	466

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

②Including enterprise bonds, short-term financing bills, super and short-term commercial paper, medium-term notes, collective bills of SMEs, corporate bonds, and private placement of bond-financing instruments.

Sources: The People's Bank of China; China Government Securities Depository Trust & Clearing Co., Ltd.

Bond issuance rates declined somewhat. Compared with the last year, in the first half of 2012 government bond issuance rates of all maturities showed a downward trend. The interest rate of 10-year government securities issued in June was 3.36 percent, down 21 basis points from those of the same maturity issued in December 2011; the interest rate of 7-year government securities was 3.14 percent, down 51 basis points from those of the same maturity issued in November 2011. The Shibor played a greater role in bond pricing. In the first half of the year, 187 fixed-rate enterprise bonds issued on the primary bond market were all based on the Shibor, with a gross issuance volume of 312.89 billion yuan. In addition, a total of 179.06 billion yuan of short-term financing bills based on the Shibor was issued, accounting for approximately 51.2 percent of the total issuance of short-term fixed-rate financing bills.

3. The volume of bill financing grew steadily, and interest rates showed a downward trend

The bill acceptance business continued to grow. In the first half of the year, commercial bills issued by enterprises totaled 8.8 trillion yuan, representing year-on-year growth of 15.2 percent; the total volume of outstanding commercial bills at end-June posted 8.1 trillion yuan, representing year-on-year growth of 20.3 percent. At end-June, outstanding commercial bills had increased by 1.5 trillion yuan from the beginning of the year. In terms of issuing industries, outstanding bankers' acceptance bills were mainly issued by enterprises in the manufacturing, wholesale, and retail industries and small and medium-sized enterprises issued 70.6 percent of the total.

Bill financing increased rapidly, rendering great support to small and medium-sized enterprises. Since the beginning of 2012, commercial banks and enterprises showed more interest in participating in bill financing. In the first half of 2012, the cumulative amount of commercial bills discounted by financial institutions posted 14.1 trillion yuan, representing year-on-year growth of 6.7 percent; the outstanding balance of commercial bills at end-June increased 67.5 percent year on year to 2.3 trillion yuan. The balance of bill financing at end-June had increased by 764.2 billion yuan from the beginning of the year, with an acceleration of 906.4 billion yuan year on year and accounting for 3.8 percent of all categories of loans, an acceleration of 1.2 percentage points from the corresponding period of the last year.

Interest rates on the bill market showed a downward trend. As the interest rates on the money market gradually declined and the supply of funds became more abundant, interest rates on the bill market showed a downward trend.

4. Stock indices stabilized and equity financing on the stock market decreased measurably

Stock indices stabilized. The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 2225 points and 9500 points respectively at end-June 2012, up 26 and 582 points from the end of the last year. The Growth Enterprise Board (GEB) Index (Chinext Price Index) of the Shenzhen Stock Exchange closed at 727 points, shedding 3 points from the end of the last year. The weighted average P/E ratio on the A-share market of the Shanghai Stock Exchange and the Shenzhen Stock Exchange declined from 13.4 times and 23.5 times respectively at the end of the last year to 11.9 times and 22.9 times.

Financing on the stock market declined notably. In the first half of 2012, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 17.5 trillion yuan, representing a decline of 29.2 percent year on year, and the daily turnover averaged 149.5 billion yuan, 58 billion yuan less than that during the same period of the previous year. The turnover on the Growth Enterprise Board amounted to 1.2 trillion yuan, representing an increase of 62.7 percent year on year. At end-June, the combined market capitalization of the Shanghai and Shenzhen Stock Exchanges increased 5.0 percent from the end of the last year to 17.3 trillion yuan, while the market capitalization of the Growth Enterprise Board increased 22.2 percent to 306 billion yuan.

Financing on the stock market declined notably. In the first half of 2012, a total of 199.4 billion yuan was raised by enterprises and financial institutions on domestic and overseas stock markets by way of IPOs, additional offerings, and rights issuances, 136.8 billion yuan less than that during the same period of the previous year.

5. Total assets in the insurance industry registered steady growth

In the first half of 2012, total premium income of the insurance industry amounted to 853.3 billion yuan, representing year-on-year growth of 5.9 percent, and total claim and benefit payments amounted to 226.3 billion yuan, representing year-on-year growth of 15.5 percent. Specifically, total claim and benefit payments in the property insurance sector increased 30.2 percent, whereas those in the life insurance sector increased 2.0 percent.

Total assets of the insurance industry registered steady growth. At end-June, total assets of the insurance industry posted 6.78 trillion yuan, an increase of 17.9 percent year on year. Among this total, bank deposits increased 27.9 percent while investment-linked assets increased 14.1 percent.

Table 8 Use of insurance funds, end-June 2012

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-June 2012	June-June 2011	End-June 2012	June-June 2011
Total assets	67,760	57,470	100.0	100.0
Of which: Bank deposits	22,578	17,658	33.3	30.7
Investments	39,226	34,393	57.9	59.8

Source: China Insurance Regulatory Commission

6. The foreign exchange market traded briskly and currency swap transactions increased rapidly

In the first half of 2012, the turnover of spot RMB/foreign exchange transactions totaled USD1.73 trillion, representing a decline of 1.43 percent year on year. The turnover of RMB/foreign exchange swap transactions totaled USD1.14 trillion, representing an increase of 43.3 percent year on year; among this total, overnight RMB/USD swap transactions amounted to USD599.3 billion, accounting for 52.8 percent of the total. The turnover on the RMB/foreign exchange forward market totaled USD64.5, a decrease of 44.3 percent year on year. The turnover of foreign currency pair transactions amounted to USD42.8, a decrease of 13 percent. In particular, USD/HKD transactions accounted for the bulk, or 44.5 percent of the total, up 1.2 percentage points from the same period of the last year. The number of participants on the foreign exchange market expanded further. At end-June, there were 338 members on the foreign exchange spot market, 74 members on the foreign exchange forward and swap markets, and 30 members on the foreign exchange options market. In addition, there were 26 market-makers on the foreign exchange spot market and 20 market-makers on the foreign exchange forward market.

7. The gold market maintained stable performance

Turnover on the gold market increased year on year. In the first half of 2012, the total trading volume of gold was 3,247.4 tons, an increase of 11.7 percent year on year, and its turnover posted 1091.4 billion yuan, an increase of 22.8 percent year on year. The daily trading volume of gold averaged 27.8 tons, an increase of 23.8 percent year on year. The trading volume of silver was 89,941.1 tons, and its turnover posted 5,759.9 billion yuan, a decrease of 46.0 percent year on year. The total trading volume of platinum was 31.5 tons, and its turnover posted 10.37 billion yuan, a decrease of 16.2 percent year on year.

The price of gold initially remained subdued but then went up. In the first half of 2012, the afternoon fixing price on the London Gold Market reached a peak of USD1,781 per ounce and a trough of USD1,540 per ounce. The highest gold price on the Shanghai Gold Exchange (AU9995) was 362.5 yuan per gram, and the lowest price was 312.7 yuan per gram. At end-June, the price of gold on the domestic market closed at 322.2 yuan per gram, up 0.75 percent from the end of the last year.

II. Institutional building in the financial market

1. Launching the interest rate swap confirmation and compression business

To further improve the efficiency of derivative transactions on the OTC market and reduce market risks, under the guidance of the PBC, the National Interbank Funding Centre launched the interest rate swap confirmation and compression business and released the relevant rules, allowing electronic confirmation and contract compression business for the interest rate swap business on the interbank market and helping to standardize the China's OTC derivatives market.

2. Simplifying market admission management for foreign exchange swap and currency swap businesses

On May 21, 2012, the State Administration of Foreign Exchange (SAFE) issued the *Notice on Adjusting Administration of Some Businesses on the Interbank Foreign Exchange Market*. In accordance with this *Notice*, the SAFE will simplify market admission management for foreign exchange swap and currency swap businesses, will carry out one-time filing management for RMB/foreign exchange futures, foreign exchange swaps, and currency swap, and will increase the modes of principal exchange for currency swap business. Domestic institutions not only can conduct RMB/foreign exchange swap business on the interbank foreign exchange market, but also can choose not to deliver RMB or foreign exchange funds either on the date when the agreement comes into force or on the date when the agreement expires, except for that stipulated by current rules. The simplified management will further allow the financial sector to serve the real sector and promote the development of the foreign exchange market.

