China Monetary Policy Report, Quarter One

(May 10, 2012)

Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

Overall, in Q1 2012 the performance of the Chinese economy was sound. The outlook for the agricultural harvest was good; output of the industrial sector was stable; and household income increased fairly rapidly while prices remained relatively stable. By March, the major indicators, including industrial output and total retail sales, were increasing month by month. In Q1, GDP increased 8.1 percent year on year and 1.8 percent quarter on quarter, reaching 10.8 trillion yuan; the consumer price index was up 3.8 percent year on year; and the trade surplus posted USD670 million yuan.

Since the beginning of 2012, the PBC has followed the overall arrangements of the Central Economic Work Conference and the State Council, continuing to strike a balance among promoting economic growth, facilitating economic restructuring, and maintaining price stability, and has implemented a prudent monetary policy and carried out fine-tunings and preemptive adjustments in view of the changes in economic conditions. A mix of monetary policy instruments was used to guide the reasonable growth of money and credit and to keep all-system financing at a proper volume. Responding to the supply and demand of liquidity, especially the changes in cash demand in the run-up to and during the Spring Festival, open market operations were conducted in a flexible manner and the deposit reserve requirement ratio was again cut by 0.5 percentage points. The macro-prudential policy framework was further improved and the relevant parameters were readjusted to dynamically adjust the differentiated deposit reserve requirement mechanism to enhance the counter-cyclical effects. The quota for agro-supporting central bank lending was increased by 60 billion yuan for the western regions and the major crop regions to promote coordination between credit and industrial policies, guide financial institutions to optimize the credit structure, and boost credit support to small and micro enterprises, the agricultural sector, farmers, the rural areas, and on-going national key projects and their follow-up projects. The reform of financial institutions continued to make progress, and the reform of the RMB exchange-rate regime was furthered 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 reasonable and stable growth of money and credit aggregates provided strong support for economic development. By end-March 2012, the outstanding balance of broad money M2 had increased 13.4 percent year on year to 89.6 trillion yuan; the outstanding balance of RMB loans was up 15.7 percent year on year and registered an increase of 2.46 trillion yuan from the beginning of 2012, 217 billion yuan more than the growth in Q1 2011. In Q1 2012, all-system financing aggregate posted 3.88 trillion yuan. The lending interest rates of financial institutions declined. In March, the weighted average lending rate offered to non-financial enterprises and other sectors posted 7.61 percent, a reduction of 0.40 percentage points from the beginning of 2011. At end-March, the central parity of the RMB against the US dollar was 6.2943 yuan for one US dollar, up 0.1 percent over end-2011.

At the current stage, many favorable factors and conditions are available to support steady and fairly rapid economic growth in China. The fundamentals remain unchanged to accommodate steady and fairly rapid growth in the long term. Since the beginning of 2012, a series of fine-tunings and preemptive measures have been adopted to preserve the basic stance for stable growth. Nevertheless, we should acknowledge that both the global and the domestic economic situations are complicated and grim. With the sovereign debt problems yet to be resolved, a global recovery is still uncertain. As the unbalanced and unsustainable problems in the Chinese economy remain acute, adjustment of demand structure may have an impact on growth in the short run and there are still uncertainties in terms of price development.

During the next period, the PBC will continue to implement the overall arrangements of the Central Economic Work Conference, the National Financial Work Conference, and the Report on the Work of the Government, continue to follow the theme of sustainable development, transforming growth model, and the principle of seeking progress while maintaining stability, continue the prudent monetary policy, closely monitor developments in the performance of the economic and financial sectors , make the macroeconomic management measures more targeted, flexible, and forward-looking, and, when necessary, adopt fine-tunings and pre-emptive adjustment measures. A mix of monetary policy instruments will be employed, and the macro-prudential policy will continue to play a counter-cyclical adjustment role to guide the stable and reasonable growth of money and credit in line with the objective of reasonable aggregates through prudent and flexible adjustments, to keep the all-system financing aggregate at a reasonable volume, to optimize the allocation of credit resources, and to support stable and fairly rapid economic growth. The market-based interest rate reform and the reform of the RMB exchange-rate regime will be advanced and the flexibility of the RMB exchange rate will be enhanced in both directions. Measures will be taken to facilitate the sound development of financial markets and to deepen the reform of financial institutions. Effective measures will be adopted 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 quarter of 2012 China's economy operated in a stable manner. Money and credit grew at a reasonable pace and liquidity in the banking sector was abundant.

I. Growth of money supply was stable and moderate

At end-March 2012, outstanding M2 registered 89.6 trillion yuan, up 13.4 percent year on year and a slight deceleration of 0.2 percentage points compared end-2011. Outstanding M1 stood at 27.8 trillion yuan, an increase of 4.4 percent year on year and a deceleration of 3.5 percentage points compared with end-2011. Currency in circulation M0 totaled 5.0 trillion yuan, up 10.6 percent year on year and a deceleration of 3.2 percentage points compared with end-2011. From January through March 2012, the net amount of cash withdrawn from circulation posted 115.4 billion yuan, 141.1 billion yuan more year on year.

In the first quarter, the pace money-supply growth picked up month by month. At end-March 2012, M2 growth was 1.0 percentage points and 0.4 percentage points faster than at end-January and end-February, whereas M1 growth was 1.3 percentage points and 0.1 percentage points more than at end-January and end-February. The subdued M1 growth was a result of slower economic growth and moderate business activities. Meanwhile, the diversion of corporate demand deposits to wealth management products and other special factors contributed to an underestimation of M1 growth. In general, monetary conditions were appropriate, thereby facilitating the balance between maintaining stable and relatively rapid economic growth, maintaining price stability, and preventing financial risks.