3. Improving institutional arrangements on the securities market

Further deepening the reform of the new stock issuing system. With a view to further promoting the reform of the information disclosure-based new stock issuing system, strengthening the authenticity, accuracy, and completeness of the disclosed information, facilitating market entities to play their due roles, promoting new stock issuing prices to realistically reflect company value, and promoting the balanced and healthy development of the primary and second securities market, the China Securities Regulatory Commission in succession issued the *Guiding Opinions on Further Deepening the Reform of the New Stock Issuing System* and the *Opinions on Enhancing the Quality of Financial Disclosures for First-time Stock Issuers,and amended the Administrative Rules for Securities Offerings and Underwriting.*

Improving the quality of statistics for the securities and futures industry. In June, the China Securities Regulatory Commission released the *Provisional Guideline No.1 on the Statistical Indicator Standard for the Securities and Futures Industry* to set the standard for nine key indicators, such as the market dividend yield ratio, the market static price-to-earning ratio, and the market static price-to-book ratio, so as to eliminate discrepancies in statistical standards, calculation methods, and data sources for the same indicators and to improve the consistency and accuracy of statistical data for the securities and futures industry.

4. Improving institutional arrangements on the insurance market

Strengthening management of investment-linked insurance products. In May 2012, the China Insurance Regulatory Commission issued the *Notice on Further Strengthening Management of the Investment-linked Insurance Business of Property Insurance Companies*, specifying the prerequisite conditions and risk control measures for investment-linked insurance products of property insurance companies, and putting forward the requirement that the scale of investment-linked insurance products should be linked to the solvency of the insurance company so as to promote the healthy and sustainable development of such business.

Increasing capital replenishment channels and strengthening solvency supervision. In May 2012, the China Insurance Regulatory Commission issued the *Circular on Matters Relevant to the Offerings of Subordinate Convertible Bonds by Listed Insurance Companies*. According to the *Circular*, listed insurance groups and companies are allowed to issue subordinate convertible bonds and can include them in their supplementary capital before the bonds are converted into stocks so as to increase the recapitalizing channels for insurance companies. In June, the China Insurance Regulatory Commission issued the *Circular on Strengthening Solvency Management of Insurance Companies*. According to the *Circular*, all insurance groups and companies should establish an internal solvency management system compatible with their business scale, business structure, and risk profile, and when they encounter insolvency problems they should develop within one month a plan for fulfilling the requirements.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q2 2012, the global recovery softened remarkably. Growth in the United States seemed to lose momentum. The European sovereign debt crisis ratcheted up, adding to increased downside risks. Though there were signs of an economic rebound in Japan, uncertainties continued to loom large. Growth momentum also moderated in the emerging market economies, and the flow of capital reflected a rising risk aversion.

1. Economic developments in the major economies

Growth momentum slowed in the United States. Incoming major economic data for the second quarter suggested less robust growth than that forecast. Notwithstanding the improved household balance sheet and housing market, the United States continued to face problems, such as a falling CPI, an elevated unemployment rate, lackluster consumer expenditures, a low private saving rate, a declining manufacturing PMI during the last three months, and moderated trade growth. Currently, the US economy is threatened by many uncertainties. Sluggish employment conditions might dampen the rebuilding of confidence and the growth of consumer expenditures. Risks around the so-called "fiscal cliff" put a brake on enterprise investments. The housing market remained gloomy. The impact of the euro area crisis will further eat into the US recovery. Meanwhile, room for fiscal and monetary policy maneuvering was shrinking. In June, the US Fed reduced its estimation of the 2012 real GDP growth to a range of 1.9-2.4 percent.

Economic conditions in the euro area contracted further. After a temporary period of containment, the EU debt crisis deteriorated sharply, adding to an adverse feedback loop among sovereign stresses, banking crises, and economic slack. In May the unemployment rate soared to 11.1 percent, a record high since the establishment of the euro area. Private consumption was affected by declining unemployment and income, and government expenditures were restrained by fiscal consolidation. At the same time, investment in the manufacturing, housing, and public sectors declined, resulting in an overall slump in investment. According to market estimations, the contribution of net exports to economic growth will recede compared with that in the last quarter. In addition, since February 2010 the manufacturing PMI and industrial confidence indicators also slid to a historic low.

The Japanese economy showed signs of a rebound but uncertainties still lingered. In

Q2, accelerated public investments boosted fixed-asset investments. Personal consumption gained steam from government measures for stimulating automobile demand. Price levels moved downwards and employment conditions improved somewhat. Year-on-year trade figures increased by a large margin against the relatively low base of the last year. Exports to North America and Australia were robust but those to Asia and Europe shrank. In the short run, the Japanese economy will continue to struggle due to the negative impact from the EU debt crisis, the global recession, the appreciation of the Japanese yen, and the domestic electricity shortage. However, in the long run, fiscal deficit and debt problems will pose the greatest risks to economic activities. Recently, the Diet of Japan approved a measure to raise the consumption tax, the effects of which have not yet been tested.

Table 9 Macroeconomic and financial indices of the major economies

Country	Index	2011Q2			2011Q3			2011Q4			2012Q1			2012Q2		
		Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.
United States	Real GDP Growth Rate (annualized quarterly rate, YOY,%)	1.3			1.8			3.0			1.9			1.5		
	Unemployment Rate (%)	9.0	9.0	9.1	9.1	9.1	9.0	8.9	8.7	8.5	8.3	8.3	8.2	8.1	8.2	8.2
	CPI (YOY, %)	3.2	3.6	3.6	3.6	3.8	3.9	3.5	3.4	3.0	2.9	2.9	2.7	2.3	1.7	1.7
	DJ Industrial Average (closing number)	12811	12570	12414	12143	11613	10913	11955	12046	12218	12633	12952	13212	13214	12393	12880
	NASDAQ(closing number)	2874	2835	2774	2756	2579	2415	2684	2620	2605	2814	2967	3092	3046	2827	2935
Euro Area	Real GDP Growth Rate (quarterly YOY,%)	1.6			1.3			0.7			0.0					
	Unemployment Rate (%)	9.9	10.0	10.0	10.1	10.1	10.2	10.3	10.4	10.4	10.7	10.8	10.9	11.0	11.2	11.2
	HICP (YOY, %)	2.8	2.7	2.7	2.6	2.5	3.0	3.0	3.0	2.7	2.7	2.7	2.7	2.6	2.4	2.4
	EURO STOXX 50(closing number)	2661	2632	2561	2511	2238	2160	2318	2299	2370	2422	2477	2459	2423	2257	2381
Japan	Real GDP Growth Rate (annualized quarterly rate.%)	-2.1			5.6			-2.3			4.1					

	Unemployment Rate (%)	4.9	4.6	4.7	4.7	4.4	4.2	4.4	4.3	4.2	4.6	4.5	4.5	4.6	4.4	4.3
	CPI (YOY,%)	-0.2	-0.1	-0.2	0.1	0.2	0.2	-0.1	-0.2	-0.1	-0.1	0.1	0.2	0.2	-0.1	-0.2
	NIKKEI225(closing number)	9850	9694	9816	9833	8955	8700	8988	8435	8455	8803	9723	10084	9521	8543	9007

Source: Statistical bureaus and central banks of the relevant economies

Most major emerging market economies experienced moderated growth, reversal of capital flows, and currency depreciations. In Q2, economic activities in most BRIC countries softened further and their trade positions worsened due to various factors, including decreasing external demand and the downward economic cycle. Against the backdrop of a tepid domestic economy and the recurrence of the EU debt crisis, most emerging market economies faced massive outflows of capital, concomitant with currency depreciations. By the end of June, the Brazilian real, Indian rupee, Russian ruble, and South African rand had depreciated against the US dollar by 10.1 percent, 9.1 percent, 10.5 percent, and 6.7 percent respectively from the end of the last quarter, and countries including Brazil and India had taken measures such as market interventions and mandatory settlement of foreign exchange to alleviate the impact of the massive capital flows on currency values.

Box 3 Major problems in the European banking system and the European responses

In Q2 2012, with the outbreak of the Spanish banking crisis, the banking system took center stage in the ongoing drama in the EU crisis responses. Taking swift measures to promote the banks' support to the real economy through credit supplies became the top priority to curb a deterioration of the debt crisis.

1. Major problems faced by the European banks

First, against the background of the sovereign debt crisis, weak economic activity, and stricter regulatory standards, banks were seriously short of capital. Since the outbreak of the crisis, slow economic growth of member countries impaired bank profitability and triggered a surge in non-performing loans. Large-scale asset write-downs eroded the capital base of the banking sector. At the same time, European banks generally cross-held large amounts of government bonds of the heavily indebted countries. When the prices of these bonds fell with the deterioration of sovereign crisis, there would be a spiral of capital losses. Meanwhile, the requirement by the European regulatory authorities to raise the capital adequacy ratio was also pro-cyclical. By December 2011, thirty-seven European banks had a total capital shortfall of up to 114.7 billion euro. In July 2012, the EBA announced that 27 banks had already met (or would soon meet) the new regulatory requirements. However, the capital levels of six large Greek banks and ten Spanish banks including Bankia were still below the standard.

Second, banks in the heavily indebted countries experienced severe bank runs with drying sources of market financing and immense liquidity stress. According to the ECB, from January to May 2012, deposits by residents in Greece, Portugal, and Spain (excluding deposits by monetary financial institutions and the central governments) decreased by 11.8 billion euro, 6.9 billion euro, and 65.8 billion euro respectively. Together with deposit withdrawals, the credit risks of the banks of these teetering countries soared, making it difficult for banks to access liquidity from the euro area inter-bank market, even though the ECB had injected a large amount of cash into the market. At a June 2012 press conference the president of the ECB commented that the inter-bank market was "dysfunctional." Therefore, the problematic banks mainly had to rely on the ECB for funds. Spanish banks borrowed a total of 324.6 billion euro from the ECB by May 12, Italian banks 281.4 billion euro by June 12, and Portuguese banks 60.5 billion euro by the end of June.

2. Consequences of the problems faced by the European banks

The abovementioned problems exacerbated the deleveraging process of the European banking system and intensified the credit crunch. The IMF expected that fifty-eight of the largest European banks would trim about USD2.6 trillion to USD3.8 trillion in assets by the end of 2013. Most banks had sufficient cash or even held an excessive amount of money due to pessimistic expectations in the economic and financial outlooks and a lack of confidence, leading to cutbacks on lending to the real economy. The continued credit crunch put a drag on the daily operations of non-financial enterprises, investment plans, and the credit and consumption of residents, thereby restraining the growth of the real economy and employment. In turn, weak economic activities hampered the recovery of the banking system.

At the same time, a negative feedback loop had formed between the banking problems and the sovereign crisis. On the one hand, funding the tumbling banks added to the government debt burden; and, on the other hand, concerns about government debts shook confidence in the banking system since the banks held a lot of the sovereign debt. As a result, the credit ratings of banks were downgraded, thereby eating into the banks' financing capabilities. Therefore, finding a remedy for the European banking impasse became key for breaking the negative feedback loop among the sovereign stress, the banking crisis, and the economic slack.

3. Major European responses to the bank problems

First, governments were pumping money into banks to make up for the capital shortfall. By the end of 2011, the Irish government had provided about 62.7 billion euro in bailout funds; Portugal announced a 6.65 billion euro recapitalization plan for its banks in June 2012; and Greece injected about 48 billion euro into the banking system in its second aid program. On June 25, 2012, due to their banking woes Spain and Cyprus sought rescue from the euro zone. On July 20, the Eurogroup granted up to 100 billion euro to Spain through the EFSF/ESM, and an aid program for Cyprus was also under negotiation. At the June 28-29 summit, leaders unanimously agreed to allow the EFSF/ESM to directly inject money into the banks in exchange for equities in an integrated regulatory framework so as to break the adverse feedback loop between the banks and the sovereign crisis.

Second, the ECB provided a liquidity backstop to banks by expanding its balance sheet. On December 21, 2011 and February 29, 2012, the ECB pumped 489 billion euro and 529.5 billion euro on the market respectively through two rounds of three-year LTRO. By the end of June, its balance sheet reached 3.1 trillion euro. In addition, the ECB expanded the range of eligible collaterals to lower the threshold for ECB loans to banks.

Third, the establishment of a "EU Banking Union" was advocated to shore up confidence in the banking system. On May 23 2012, José Manuel Barroso, president of the European Commission, raised the concept of a "Banking Union" for the first time at an informal EU leaders' meeting, describing the four pillars of the future banking union, including: a common deposit insurance regime covering all EU banks; a resolution fund and institution to deal with cross-border and systemic banks; a single banking supervisor charged with overseeing major systemic banks or banks with cross-border operations; and unified prudential rules for all EU banks. On June 26, together with President Draghi of the ECB, President Barroso of the European Commission, and President Juncker of the Eurogroup, President Van Rompuy of the European Council published a report entitled Towards a Genuine Economic and Monetary Union, which proposed a vision for the EMU in the following ten years based on four essential building blocks, including an integrated financial framework. The core content of building an integrated financial framework was the establishment of a unified supervisory mechanism for the banks, a deposit insurance mechanism, and a risk resolution framework. Currently, the European Commission has already drafted a proposal for a single bank-resolution mechanism and fund, and it will soon render a draft resolution on a single regulatory framework with the participation of the ECB.

2. Global financial market development

In Q2 2012, risk aversion increased against the deteriorating global economic outlook, causing large fluctuations in international financial markets. The June 28-29 European summit only served as a temporary stimulus to the world market.

Flight-to-safety demand drove international capital flows out of Europe and the emerging market economies. Because of the upper limit on the Swiss franc's exchange rate against the euro set by the National Bank of Switzerland, risk aversion demand for the Swiss franc was changed to the United States and Japan, pushing up the US dollar and the Japanese yen while forcing down the euro and the currencies of the emerging market economies. By the end of June, the exchange rate of the euro against the US dollar stood at 1.2658 dollar per euro, down by 5.1 percent from the end of the last quarter; and that of the Japanese yen against the US dollar stood at 79.77 yen per dollar, up by 3.8 percent from the end of the last quarter. The currencies of the BRIC countries, except for the RMB, depreciated as much as 6 to 11 percent against the US dollar.

The US dollar Libor tilted downwards. Factors such as unfulfilled market expectations for QE3 by the US Fed caused the 1-year US dollar Libor to rebound from the year low of 1.05 percent reached on April 25. On June 29, the 1-year Libor read at 1.07 percent, down 0.06 percentage points from the end of the last year. The Euribor dropped by a large margin due to the liquidity injection by the ECB and market expectation of further monetary policy easing. On June 29, the 1-year Euribor registered 1.21 percent, down 0.74 percentage points from the end of the last year.

Risk aversion demand also drove capital flows from the stock market to the security market. Major stock indices fluctuated downwards, offsetting the gains in the first quarter. At the same time, movements of major treasury bonds diverged. Yields of government securities in the heavily indebted countries edged up continuously, and the yield of 10-year Spanish treasuries broke the 7 percent warning limit several times. However, treasuries in the United States, Germany, and Japan showed characteristics of a "safe haven," with their yields declining to historic lows.

Commodity prices as well as oil prices plummeted. The sources of the falling oil prices can be traced to factors such as the weak demand for oil because of the European recession and the softening of the Chinese economy, high oil production in the OPEC countries and additional oil supplies from the non-OPEC countries, and the continuously appreciating US dollar. From May 31 to June 28, Brent oil futures declined by 10.3 percent. The price of gold receded to below USD1600 per ounce and the prices of industrial metal and agro-products also retreated.