At end-March 2012, outstanding base money registered 22.7 trillion yuan, up 17.7 percent year on year and 207.9 billion yuan more than at the beginning of the year. The money multiplier stood at 3.95, which was 0.16 higher than at end-2011, indicating robust money expansion. The excess reserve ratio of financial institutions stood at 2.2 percent and the excess reserve ratio of rural credit cooperatives (RCCs) stood at 3.6 percent.

II. Deposits of financial institutions increased substantially by the end of the quarter

At end-March 2012, outstanding deposits in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, the same hereinafter) stood at 86.8 trillion yuan, up 13.0 percent year on year and a deceleration of 0.5 percentage points over end-2011. The outstanding value was 4.2 trillion yuan more than that at the beginning of 2012, an acceleration of 141.7 billion yuan year on year. Outstanding RMB deposits registered 84.7 trillion yuan, up 12.5 percent year on year and a deceleration of 1.0 percentage points over that at end-2011. This amount was almost flat with that at end-January and end-February, and 3.8 trillion yuan more compared with that at the beginning of 2012, a deceleration of 218.5 billion yuan year on year. New deposits in March reached 3.0 trillion yuan, accounting for 78.5 percent of new deposits during Q1, primarily due to the maturing of off-balance sheet wealth management products at the end of the quarter and the rapid rise in new loans. Outstanding deposits in foreign currency posted USD341.8 billion, an increase of 44.3 percent year on year or USD66.8 billion over that at the beginning of 2012, which was USD55.6 billion more year on year probably as a result of changes in RMB exchange-rate expectations.

Broken down by sectors, the growth of household deposits was relatively rapid, whereas that of non-financial institutions was flat. At end-March 2012, outstanding household deposits stood at 38.0 trillion yuan, up 16.1 percent year on year and an acceleration of 0.4 percentage points over end-2011. This was also 3.1 trillion yuan more than that at the beginning of 2012 and an increase of 463.9 billion yuan compared with that at end-March 2011. Outstanding RMB deposits of non-financial institutions totaled 29.9 trillion yuan, up 6.2 percent year on year and a deceleration of 3.0 percentage points over end-2011. This represented a decrease of 70.7 billion yuan compared with that at the beginning of 2012, constituting a deceleration of 456.1 billion yuan year on year. The growth of RMB deposits of non-financial institutions declined to 4.8 percent at end-January, partly due to the Spring Festival and the plunge in time deposits. It picked up in February and March. At end-March, outstanding fiscal deposits reached 2.7 trillion yuan, up 67.9 billion yuan from the beginning of 2012, a deceleration of 278 billion yuan year on year.

III. The credit structure of financial institutions continued to improve

At end-March 2012, outstanding loans in domestic and foreign currencies of all financial institutions reached 60.8 trillion yuan, up 15.5 percent year on year and a deceleration of 0.2 percentage points over end-2011. This marks an increase of 2.6 trillion yuan compared with that at the beginning of 2012, an acceleration of 198.5 billion yuan year on year. At end-March 2012, outstanding RMB loans stood at 57.2

trillion yuan, up 15.7 percent year on year. This growth was 0.1 percentage points lower than that at end-2011, and 0.7 percentage points and 0.5 percentage points higher than that at end-January and end-February respectively. The value of outstanding RMB loans was 2.46 trillion yuan more than the value of outstanding RMB loans at the beginning of 2012, constituting an acceleration of 217 billion yuan year on year. New loans extended January through March registered 738.1 billion yuan, 710.7 billion yuan, and 1.0114 trillon yuan respectively, an even distribution across the 3 months. The over-concentration of lending in January since 2008 has been alleviated. Among the first three months of 2012, new credit extensions in March hit a record high since February 2011, 332 billion yuan more year on year. In general, credit demand was basically met, with credit providing robust support for economic growth.

The overall credit structure continued to improve, with a remarkable rise in short-term loans and robust credit support to small and micro-sized enterprises, agriculture, rural areas, and farmers. At end-March 2012, loans to the household sector increased 18.1 percent year on year, which was 499.5 billion yuan more compared with that at the beginning of 2012. Among this total, home mortgages grew steadily by 131.3 billion yuan over end-2011. Loans to non-financial institutions and other sectors grew 14.9 percent year on year, an acceleration of 1.0 percentage points compared with end-2011. Their value increased by 2.0 trillion yuan compared with the beginning of 2012, an acceleration of 470 billion yuan year on year. Among this total, growth of medium- and long-term loans rose by 832.1 billion yuan over beginning-2012, 623.3 billion yuan less year on year. Short-term lending, including bill financing, increased by 1.6 trillion yuan over the beginning of 2012, 814.8 billion yuan more year on year. Credit support extended to SMEs and agriculture, rural areas, and farmers remained robust. In Q1, outstanding RMB loans extended by banking financial institutions to medium-sized enterprises went up 14.5 percent year on year, which was 2.6 percentage points more than those extended to large-sized enterprises, while those extended to small and micro-sized enterprises grew by 20.5 percent year on year, 8.6 percentage points higher than those to large-sized enterprises. Domestic and foreign currency-denominated loans extended to agriculture, rural areas, and farmers by major financial institutions, rural cooperative financial institutions, urban credit cooperatives, village and township banks, and financial companies maintained vigorous growth. At end-March 2012, new loans to rural areas stood at 718.3 billion yuan, and the outstanding value was up 21.3 percent year on year. New loans to rural households registered 186.7 billion yuan, and their outstanding value went up 16 percent compared with end-March 2011. The value of new loans to the agricultural sector posted 136.3 billion yuan in the first quarter, and by end-March their outstanding value was up 9.0 percent year on 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, whereas that of Chinese-funded small and medium banks operating nationwide and that of foreign-funded financial institutions decelerated.