3. The monetary policies of the major economies

The major advanced countries adhered to an accommodative monetary policy. In the first half of the year, the major advanced economies maintained extremely loose monetary policies to counter the lingering impact of the European sovereign crisis. The FOMC of the US Fed decided to keep the target range for the federal fund rate unchanged at 0 to 0.25 percent until the end of 2014, and on June 20 it announced it would expand Operation Twists by USD267 billion through 2012. The ECB continued to loosen its monetary stance and announced on June 6 that it would keep its main refinancing operations (MROs) as fixed rate tender at least until January 15, 2013 and it would conduct three-month longer-term refinancing operations (LTROs). On June 20, it broadened the scope of the eligible collaterals and reduced the rating threshold and eligibility requirements for certain asset-backed securities to stimulate bank credits. Out of concern about the deteriorating conditions in the euro area, on

July 5 the ECB cut the main refinancing operation interest rate by 25 basis points to a record low of 0.75 percent, and it also slashed the interest rates on the marginal lending facility and the deposit facility by 25 basis points to 1.5 percent and 0 percent respectively. The Bank of Japan kept its "zero interest rate" policy unchanged, decided to increase the size of its asset purchase program by 5 trillion yen to a total of 70 trillion yen, and increased the purchase of longer-term assets to 10 trillion yen. The Bank of England maintained the Bank Rate at 0.5 percent, initialized the ECTR auctions on June 14, and expanded the size of its Asset Purchase Program by ￡500 billion pounds to a total of ￡375 billion pounds.

Most emerging market economies also eased their monetary policy stances. On April 18 and May 30, the Bank of Brazil lowered its benchmark interest rate by a total of 125 basis points to 8.5 percent; on April 14, the Reserve Bank of India cut its repo rate by 50 basis points to 8.0 percent; on July 12 the Bank of Korea slashed the benchmark rate by 25 basis points to 3 percent; and on five occasions in 2012 Vietnam reduced its official rate to stimulate economic growth. In addition, Indonesia, Thailand, the Philippines, and Chile also lowered their benchmark interest rates. To fight against inflationary pressures, Poland and Malaysia raised their policy rates.

4. World economic outlook and major risks

In the following quarters, global economic activities will remain sluggish. The US recovery will will lack a solid foundation. Sovereign debt crisis in the euro area will hurt the already teetering economy. Though rebounding, the Japanese economy will face increasing uncertainties. The economic slowdown has moderated in the emerging market economies, but rapid growth is not in sight for the near future. Price levels in the advanced economies such as Europe, the United States, and Japan will remain low and stable, while those in the emerging market economies gradually were on track from a relatively high level.

The outlook for the global economy remains uncertain with the following several major risks:

First, the EU debt crisis remains the largest downside risk to the global economy, as manifest in the following characteristics: the yields of Spanish and Italian government bonds are still elevated; Spain could hardly hit the target of the fiscal deficit cut; reform progress is insufficient to lift Greece out of the current deep recession, and the risks of a Greek exit has not been completely eliminated. If the EU countries cannot deliver on the consensus reached on a timely basis and gain market confidence, the sovereign debt crisis will continue to ferment, adding to bank woes and economic contraction. The protraction of such conditions will cause more damage to the European and world economy, and may even lead to a double dip in the global economy.

Second, the major advanced economies are deleveraging at a synchronized pace.

Uncertainties in the world economic outlook led to higher risk aversion, resulting in a synchronized deleveraging of households, governments, and enterprises in the major advanced countries and adding to the downside risks. Given the ongoing fiscal consolidation and already extremely loose monetary policies in those countries, there is reduced room for policy response compared with the situation before the subprime crisis.

Third, geopolitical risks might cause oil prices to rally. Given the combined effect of the recent upheaval in Syria, signs of intensifying Iranian nuclear crisis, and the deteriorating Middle Eastern conditions, there might be supply side shocks to push up oil prices. On July 12, the United States imposed new economic sanctions on Iran, and oil production in Iran fell to a historic low.

Fourth, the emerging market economies are facing rising risks from exchange fluctuations and capital flows. With rising economic risks and against the background of volatile global financial markets, some emerging market economies may be exposed to fluctuations in capital flows and exchange rates.

Fifth, trade protectionism might come to the fore. Facing the gloomy outlook for most of the advanced economies, the high unemployment rates, and the rising populism, some countries might adopt measures to protect domestic industries, employment, and investment, adding to the risks of rising trade protectionism throughout the world.

II. Analysis of China's macroeconomic performance

In the first half of the year, China’s economy continued to grow at a pace within the intended range and headed in the directions of stabilization amidst moderation. The agricultural sector performed well, and growth of industrial production moderated; consumption and fixed-asset investments grew steadily; growth of imports and exports rebounded slightly; price hikes continued to decelerate; and the employment situation stabilized. In the first half of the year, the Gross Domestic Product (GDP) registered 22.7 trillion yuan, up 7.8 percent year on year. In particular, GDP growth in the second quarter was up 7.6 percent year on year, representing a deceleration of 0.5 percentage points from the previous quarter and up 1.8 percent quarter on quarter.

1. Consumption and investments grew steadily, and growth of imports and exports rebounded slightly

Supported by the rapid income gains of urban and rural residents, domestic consumer demand increased steadily. In the first half of 2012, per capita disposable income of urban households posted 12,509 yuan, representing year-on-year growth of 13.3 percent and price-adjusted real growth of 9.7 percent. The per capita cash income of rural households registered 4,303 yuan, up 16.1 percent in nominal terms or 12.4 percent in real terms. The PBC survey of urban depositors in the second quarter shows that the residents’ income index which posted 50.1 percent, though 1.8 percentage points lower than that in the previous quarter, remained above the 50 percent threshold and in the expansionary zone. In the first half of the year, retail sales of consumer goods totaled 9,822.2 billion yuan, a year-on-year increase of 14.4 percent in nominal terms. Growth in real terms stood at 11.2 percent, an acceleration of 0.3 percentage points from the first quarter, and a deceleration of 0.4 percentage points from the same period of the last year. Broken down by urban and rural areas, retail sales in rural areas outpaced retail sales in urban areas. In the first half of the year, retail sales in urban areas registered 8,512.3 billion yuan, up 14.3 percent year on year, whereas retail sales in rural areas grew 14.5 percent year on year to 1,309.9 billion yuan.

Fixed-asset investments grew steadily. In the first half of the year, fixed-asset investments (excluding investments by rural households) totaled 15.1 trillion yuan, up 20.4 percent year on year. The price-adjusted real growth posted 18.0 percent, representing a deceleration of 0.2 and 1.0 percentage points from the first quarter and the same period of the last year respectively. Among this total, investments by state-owned and state shareholding enterprises grew 13.8 percent year on year to 4.9 trillion yuan. Broken down by region, growth of fixed-asset investments in the central and western regions notably outpaced that in the eastern region, with growth in the eastern, central, and western regions registering 19.3 percent, 25.3 percent, and 23.9 percent respectively. Broken down by industry, fixed-asset investments in the primary, secondary, and tertiary industries grew 28.6 percent, 23.7 percent, and 17.4 percent respectively. In the first half of the year, total investments in newly started projects reached 13.8 trillion yuan, up 23.2 percent year on year and representing an acceleration of 8.3 percentage points from the same period of the last year. About 175,000 projects were newly started, 7,518 more than that during the same period of the last year. In the first half of the year, total investments in projects under construction posted 54.3 trillion yuan, up 15.3 percent year on year, whereas the number of projects under construction increased by 10,958 from the same period of the last year to reach about 313,000.