Table 1 RMB loans of financial institutions, Q1 2012

Unit: 100 million yuan

	Q1 2012		Q1 2011	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	12052	1029	11024	−2753
Chinese-funded Small and Medium Banks Operating Nationwide②	5968	−621	6589	336
Chinese-funded Small and Medium Local Banks③	3277	1410	1867	176
Rural Cooperative Financial Institutions④	4824	232	4592	−171
Foreign-funded Financial Institutions	154	−32	186	−325

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-March 2012, outstanding foreign-currency loans of financial institutions reached USD559.5 billion, up 17.2 percent year on year. This was an increase of USD21.1 billion over that at the beginning of 2012, a deceleration of USD5.9 billion. Trade financing increased by USD10 billion, accounting for 47.6 percent of new loans denominated in foreign currencies, up 12.2 percentage points year on year. Robust trade financing supported import and export activities. Overseas loans and medium- and long-term loans climbed by USD10.5 billion, accounting for 49.7 percent of total new loans denominated in foreign currencies.

IV. The all-system financing aggregate edged up month by month

It is estimated that in Q1 2012 the all-system financing aggregate registered 3.88 trillion yuan, down 348.7 billion yuan year on year. They registered 1.86 trillion yuan in March 2012, up 813.6 billion yuan and 881.3 billion yuan over end-January and end-February respectively. Among this total, new RMB loans posted 2.46 trillion yuan, an acceleration of 217 billion yuan year on year. Foreign-currency-denominated loans increased by the equivalent of 132.7 billion yuan, a deceleration of 45.4 billion yuan year on year. New entrusted loans rose by 280.9 billion yuan, a deceleration of 39.5 billion yuan year on year. Trust loans increased by 172.1 billion yuan, an acceleration of 163 billion yuan. Undiscounted bankers' acceptances grew 227.1 billion yuan year on year, a deceleration of 534 billion yuan. Net financing via corporate bond issuances registered 396 billion yuan, a deceleration of 61 billion yuan compared with the same period of 2011. A total of 87.5 billion yuan was raised by domestic non-financial institutions via the stock market, down 68.3 billion yuan year on year.

The structure of financing took on the following features. First, RMB loans accounted for a much larger share. In Q1, new RMB loans constituted 63.5 percent of total financing to the real economy, up 10.4 percentage points year on year and their largest share since 2010. Second, off-balance sheet financing provided by financial institutions to the real economy declined by a large margin year on year, primarily as a result of much slower year-on-year growth in undiscounted bankers' acceptances. Third, direct financing was lukewarm. A total of 483.5 billion yuan was raised by non-financial enterprises on the stock market and by issuing enterprise bonds, which was 129.3 billion yuan less year on year.

Box 1 Private financing

1. Definition of private financing

Private financing, as opposed to financing through the formal financial sector, refers to financing activities between natural persons, legal persons, organizations, and market participants other than lawfully associated financial institutions.

As the wealth of the corporate and household sectors accumulates along with social and economic development, the emergence of private lending to some extent is inevitable as formal financing falls short of demand and the transformation from industrial capital to financial capital is still underway. Private financing, as opposed to formal financing, has the advantages of low costs of collecting and processing information, simple procedures, flexibility, low transaction costs, flexibility in dealing with overdue repayment collections, and special risk-control mechanisms.

Unregulated private financing may be covert and off the radar of monitoring, which makes it vulnerable to illegal financing and money laundering. Legislation is needed to standardize and regulate private financing and to channel it to support economic development while minimizing potential harm.

2. Legislation on private financing has basically been put into place

Private financing includes market activities between individuals or organizations based on free will. Governed by the General Principles of the Civil Law and the Contract Law of China, private financing between natural persons, legal persons, or other organizations is allowed and protected if it is compliant with the governing legislation. Defaults may be settled via mediation or civil court trials.

Different pieces of legislation in China, including the Criminal Law, the Law of the People's Republic of China on Public Security Administrative Punishments, Amendments to the Criminal Law, and the Opinions of the Supreme People’s Court on Trials of Lending Cases by the People’s Courts provide for punitive measures for illegal conduct or irregularities that crop up in private financing, such as unlawful deposit taking, fraudulent fundraising, and usury or personal injury as a result of violent collection of overdue payments.

The Opinions of the Supreme People’s Court on Trials of Lending Cases by the People’s Courts stipulate that the interest rate for private lending may be higher than that for bank lending, in line with the levels that the local People’s Courts see as appropriate, but it should not be as much as or more than 4 times the bank lending rate. Any claim for interest payments gained beyond the cap is not protected by law.

3. Guiding and regulating private financing to foster its healthy development

The State Council indicated the need to regulate private financing when granting approval to set up a pilot zone for comprehensive financial reform in Wenzhou. A set of measures were implemented, including the formulation of administrative measures to regulate private financing, establishing a private financing filing and management system, and improving the monitoring system to guide and regulate private financing to foster its healthy development.

First, improving the corresponding legal system to guide private financing to operate in a standardized and transparent manner. Efforts will be made to study and improve the rules and regulations on non-deposit taking credit brokers to foster a multi-tiered credit market, to stipulate explicitly that private financing contracts should be based on free will, to standardize the elements to be covered in the contracts, and to define the legal status and scope of the business of financing intermediaries to regulate operations.

Second, easing access to the financial market based on effective regulation and risk control. Efforts will be made to implement the *Several Opinions of the State Council* *on Encouraging and Guiding the Healthy Development of Private Financing*, to channel quality private capital to the financial sector, promote the development of grassroots financial institutions, improve grassroots financial services, and effectively support small and micro-enterprises. Meanwhile, a deposit insurance system will be set up at an accelerated pace, and a market-based risk resolution regime will be put into place to prevent systemic risks.

Third, exploring the setting up of a private financing monitoring and analysis system to warn against and resolve risks in a timely manner and to prevent mass incidents and outbursts of regional risks. Measures will be taken to create a large-value private lending registration scheme, requiring the registration of private lending activities that exceed a certain frequency or value, so as to monitor, guide, and manage the flow of funds more effectively.

Fourth, adopting differentiated and classified management. Reasonable and lawful private financing activities are protected and tough punitive measures will be taken by public security and law enforcement agencies against illegal conduct including fraudulent fundraising, profit-seeking on-lending, money laundering, and violent collection of overdue repayments that caused personal injury.

Fifth, advocating market principles and legal concepts in contracts based on free will, and independent responsibility and creditworthiness so that private lending participants will build their capacity for evaluation and tolerance of risks. Participants should understand that the government is not obliged to compensate for private lending losses in cases of default, to manage appetites for unreasonable risks, and to forgo wishful demands for government compensation.

V. The lending rates of financial institutions generally declined

In the first three months, lending rates offered to non-financial institutions and other sectors generally went down due to the decline in bill financing rates. In March, the weighted average lending rate stood at 7.61 percent, down 0.4 percentage points compared with the beginning of the year. The weighted average interest rate of ordinary loans registered 7.97 percent, up 0.17 percentage points over the beginning of 2012, and the weighted average bill financing rate posted 6.2 percent, down 2.86 percentage points compared to the beginning of the year. The weighted average residential mortgage rate edged down to 7.43 percent in March, down 0.19 percentage points compared to the beginning of 2012.

The share of loans with interest rates higher than the benchmark constituted a larger share. In March, the share of loans with interest rates higher than, flat, or lower than the benchmark stood at 70.43 percent, 4.62 percent, and 24.95 percent respectively, marking an increase of 4.41 percentage points, a decrease of 2.40 percentage points, and a decrease of 2.01 percentage points respectively compared with the beginning of 2012.

Against the background of subdued benchmark interest rates on international markets and changes in the supply and demand for foreign exchange domestically and overseas, the weighted average demand deposit interest rate and the interest rate of less than 3-month large-value US dollar deposits registered 0.27 percent and 2.91 percent respectively, marking a decline of 0.04 percentage points and 0.38 percentage points respectively compared with the beginning of the year. The weighted average interest rate of less than 3 month and 3 month (inclusive) to 6 month US dollar loans posted 3.56 percent and 4.00 percent respectively, down 0.29 percentage points and 0.31 percentage points compared with the beginning of 2012.

Table 2 Shares of loans with rates floating at various ranges of the benchmark rate, January through March 2012

unit：%

	Lower than the benchmark	At the benchmark	Higher than the benchmark					
	[0.9，1)	1	sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2
January	4. 79	26. 22	68. 99	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

Source: People's Bank of China

Table 3 The average interest rate for large-value deposits and loans denominated in US dollars, January through March 2012

Unit：%

	Large-value deposits	Loans

	Demand deposits	Within 3 months	3-6 months	6-12 months	1 year	Above 1 year	Within 3 months	3-6 months	6-12 months	1 year	Above 1 year
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

Source: People's Bank of China

VI. The flexibility of the RMB exchange rate rose significantly

Since the beginning of 2012, the RMB exchange rate moved in both directions with greater flexibility and diverging expectations. At end-March 2012, the central parity of the RMB against the US dollar was 6.2943 yuan per US dollar, up 66 basis points or 0.1 percent over end-2011. From the reform of the RMB exchange-rate regime in 2005 to end-March 2012, the RMB appreciated 31.49 percent against the US dollar. The BIS estimates that in Q1 2012 the nominal effective RMB exchange rate appreciated 0.17 percent and the real effective exchange rate depreciated 0.81 percent; from the start of the exchange-rate reform in 2005 to March 2012 the nominal effective RMB exchange rate appreciated 21.37 percent and the real effective exchange rate appreciated 29.38 percent.

Part 2 Monetary Policy Operations

In line with the spirit of the Central Economic Work Conference and the overall arrangements of the State Council, since the beginning of 2012 the PBC continued to implement a prudent monetary policy. With enhanced macro-prudential management, better targeted and more flexible and forward-looking policies, as well as preemptive adjustments and fine-tunings as appropriate in response to economic developments, the PBC guided a proper growth of money and credit supply, maintained all-system financing aggregate at a reasonable level, encouraged financial institutions to improve their credit structures, promoted financial enterprise reform in a steady manner, and improved the RMB exchange-rate regime, thereby contributing to stable economic and financial performance.