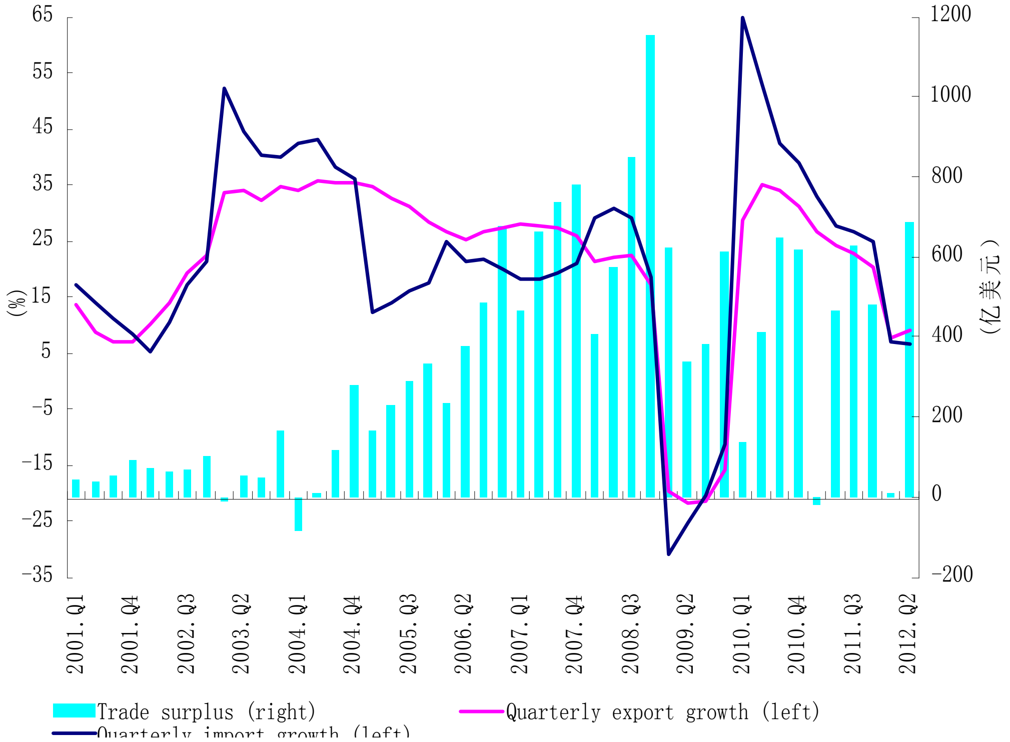


Figure 3 Import and export growth and the trade balance

Sources: General Administration of Customs; the People's Bank of China

Growth of imports and exports rebounded slightly. In the first half of the year, imports and exports grew 8.0 percent year on year, an acceleration of 0.8 percentage points from the first quarter. Exports increased by 9.2 percent year on year to USD954.4 billion, representing an acceleration of 1.6 percentage points from the first quarter; imports were up 6.7 percent year on year to USD885.5 billion, a deceleration of 0.2 percentage points from the first quarter; as a result, the trade surplus posted USD68.92 billion; in particular the trade surplus in the second quarter stood at USD68.18 billion. The export product mix was improved, as exports of mechanical and electrical products grew rapidly, the share of labor-intensive products dropped, and exports of highly energy-consuming and heavily polluting products declined. In the first half of the year, exports of mechanical and electrical products increased by 10.5 percent year on year to USD550.2 billion, 1.3 percentage points faster than the growth of all exports during the same period of time and accounting for 57.7 percent of the total export volume. Exports of 7 major categories of labor-intensive products such as textiles and apparel posted year-on-year growth of 7.7 percent to USD186.5 billion, accounting for 19.5 percent of total export volume; this share was 0.3 percentage points less than that during the same period of the last year. Exports of heavily energy-consuming and highly polluting products posted a year-on-year decrease of 3.8 percent, reaching USD43.8 billion. The trade diversification process continued, and the trading volume with the emerging market economies grew steadily. The import product mix was also improved, with imports of energy and resource products and consumer goods registering rapid growth.

2. Agricultural production grew steadily and industrial production slowed down

Growth of the primary and tertiary industries edged up. In the first half of the year, the value-added of the primary, secondary, and tertiary industries reached 1.75 trillion yuan, 11.10 trillion yuan, and 9.87 trillion yuan respectively, up 4.3 percent, 8.3 percent, and 7.7 percent year on year, representing acceleration of 0.5, -0.8, and 0.2 percentage points respectively from the first quarter. The shares of the three industries in GDP were 7.7 percent, 48.9 percent, and 43.4 percent respectively.

Agricultural production maintained a stable development momentum, and there was a bumper summer harvest. The summer grain output reached 129.95 million tons, up 3.56 million tons or 2.8 percent from the same period of the last year, marking the ninth consecutive year of an increase in output. In the first half of the year, the total output of meat (including pork, beef, mutton, and poultry) posted 39.25 million tons, up 5.5 percent year on year.

Growth of industrial production slowed down, and corporate profits slid. In the first half of the year, the value-added of statistically large enterprises grew by 10.5 percent year on year, representing a deceleration of 1.1 and 3.8 percentage points from the previous quarter and the same period of the last year. In particular, in June the seasonally adjusted industrial value-added was up 0.76 percent month on month, representing a deceleration of 0.13 percentage points from May. In the first half of the year, profits of statistically large enterprises were down by 2.2 percent year on year to 2.31 trillion yuan, and returns on total assets of those enterprises from their main businesses posted 5.43 percent, down 0.77 percentage points from the same period of the last year. In the first half of the year, 97.5 percent of all industrial products were sold, 0.6 percentage points less than that during the same period of the last year. The survey of 5,000 industrial enterprises conducted by the PBC in the second quarter reveals that the business index dropped by 0.7 percentage points from the previous quarter, reaching 63.7 percent. Market demand continued to slide, with the enterprise market demand index posting 53.6 percent in the second quarter, down by 1.3 and 9.3 percentage points from the first quarter and the same period of the last year respectively and continuing the declining trend since the first quarter of 2011. In particular, the domestic order index registered 50.2 percent, down by 0.3 percentage points from the previous quarter. Affected by the slowing growth of sales, the inventory index of finished products posted 54.8 percent, up by 0.4 and 3.5 percentage points from the previous quarter and the same period of the last year respectively. The corporate profitability index posted 52.6 percent, up by 1.4 percentage points, but this was 6.1 percentage points less than that during the same period of the last year.

3. The growth of consumer prices continued to moderate, and there was a further decline in the prices of upstream products

The consumer price hike continued to pull back. In the second quarter, the CPI gained 2.9 percent year on year, decelerating by 0.9 and 2.8 percentage points from the previous quarter and the same period of the last year respectively. The monthly CPI grew 3.4 percent, 3.0 percent, and 2.2 percent respectively in the three months of the second quarter. Within the CPI basket, prices of food items grew 5.7 percent year on year in the second quarter, representing a deceleration of 2.4 percentage points from the previous quarter and driving the CPI up by 1.8 percentage points; prices of non-food items gained 1.5 percent, representing a deceleration of 0.3 percentage points from the previous quarter and shoring up the CPI by 1.1 percentage points. Broken down by goods and services, the prices of consumer goods gained 3.3 percent year on year, a deceleration of 1.3 percentage points from the previous quarter, obviously faster than that in previous quarters; prices of services were up 1.8 percent year on year, representing an acceleration of 0.1 percentage points from the previous quarter and slightly faster than earlier. The year-on-year deceleration of the consumer price increase was due to the combined effects of the base period factor and the weakening new price-rising factor induced by the month-on-month CPI decline. The base period factor fell by 0.6 percentage points from 2.2 percent in the first quarter to 1.6 percent in the second quarter; due to the significant quarter-on-quarter decrease in food prices, the CPI in the second quarter was lower than the average between 2001 and 2010; therefore, the new price-rising factor in the second quarter was 0.3 percentage points lower than that in the first quarter.

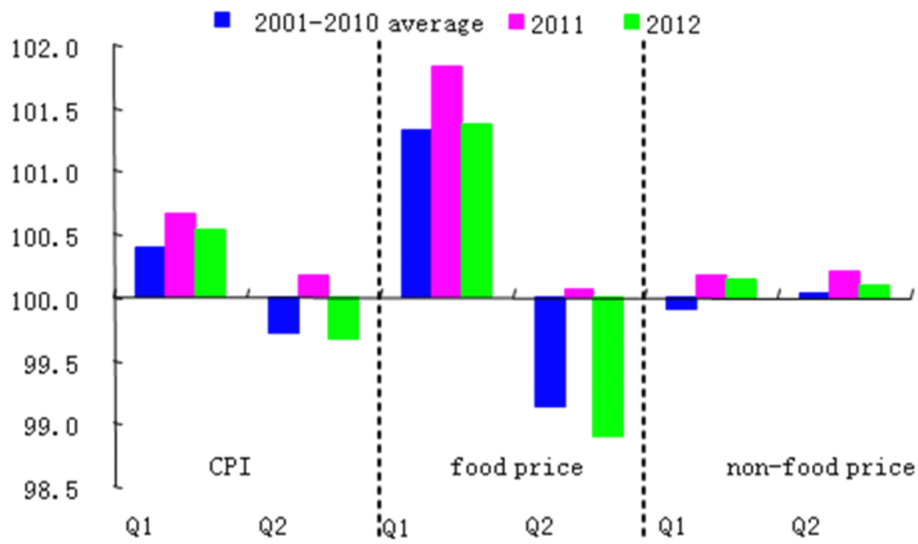


Figure 4 Average month-on-month CPI in Q2 lower than the historical average

Sources: National Bureau of Statistics; calculations by the staff of the People's Bank of China

Producer prices declined further. Affected by weakening demand as a result of the domestic economic slowdown and the decline in commodity prices on the international market, growth of ex-factory producer prices of industrial products and industrial producer purchasing prices in year-on-year terms moved into the negative zone in March and April. In the second quarter, ex-factory producer prices of industrial products declined 1.4 percent year on year, posting 0.7 percent, 1.4 percent, and 2.1 percent in the three months respectively. Prices of capital goods dropped by 2.1 percent year on year, representing an acceleration of 1.8 percentage points from the previous quarter, whereas prices of consumer goods gained 0.9 percent year on year, a deceleration of 0.8 percentage points from the previous quarter. The industrial producer purchasing price index posted 0.8 percent, 1.6 percent, and 2.5 percent in the three months respectively, averaging 1.6 percent. In the second quarter, the producer prices of agricultural products (the prices at which farmers sell their products) climbed by 3.0 percent year on year, 3.7 percentage points lower than the price index of agricultural capital goods during the same period.

Commodity prices on the international market dipped. The average price of crude oil futures on the New York Mercantile Exchange fell by 2.7 percent, 8.4 percent, and 13.0 percent in the three months of the second quarter respectively; as a result the average price in the first six months was 22.4 percent less than that in the first three months. On the London Metals Exchange, the average prices of spot copper dropped by 2.4 percent, 4.1 percent, and 6.3 percent in the three months of the second quarter, resulting in a dip by 12.3 percent from the average in March to the average in June; while the average prices of spot aluminum declined by 6.3 percent, 2.3 percent, and 5.8 percent in the three months respectively, making the June average 13.7 percent less than the March average. From the beginning of the second quarter, in light of the oil price movements on the international market, economic development both at home and abroad, and supply and demand on the domestic oil product market, and in accordance with the current oil product pricing mechanism, the National Development and Reform Commission lowered the prices of oil products on three occasions, on May 10, June 9, and July 11, cutting the prices of petrol and diesel by a total of 1,280 yuan and 1,220 yuan respectively.

Import prices fell in year-on-year terms, whereas export prices continued to rise. As the effects of the decline in the price of commodities such as crude oil unfolded, in April import prices started to decrease in year-on-year terms. In the three months of the second quarter, import prices were down by 0.2 percent, 1.1 percent, and 0.7 percent year on year respectively, averaging 0.7 percent; export prices grew by 4.8 percent, 2.9 percent, and 2.9 percent in the three months respectively year on year, averaging 3.5 percent.

The GDP deflator continued to fall. The GDP registered 22.7 trillion yuan in the first half of the year, up 7.8 percent year on year in real terms. The change in the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 2.4 percent, down 5.0 and 0.5 percentage points from the same period of the last year and the previous quarter respectively.

4. Growth of fiscal revenue slowed down

In the first half of the year, fiscal revenue (excluding debt income) surged by 12.2

percent year on year to 6.38 trillion yuan, representing a deceleration of 19.0 percentage points from the same period of the previous year, whereas fiscal expenditures registered 5.39 trillion yuan, up 21.3 percent year on year, representing a deceleration of 10.1 percentage points from the same period of the last year. As a result, revenue was 990.2 billion yuan more than expenditures.

As for the structure of fiscal revenue, tax revenue posted 5.49 trillion yuan for the first half of the year, up 9.8 percent year on year and representing a deceleration of 19.8 percentage points from the same period of the previous year. In particular, the domestic VAT, the VAT and excise tax on imported products, the corporate income tax, the business tax, the consumption tax, and the personal income tax were up 8.1 percent, 7.4 percent, 17.3 percent, 9.6 percent, 11.7 percent, and -8.0 percent respectively year on year. Revenue from these six tax items accounted for 77.7 percent of total national fiscal revenue.

As for the structure of fiscal expenditures, in the first half of the year the five fastest growing spending items were transportation, government-subsidized housing, diplomatic affairs, education, and national resources and meteorology, up by 44.1 percent, 36.4 percent, 36.7 percent, 28.9 percent, and 27.8 percent respectively year on year. In the expenditure basket, the five largest items were education, social security and employment, agriculture, forestry and water-related issues, urban and rural communities, and transportation, accounting for 14.7 percent, 12.2 percent, 8.6 percent, 7.8 percent, and 6.9 percent respectively of fiscal expenditures, and registering relatively rapid growth.

5. The employment situation was generally stable

Data from the Ministry of Human Resources and Social Security show that in the first half of the year 6.94 million people joined the work force, an increase of 390,000 year on year, whereas 2.94 million laid-off workers were re-employed and 950,000 people with employment difficulties found jobs. As of end-June, the registered unemployment rate in the urban areas posted 4.1 percent, at a par with that in the previous quarter. Statistical analysis in the second quarter conducted by the China Human Resources Market Information Monitoring Center on public employment service agencies in 102 cities shows that supply and demand in the labor market were generally balanced, and more people joined the labor market in the second quarter than during the same period of the last year. Compared to the previous quarter, demand dwindled somewhat, whereas job seekers increased. Broken down by region, the number of people in the labor market in the eastern region declined year on year, whereas the number of people in the labor market in the central and the western regions grew year on year. Broken down by industry, fewer jobs were offered by the manufacturing, hotel and catering industries, whereas jobs offered by the household services and other services industries increased. About 90 percent of the jobs had age and educational background requirements, and compared to the same period of the last year and the first quarter, there was a fairly big dent in requirement-free demand.

6. The balance of payments improved further

In the first quarter of 2012, China continued to run a twin surplus in the current account and the capital and financial account, and international reserves grew further. The current account surplus declined by 18.4 percent year on year to USD23.5 billion; the capital and financial account surplus was down by 34.8 percent year on year to USD56.1 billion; and international reserves increased by USD74.6 billion due to trading activities. In the first half of the year, in the context of the world economic slowdown, the deepening European debt crisis, and the change in the one-way bet on RMB exchange-rate movements, cross-border capital flows became more balanced despite fluctuations, and the surplus in the balance of payments (BOP) decreased. In the latter half of the year, cross-border capital flows are expected to remain basically balanced. Be it net inflows or outflows, the volume will be small. If there are no major events, it is fairly unlikely that capital flows will be reversed.

The stock of external debt increased. As of end-March, the stock of China's external debt stood at USD751.26 billion, up 28.2 percent year on year. Among this total, the stock of registered external debt posted USD480.16 billion, up 30.9 percent year on year and accounting for 63.9 percent of the total; short-term external debt posted USD557.7 billion, a year-on-year increase of 35.5 percent and accounting for 74.2 percent of the total.

7. Sectoral analysis

Industrial profits continued to decline year on year. In the first half of the year, 27 out of 41 industrial sectors reported a year-on-year growth in profits. Among industries, the profits of the electricity and heat generation and distribution industry, the agricultural products processing industry, and the automobile manufacturing industry grew by 23.8 percent, 16.5 percent, and 10.0 percent respectively year on year; the profits of the ferrous metals smelting and rolling industry, the chemical raw materials and chemical products manufacturing industry, and the computer, telecommunications, and other electronic equipment manufacturing industries fell by 56.5 percent, 22.5 percent, and 2.8 percent respectively year on year. The oil refinement industry and the coking and nuclear fuel-processing industry turned from profits in the same period of the last year to losses in the period this year. Growth of coal, electricity, petroleum, and transportation generally slowed down. In the first half of the year, coal production grew 7.7 percent year on year to 1.95 billion tons, power generation increased 3.7 percent year on year to 2,295 billion kilowatt hours, crude oil output was down by 1.6 percent year on year to 100 million tons, and the volume of cargo transportation rose 12.2 percent year on year to 315 million tons.

(1) The real estate sector

In the first half of 2012, the real estate market performed in a stable manner. The volume of trading initially fell but then went up. More cities experienced year-on-year declines in housing prices, but in some of the cities this was at a lower pace. Investment in real estate development moderated. The area of new starts dwindled. The growth of real estate loans stopped declining and headed toward the direction of stabilization.