I. Flexible open market operations

In response to heightened volatility in liquidity supply and demand in the banking system in 2011, the PBC flexibly conducted open market operations to support adjustments to the reserve requirement policy while intensifying analysis and monitoring of domestic and international economic and financial developments as well as banking system liquidity. The carefully calibrated direction, intensity, and pace of open market operations to adjust liquidity in a proper and timely manner helped maintain proper liquidity in the banking system.

Open market operations played a stronger role as a venue for proactive adjustments and fine-tunings as the mix of tools was continuously improved in line with changes in aggregate liquidity gaps. The PBC used short-term reverse repos to inject liquidity into the banking system ahead of the Spring Festival, thereby moderating the possible liquidity fluctuations caused by the seasonal surge in demand for cash. After the festival, as a complement to the cuts in the reserve requirement ratio, the PBC conducted 398 billion yuan of short-term repos in the first quarter to make sure that the maturity dates of open market operations were evenly distributed over the period while keeping the liquidity at a reasonable level.

Interest rates of open market operations remained stable to guide market expectations. This was achieved through stronger cooperation between open market operations and other monetary policy tools amid the volatile market expectations caused by the rapidly changing external economic environment. At end-March, interest rates for 28-day repos and 91-day repos posted 2.80 percent and 3.14 percent respectively.

The PBC properly conducted state treasury cash management operations. In the first quarter of 2012, the PBC deposited 30 billion yuan and 60 billion yuan of 6-month state treasury funds in commercial banks on two separate operations.

II. A cut in the reserve requirement by 0.5 percentage points and improvements in the mechanism that adjusts the differentiated reserve requirement on a continuous and case-by-case basis

As less RMB liquidity was created to purchase foreign currencies during the first quarter 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 reserve requirement was lowered by another 0.5 percentage points on February 24, 2012 to keep liquidity in the banking system at a proper level. In the meantime, as a number of economic indicators dropped and lending growth in January moderated, the PBC continued to improve the mechanism that adjusts the differentiated reserve requirement on a continuous and case-by-case basis as a counter-cyclical macro-prudential management instrument by calibrating certain parameters to sustain 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.

III. Strengthened window guidance and credit policy guidance

In light of the underlying philosophy that the financial sector develops to serve the real economy, the PBC followed a differentiated approach to credit guidance, enhanced examination of lending distribution, promoted better coordination between credit policy and industrial policy, and encouraged improvements in the credit structure. To encourage stronger financial services for tourism and irrigation projects, the PBC, working with other government agencies, developed the *Notice on Financial Support for Accelerating the Development of Tourism*, and the *Notice on Financial Services for the Reform and Development of Irrigation*. The PBC urged financial institutions to fully implement policies to provide financial support to the services sector, including the cultural industry, services outsourcing, and logistics. It guided credit flows to small and micro-sized enterprises, agriculture, rural areas, and farmers, affordable housing projects, strategic emerging industries, and other key areas and weak links in the economy. The PBC continued to improve financial services that are closely related to the people's livelihood, and encouraged financial institutions to reasonably price mortgage loans according to risks and within the announced floating band from the benchmark interest rates, so as to meet the needs of first-time home buyers. The PBC also reined in lending to heavily energy-consuming and polluting industries as well as industries with excess capacity.

Box 2 Favorable financial policies for agriculture, rural areas, and farmers

During recent years, following the overall arrangements of the State Council, the PBC intensified policy efforts to support agriculture, rural areas, and farmers through a wide range of policy tools, including efforts to enhance the capital of agro-linked financial institutions, make innovations in rural financial products, strengthen the rural financial infrastructure, and improve rural financial services.

1. Agro-linked lending by the PBC and financial institutions increased. Central bank lending has been an important part of the PBC's efforts to support the agricultural sector and the wider real economy. In 2011, as the sources of liquidity in the banking system varied due to a notably more balanced BOP account and a narrowing gap between supply and demand in the foreign exchange market, the PBC took advantage of the situation to provide an additional 50 billion yuan of agro-linked central bank lending, which supported greater agro-linked loans by rural financial institutions while, as a way of providing discretionary liquidity, ensured proper money and credit growth.

Since 2012, central bank lending to large grain-producing provinces (autonomous regions) has been expanded on several occasions to provide greater incentives, increasing by 60 billion yuan thus far, the largest increase in history. In early March, to support spring farming activities, the PBC issued the *Notice on Using Agro-linked Central Bank Lending to Increase Agro-linked Credit Supply* and provided another 10 billion yuan of central lending for this purpose. On March 30, an additional 30 billion yuan of agro-linked central bank lending was provided to rural credit cooperatives (RCCs) incorporated at the county level as well as to village and township banks that met the standards for follow-up monitoring and assessments after redemption of special bills and on the share of new deposits in lending to local borrowers, encouraging RCCs to build on past progress to deepen reform. On April 17, another 20 billion yuan of central bank lending was made to encourage RCCs and village and township banks to increase agro-linked credit supply in support of spring farming activities, mainly in the major grain-producing provinces (autonomous regions) and provinces with a strong need for agro-linked central bank lending. As of end-April, 2012, the quota of agro-linked central bank lending was 214.3 billion yuan, with an outstanding amount of 123.9 billion yuan, up by 37.9 billion yuan year on year. Agro-linked central bank lending in the first four months of 2012 totaled 70.5 billion yuan, up 26.3 billion yuan year on year.