Though more cities witnessed a year-on-year decline in housing prices, the number of cities witnessing a quarter-on-quarter increase in prices also grew. In June, the price of newly built commercial residential housing dropped year on year in 57 out of 70 large- and medium-sized cities, 19 more than in March; and among the cities reporting a year-on-year price hike no cities reported growth higher than 1.2 percent; the prices of pre-occupied residential housing fell year on year in 58 cities, 9 more than in March. The price of newly built commercial residential housing grew in month-on-month terms in 25 cities, 17 more than in March; the price of pre-occupied residential housing increased in month-on-month terms in 31 cities, 15 more than in March.

The decline in sales of commercial real estate slowed down. In the first half of the year, the sold floor area of commercial real estate posted 400 million square meters, down 10.0 percent year on year, a deceleration of 3.6 percentage points from the first quarter. Sales of commercial real estate were down 5.2 percent year on year to 2.3 trillion yuan, a deceleration of 9.4 percentage points from the first quarter. In particular, the decline in the sold floor area of commercial residential housing continued to decelerate since March and posted 11.2 percent in the first half of the year.

Real estate development investment continued to roll back. In the first half of the year, completed investment in real estate development totaled 3.1 trillion yuan, up 16.6 percent year on year, representing a deceleration of 6.9 percentage points from the previous quarter. In particular, investment in commercial residential housing was up by 12.0 percent year on year to 2.1 trillion yuan, a deceleration of 7 percentage points from the first quarter and accounting for 68.2 percent of total real estate development investment. In the first half of the year, the floor area of newly built housing dropped by 7.1 percent year on year to 920 million square meters, with the second quarter witnessing year-on-year declines in all three months, in contrast to growth of 0.3 percent year on year in the first quarter. The floor area of housing under construction grew 17.2 percent year on year to 4.76 billion square meters, a deceleration of 7.8 percentage points from the previous quarter. The floor area of completed housing stood at 330 million square meters, up 20.7 percent year on year and representing a deceleration of 18.6 percentage points from the previous quarter.

The growth of real estate loans stopped declining and stabilized. As of end-June, outstanding real estate loans of the major financial institutions (including foreign-funded financial institutions) posted 11.32 trillion yuan, an increase of 10.3 percent year on year and an acceleration of 0.2 and -3.6 percentage points from end-March and end-2011 respectively, and accounting for 19.5 percent of all outstanding loans. Among this total, outstanding mortgage loans registered 6.9 trillion yuan, up 10.2 percent year on year, a deceleration of 1 percentage point from end-March; in particular, growth in June turned positive for the first time after being negative for 25 consecutive months. Outstanding real estate development loans were up 11.3 percent year on year to 2.92 trillion yuan, representing an acceleration of 0.3 percentage points from end-March. Outstanding land development loans grew by 0.8 percent year on year to 803.7 billion yuan, whereas growth at end-March was -8.0 percent year on year. In the first half of the year, new real estate loans reached 565.3 billion yuan, a decrease of 227.1 billion yuan year on year. New loans to the real estate sector accounted for 12.3 percent of total new loans, up 2 percentage points from the previous quarter but down 5.2 percentage points from the annual figure in 2011.

Statistics of the Ministry of Housing and Urban-Rural Development show that as of end-June 2012, 4.7 million units of government-subsidized housing broke ground, accounting for 63 percent of the planned volume. About 2.6 million units were completed, and completed investment totaled 507 billion yuan. As the construction of government-subsidized housing was undertaken more rapidly on all fronts, credit support continued to flow in. As of end-June, outstanding loans for government-subsidized housing reached 478.4 billion yuan, accounting for 21.7 percent of the total real estate development loans. In the first half of the year, new loans for government-subsidized housing increased by 86.9 billion yuan, accounting for 65.8 percent of the new loans to real estate development. Moreover, the pilot program to use housing provident fund loans to support the construction of government-subsidized housing was advanced steadily. As of end-June, the 29 pilot cities approved 41.5 billion yuan of loans, accounting for 83 percent of the credit quota of 50.2 billion yuan. About 30.2 billion yuan in loans was disbursed to 97 projects based on their construction progress.

(2) The iron and steel industry

The iron and steel industry is a basic industry in the national economy. In the past several years, this industry has been developing rather rapidly and it has made strides in energy conservation and pollution reduction, thus effectively supporting the stable and relatively rapid development of the economy. However, increasing constraining factors such as resource and environmental constraints have sent profits on a downward trend, and structural problems remain acute.

Imbalanced supply and demand has resulted in growing stockpiles. Demand for iron and steel has moved into a stage of stable growth. After reaching a peak of 24.6 percent, growth of apparent consumption of crude steel remained below 9 percent for two successive years. Since the beginning of 2012, due to such factors as the slowdown in the major steel-consuming industries such as real estate, railways, automobiles, ship making, machinery, household appliances, and light industry, growth in the demand for steel has been tepid. Apparent consumption of crude steel posted 336 million tons in the first half of the year, at a par with that in the same period of the last year. Meanwhile, there are clear signs of overcapacity in the industry. There are 500 enterprises capable of steel smelting, 700 enterprises capable of iron smelting, and 3,000 to 4,000 enterprises capable of steel rolling, and their combined capacity of crude steel production reaches 900 million tons. In the first half of 2012, the total output of crude steel registered 357 million tons. Imbalanced supply and demand has rapidly pushed up stockpiles. According to statistics of the China Iron and Steel Association, the steel inventory of iron and steel enterprises reporting data to the association grew 34.4 percent year on year, reaching 12.878 million tons in June, an increase of 2.939 million tons or 29.6 percent from the beginning of the year.

Declining prices of steel products and consistently high prices of raw materials have led to more loss-making enterprises. Affected by the low business activity in the industry, prices of steel products have been on the decline. In June, the average composite index of steel product prices was down 2.89 points from May to 115.87, a decrease of 19.33 points year on year. The significant decrease in steel product prices has pushed down the prices of raw materials, mainly iron ore; however, the drop in prices of raw materials was much less than the drop in prices of steel products, and as a result the profits of the iron and steel industry plummeted. In the first half of 2012, profits of large- and medium-sized enterprises registered merely 2.385 billion yuan, down 95.81 percent year on year, and 33.75 percent of the enterprises suffered losses.

The 12th Five-Year Plan period is critical for the iron and steel industry to transform its development pattern. According to the requirements outlined in the 12th Five-Year

Development Plan of the Iron and Steel Industry, the industry will focus on structural adjustments and transformation, rely on independent innovation and technological upgrading, improve quality, increase the types of high-performance steel products, and accelerate the transformation from quantity to quality. Efforts will also be made to optimize the geographical layout, guide mergers and acquisitions, strictly control capacity expansion, further increase the concentration of the industry, advance energy savings and pollution reductions, and ensure access to resources so as to effectively satisfy the demands of eco-social development.

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

I. Outlook for the Chinese economy

At present, China is still in a period of strategic opportunities for development and the fundamentals remain basically unchanged to support stable and fairly rapid growth. The driving forces and potential for growth are quite strong. With the fine-tuning measures and pre-emptive adjustment policy measures, the Chinese economy is expected to continue its steady growth. China is still in the process of urbanization, informatization, industrialization, and agricultural modernization. In 2011, the rate of urbanization exceeded 50 percent but there is still room for further development compared with that of the advanced economies. In particular, with growth in the hinterland and western part of China accelerating, the localities are keen to pursue leapfrog development. Given the relatively low level per capita distribution of infrastructure, the room for investment in industrial upgrading and infrastructure development is fairly abundant and some emerging industries have developed rapidly. In the first half of 2012, macro-economic management strengthened fine-tuning and pre-emptive adjustments. Several important pricing signals were adjusted, including the decline in money market interest rates, loan interest rates, and discount rates. The prices of raw materials and intermediate products declined. Furthermore, other factors, including the strength of fiscal conditions, the willingness of banks to lend, and the rebound of all-system aggregate financing will help stabilize demand growth.