2. A differentiated reserve requirement policy was implemented to enhance financial support to the agricultural sector. In 2010, the State Council approved a plan for deepening the joint stock reform in the China Agricultural Bank (ABC), including the pilot program for building a dedicated department for rural financial services at the ABC branches in Sichuan and 7 other provinces. In line with this reform plan, the PBC developed specific rules for implementing the differentiated reserve requirement policy in the ABC rural finance departments with large agro-linked loans, applying a favorable reserve requirement that was 2 percentage points lower than that applicable for the ABC. In 2012 these preferential rules were expanded from 8 provinces to 12 provinces, and were implemented in 565 qualified rural finance divisions on March 25. This was expected to free 23 billion yuan of funds to meet agro-linked needs, an increase of 7 billion yuan year on year.

RCCs continued to enjoy a preferential reserve requirement, which was 6 percentage points lower than that for large commercial banks, and 7 percentage points lower for RCCs with smaller assets and a higher percentage of agro-linked loans. In the meantime, the reserve requirement was used as a policy incentive for financial institutions incorporated at the county level, which would enjoy a 1 percentage point cut in the reserve requirement as long as the share of new lending to local borrowers exceeded the set level.

3. The PBC improved rural financial services by encouraging agro-linked financial institutions to invent new rural financial products and new ways to provide services. After the PBC, jointly with the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC), issued the *Notice on Promoting Innovation in Rural Financial Products and Service Modalities* in July 2010, efforts have been made to

encourage agro-linked financial institutions to design products tailored to rural needs and to improve services. A special monitoring and reporting system was built, and action was taken to promote exchanges of experiences and adoption of best practices as part of the effort to improve rural financial services.

4. The PBC enhanced the rural financial infrastructure to build an enabling environment for better rural financial services. The rural credit information system was improved, with a nationwide basic credit record database that covers rural businesses and farmers. Flexible access solutions were developed to facilitate the access of rural financial institutions to the Large Value Payment System, Bulk Electronic Payment System, and National Check Image Exchange System. Efforts were also made to promote the use of bankcards for migrant workers and the use of other non-cash payment instruments as well as tailored services like withdrawals through POS terminals installed in villages, thereby facilitating payments in rural areas, allowing migrant workers to deposit or withdraw money in different cities, and making possible small cash withdrawals in remote rural areas.

In general, these policies contributed to a notably stronger supply of agro-linked credit. As of end-March 2012, outstanding agro-linked lending totaled 15.5 trillion yuan, up 21.7 percent year on year and outpacing overall lending growth by 6.2 percentage points. The resultant improvements in rural financial services have been important for ensuring the continuous growth of grain production during the past 8 years and for accelerating development of social programs and overall transformation in the rural areas.

IV. Development of cross-border use of RMB

The framework for cross-border use of RMB was enhanced. In March 2012 the PBC, in cooperation with relevant government agencies, issued the *Notice on Issues regarding Qualifications for RMB Settlement in Goods Exports*, which allowed all qualified import and export enterprises to settle their exports of goods in RMB. Enterprises with a record of serious violations of tax, customs, or financial policies during the past two years were put under special oversight to ensure compliance. The *Notice* played a key role in promoting balanced use of RMB settlement in cross-border trade. With this development, any Chinese enterprise that engages in imports or exports of goods, services, and other current account items is free to use RMB as the currency for numeraire, settlement, or payment.

RMB settlement of cross-border trade and investment grew considerably. In the first quarter, RMB settlement of cross-border trade recorded 580.4 billion yuan, growing 61 percent year on year. This included 416.57 billion yuan in goods trade, and 163.83 billion yuan in exports of services and other items under the current account. Actual RMB receipts and payments in the first quarter totaled 550.01 billion yuan, bringing the receipt-to-payment ratio from 1:1.7 in 2011 to 1:1.4, suggesting a more balanced use of RMB in settling imports and exports. RMB settlement of cross-border direct investments reached 49.87 billion yuan in the first three months of 2012, including 2.87 billion yuan of outbound direct investments and 47 billion yuan of foreign direct investments.

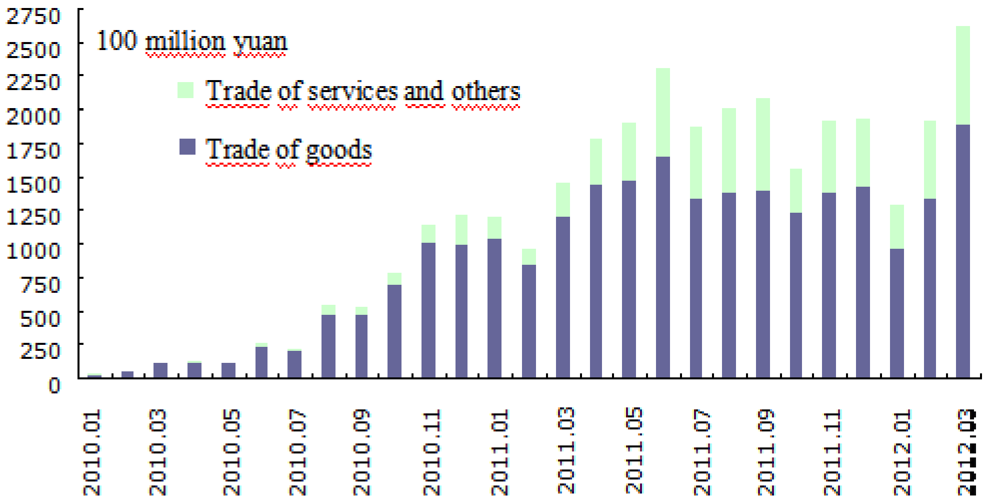


Figure 1 RMB settlement of cross-border trade

Source: People's Bank of China

V. Improvements in the RMB exchange-rate regime

The PBC further improved the reform of the RMB exchange-rate regime in line with the principle of making it a self-initiated, controllable, and gradual process. Focusing on the role of market supply and demand, the PBC enhanced RMB exchange-rate resilience with reference to a basket of currencies and kept the RMB exchange rate basically stable at an adaptive and equilibrium level. In the first quarter, the central parity of the RMB against the US dollar peaked at 6.2840 yuan per dollar and reached a trough of 6.3359 yuan per dollar. It appreciated on 29 out of the 58 trading days in the first three months, and depreciated on the remaining 29 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, Japanese yen, and other major international currencies. At end-March, the central parity of the RMB against the euro registered 8.3944 yuan per euro, a depreciation of 2.76 percent from end-2011, and the central parity of the RMB against the Japanese yen stood at 7.6690 yuan per 100 Japanese yen, an appreciation of 5.75 percent from end-2011. Beginning from the reform of the RMB exchange-rate regime in 2005 to end-March 2012, on a cumulative basis the RMB appreciated 19.30 percent against the euro and depreciated 4.73 percent against the Japanese yen.

In the first quarter, the interbank foreign exchange spot market recorded 5457.84 billion yuan of transactions in RMB against the US dollar, 14.7 billion yuan in RMB against the euro, 18.37 billion yuan in RMB against the Hong Kong dollar, 7.72 billion yuan in RMB against the Japanese yen, 2.16 billion yuan in RMB against the pound sterling, 1.25 billion yuan in RMB against the Thai baht, 620 million yuan in RMB against the Russian ruble, and 250 million in RMB against the Malaysian ringgit.

Effective April 16, 2012, the RMB exchange rate against the US dollar is allowed to float in a wider band on the interbank spot foreign exchange market, from the previous 0.5 percent to 1 percent around the central parity, while the spread between the highest selling price and the lowest buying price offered by designated foreign exchange banks on the same day is allowed to increase by up to 2 percent from the central parity from its previous 1 percent. PBC operations in the foreign exchange market, while becoming less frequent, were accordingly reoriented to moderating excess exchange-rate volatility. Exchange-rate fluctuations in the interbank market have strengthened since the floating range was expanded, enhancing the market’s capacity to seek an equilibrium level, while the foreign exchange market has generally remained stable.

VI. Deepened reform of financial institutions

With the joint-stock reform completed on January 21, the Postal Savings Bank of China Co., Ltd. was transformed into the Postal Savings Bank of China Corporation, with registered capital of 45 billion yuan. The reform was designed to improve corporate governance and enhance a modernized corporate system, thereby turning the institution into a modern commercial bank with adequate capital, robust internal control, sound operations, quality services, good profitability, and strong competitiveness to serve agriculture, rural areas, and rural and urban residents as well as SMEs.

The transformation of asset management companies made steady progress. The China Huarong Asset Management Company will be restructured as a joint stock corporation, as approved by the State Council. It is planned that the new corporation will introduce domestic and overseas strategic investors through secondary offerings, improve the equity structure, enhance its capital position, and go public at the appropriate time. The China Cinda Asset Management Company has introduced the National Council for Social Security Fund, the UBS Group, CITIC Capital Holdings Ltd., and Standard and Chartered Bank as four strategic investors, bringing 10.37 billion yuan of investment and holding 16.54 percent of Cinda's shares after the capital increase.

Initial achievements were made in terms of RCC reform, as reflected in the continued improvements in their operational performance and financial position, and their enhanced leading role in rural financial services. At end-March, the capital adequacy ratio of the RCCs stood at 10.4 percent, down 0.3 percentage points from end-2011, whereas their NPL ratio had declined 0.5 percentage points to 5.0 percent from end-2011, and their asset/profit ratio had increased by 0.3 percentage points from end-2011 to 1.3 percent. Outstanding RCC deposits reached 10.9 trillion yuan, an increase of 722.4 billion yuan from end-2011, and outstanding loans recorded 7.2 trillion yuan, an increase of 482.1 billion yuan, including 4.9 trillion yuan of agro-linked loans, up by 242.3 billion yuan from end-2011. Outstanding lending to rural households totaled 2.5 trillion yuan, an increase of 129.3 billion yuan from the end of last year.

Steady progress was made in terms of RCC property rights reform. As of end-March, a total of 219 rural commercial banks and 187 rural cooperative banks have been established, representing an increase of 7 and a reduction of 3 respectively, whereas a total number of 1,878 RCCs with legal-person status at the county (city) level have been built, down by 4 from end-2011. Moreover, some RCCs have effectively explored building alternative property rights systems and organizations, clarifying property ownership, and improving corporate governance.