Nevertheless, there are difficulties and challenges. Since the global economy is de-leveraging and rebalancing, structural adjustments inevitably will have some impact on growth, and the global environment is likely to be weak and fluctuating. In China, the tasks of making structural adjustments and expanding domestic demand remain arduous and internal drivers are yet to be strengthened, thus in the face of a more complicated situation macro-economic policies need to strike a balance among growth rate, structure, and prices. At the same time, potential risks in the real sector and in the financial system are not to be neglected as some enterprises face declining profitability and the real estate market is adjusting. Given the size of the Chinese economy, the declining growth of the labor force year after year, the stronger resource and environmental constraints, and the on-going transformation of the growth model, the potential economic growth rate is likely to slow down for a period. While efforts are being made to preserve stable growth, it is imperative to pay more attention to the quality and sustainability of growth and to improvements in the people's well-being and livelihood.

The overall price situation is fairly stable and the future outlook of the economy depends on the domestic and global environments and aggregate demand. Given the stable and moderating growth, the good summer grain harvests for nine consecutive years, the abundant industrial output and supply, and the changes in the supply and demand relationship provide a favorable environment for a moderation of inflation. It is necessary to note that the year-on-year CPI is affected by the price level of the base period. Given the large price hike in the first seven months of 2011, the year-on-year CPI appeared to be declining rapidly in the first several months of 2012. But in month-on-month terms, the CPI of June over that in May did not move any faster beyond the historical average. Therefore, it is possible to use the seasonally adjusted month-on-month indicator to measure the change in the price level more accurately and objectively. Similarly, due to the reduction in the base level, the year-on-year CPI might rebound after August, though by a relatively modest range judging from the current situation. It is worth noting that due to the potential upward pressures on labor costs and the prices of resource products and some non-tradable goods, price movements remain sensitive to the expansion of demand. The inflationary effect of the policy stimulus is on the rise while its impact on growth is weakening. Empirical evidence shows that the elasticity of the CPI to the output gap has been higher after the global financial crisis. Therefore, it is necessary to pay attention to the potential impact of changes in demand on prices. According to the PBC's urban depositors survey in Q2 2012, the household price expectation index was 65.5 percent, 3.4 percentage points higher than that in Q1; 20.4 percent of the respondents expected higher housing prices next quarter, a relatively low proportion since the beginning of 2009, but still an increase of 2.8 percentage points from the previous quarter.

II. Monetary policy in the next stage

Going forward, the PBC will follow the overall arrangements of the State Council, take sustainable development as the central theme and acceleration in the shift of the growth pattern as the core of its policy conduct, follow the principle of making progress while maintaining stability, and properly handle the relationship among preserving relatively rapid and stable growth, economic restructuring, and managing inflation expectations and attaching even greater importance to preserving steady growth. We will continue to implement a sound monetary policy, closely monitor economic and financial developments at home and abroad, pay attention to changes in aggregate demand, make macroeconomic management measures even more targeted, flexible, and forward-looking, and initiate fine-tuning and pre-emptive adjustments as appropriate. Efforts will be made to make the monetary policy more effective, to resolve the tensions between supply and demand of credit money, and to enhance financial services to the real sector. Measures will be adopted to effectively manage systemic financial risks, maintain the stability of the financial system, keep the overall price level basically stable and economic growth at a steady and fairly rapid pace, and create a stable and appropriate monetary and financial environment for economic restructuring.

First, by using a mix of monetary policy instruments and improving the macro-prudential policy framework, the PBC will guide the stable and proper growth of money and credit aggregates and keep all-system financing aggregates at a proper level. Efforts will be made to further optimize liquidity management. In view of foreign exchange inflows, changes in demand for and supply of market funds, short-term special factors, and other factors, a combination of liquidity management instruments will be used, such as reverse repos, repos, central bank bills, the deposit reserve requirement ratio, and so forth, to flexibly adjust liquidity in the banking system and to guide the stable movement of market interest rates. A counter-cyclical macro-prudential policy will be implemented, and its parameters will be adjusted based on changes in the economic climate, the soundness of financial institutions, and implementation of credit policy so as to guide financial institutions to support real sector development in a more targeted and pre-emptive manner.

Second, credit resource allocations will be optimized to support economic restructuring and to better serve the real sector. Measures will be taken to improve the structure of the stock of credit assets. Coordination of credit and industrial policies will be enhanced and guidance of the macro credit policy improved. Financial institutions will be guided to intensify credit support to facilitate economic restructuring, in particular by increasing credit to agriculture, rural areas, and farmers as well as to micro and small enterprises. Financial support will be provided to major projects that are vital to the national economy and that can boost economic activities in the surrounding areas, and to emerging strategic industries, energy conservation and environmental protection, culture and media, modern services industries, high-end manufacturing sectors, independent innovation, and rural irrigation and water conservancy projects, and to meet the financing needs of railways and other ongoing and follow-up key national projects. Financial institutions will be encouraged to contribute their part to improving the people's livelihood and to support stability and job creation, focusing on job creation for and self-employment by women, university graduates, and migrant workers who have returned to their home villages and on supporting underdeveloped areas and those inhabited by ethnic minorities. Furthermore, the financial sector will be encouraged to support job creation, poverty reduction, students in need, and emergency responses and disaster relief. Financial institutions will be guided to strictly control lending to energy-intensive and highly polluting industries and to those with excess capacity and to implement the differentiated housing mortgage policies, to support the construction of welfare housing and common commercial housing projects with apartments with modest floor plans and first purchases of apartments by borrower for his/her own use, and to contain speculative purchases and purchases for investment purposes.

Third, the market-based interest rate reform and the RMB exchange-rate regime reform will be advanced while efforts will also be made to improve the efficiency of resource allocations of the financial system and to improve the macroeconomic management mechanism. Measures will be taken to cultivate a system of market base rates and to improve the central bank's capacity to guide market interest rates Financial institutions will be encouraged to use their autonomy in offering interest rates within a set range of the benchmark rates to properly price products, strengthen non-deposit liability management and cost constraints, assess interest rate risks, improve pricing capacity, maintain pricing order, and promote balanced development of the real and financial sectors. The RMB exchange-rate regime will be improved to enhance RMB exchange-rate flexibility in both directions and to keep the exchange rate basically stable at an adaptive and equilibrium level. The PBC will further improve foreign-exchange operations, reduce the frequency of interventions, and increase the flexibility of policy conduct for market demand and supply to play a greater role. Development of the foreign exchange market will be advanced and innovation in exchange-rate risk management instruments will be promoted. The use of RMB in cross-border trade and investments will be encouraged, and channels for inflows and outflows of RMB funds will be broadened. Direct trading of RMB against the emerging market currencies will be promoted in the inter-bank market. The impact of changes in the international situation on capital movements will be closely monitored and effective monitoring of cross-border capital flows will be enhanced.

Fourth, sound development of the financial market will be promoted, and the reform of financial institutions will be deepened. Efforts will be made to further develop the bond market, to step up support for direct financing, and to broaden financing channels for small and micro enterprises. Measures will be adopted to promote financial market innovation and to enhance risk awareness. Emphasis will be placed on the role of the market mechanism, on consolidating and strengthening the market infrastructure, and on stronger supervision and regulation to promote the healthy and sound development of financial markets. Reform of large commercial banks will be deepened to improve corporate governance and the risk management mechanism and to increase innovation and development capacity and international competitiveness. The pilot program of the County Area Banking Division of the Agricultural Bank of China will be advanced to improve the Bank's financial services to the agricultural sector. Development of policy financing will be considered comprehensively; the market reform of the China Development Bank will be deepened while the reform of the Export-Import Bank of China and the Agricultural Development Bank of China will be advanced based on the principle of one set of specific policies for each bank and on providing specific guidance. The pilot reform of cross-sectoral operations will be advanced on a prudent and progressive basis, and the measures designed for the Pilot Comprehensive Financial Reform Area in Wenzhou will be advanced to promote the sound development of private financing on the basis of legislation and regulation. Private capital will be encouraged to play a part in the reform of local financial institutions and to speed up the development of new types of financial institutions.

Fifth, 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 soundly. Financial institutions will be urged to strengthen internal control and risk management, better monitor and manage risks in lending to local government financing platforms, off-balance sheet operations, and real estate financing. Measures will be adopted to prevent cross-sectoral and cross-market risks and to prevent the spread to the financial system of risks associated with the real economy in some regions, industries, and enterprises and those arising from financing activities outside of the formal financial system. It is necessary to prevent the contagion of financial risks and moral hazards and to safeguard the bottom line of allowing no systemic risks to occur locally.