Box 3 Profits in the banking sector

In 2011, net profits of Chinese banking financial institutions reached 1.25 trillion yuan, up 39.2 percent year on year. Net profits of commercial banks totaled 1.04 trillion yuan, a year-on-year increase of 36.3 percent. The strong growth of banking profits is mainly driven by steady and rapid economic growth, expansion of banking assets, robust growth of intermediary services, and improved operational and management skills. Despite the expansion of direct financing during recent years, indirect financing remains at a high level as a share of total financing, contributing to an increasingly stronger need for expanding banking assets as the economy continues to grow rapidly. Total banking assets reached 113.3 trillion yuan at end-2011, representing a doubling of the 53.1 trillion yuan at end-2007. While rapid expansion of banking assets immediately lead to growth in profits, it is important to support efforts to address the shocks of the international financial crisis and to sustain stable economic development. In the meantime, profitability in the banking sector also improved due to the financial reforms that have enhanced the corporate governance structure, risk management mechanisms, managerial skills and efficiency, business upgrading and product innovation, and asset quality. The capital-to-profit ratio for the banking sector recorded 19.2 percent in 2011, up by 1.7 percentage points from 2010, while the asset-to-profit ratio posted 1.2 percent, up 0.2 percentage points from 2010.

It should be noted that while the net interest rate spread for the Chinese banking sector edged up to about 2.8 percent in 2011, it is still lower than the level in previous years, i.e., 2.9 percent in 2007 or 3 percent in 2008. In line with international averages, it is significantly lower than the spread in other BRICS countries and below the level in the U.S. and Korea, though above the level in Japan, Germany, and other countries. With the expansion of banking assets, income from intermediary services also grows as banks expand the scope and improve the quality of intermediary services to better meet the needs of customers. Nevertheless, the partial focus of assessments on income from intermediary services also leads to unreasonable fees and extra lending conditions in some banks. To address this issue, banks need to further improve their level of services and to enhance awareness of their role as a service provider. They need to enhance transparency regarding fees and to ensure that intermediary services develop in a healthy manner by improving long-term mechanisms for performance assessments, internal management, and other areas, so as to eliminate the gap between services and charges and to prevent other irregular business behavior.

Profits in the banking sector are mainly used to pay income tax and dividends, build provisions for impairment of assets and to enhance capital adequacy through profit retention. Banks are among the biggest payers of corporate income tax, contributing 27.6 percent to the total enterprise income tax in 2011. From 2007 to 2011, about 17.8 percent of banking pre-provision operating profits went to income tax, while 22.1 percent was paid to investors as dividends, the bulk of which went to the government as dominant holder of banking shares, to make up for the massive public investments in the financial reform. Moreover, bank profits are cyclical in nature, as reflected in the recent slowdown in profit growth of some listed banks during the first quarter as economic growth moderated. This highlights the need to build provisions in times of strong economic growth to insure against possible future surges in NPLs or economic fluctuations. In this connection, from 2007 to 2011 banks built strong provisions for asset write-offs, equivalent to 24.5 percent of the pre-provision operating profits. More importantly, banks use retained profits to strengthen their capital, which enhances their capacity to support the real economy. Out of the 4.5 trillion yuan increase in core capital between 2007 and 2011, around 2.4 trillion yuan was allocated from retained profits, accounting for 35.6 percent of pre-provision operating profits.

VII. Deepened reform of foreign exchange administration

Institutional improvements were made to guard against shocks from cross-border capital flows. Efforts were made to closely watch cross-border capital flows, adopt a balanced approach in managing capital inflows and outflows, develop contingency plans for strong net capital inflows and policy responses to massive capital outflows, and continue to combat irregular capital flows.

Progress was made in reforming the administration of foreign exchange for trade in goods, which had been launched on a pilot basis in Jiangsu, Shandong, Fujian, and other 4 provinces (municipalities). As a result, a new management model that balances trade facilitation and risk management has taken shape, under which the previous case-by-case procedures for foreign exchange writing-off is removed for normal imports and exports by enterprises with a good record of compliance and is replaced by a new process that filters and matches goods flow and cash flows at the aggregate level, supported by continuous monitoring and category-specific supervision, streamlining procedures for both banks and enterprises, and reducing operational costs.

Actions were taken to promote trade and investment facilitation. The quota for outstanding short-term external debt was redistributed in favor of small and medium-sized banks based in the central or western regions or to serve small and micro-sized enterprises to meet the needs of Chinese-funded enterprises for short-term financing. Banks were allowed to square their currency mismatch exposures incurred from the trading of precious metal, helping them provide more convenient and efficient precious metal trading services for their customers. The items and procedures for annual foreign exchange examination of foreign-invested enterprises were streamlined.

Measures were taken to further expand channels for cross-border capital flows to promote capital account convertibility in an orderly manner. In the first quarter, a total of USD2.91 billion of foreign investment from 23 investors was approved under the Qualified Foreign Institutional Investor (QFII) scheme, and USD300 million of outbound investments was approved under the Qualified Domestic Institutional Investor (QDII) scheme. With the implementation of the RMB Qualified Foreign Institutional Investor (RQFII) scheme, the first installment of 20 billion yuan in the investment quota was distributed among 21 qualified institutions, and the flow of these funds was subject to continuous monitoring.

Part 3 Financial Market Analysis

In the first quarter of 2012, China’s financial market continued its healthy and stable performance. Transactions on the money market increased rapidly and interest rates declined notably. Both the bond market operations and bond issuance volume were stable. Stock indices edged up and financing on the stock market declined.

I. Financial market analysis

1. Transactions on the money market registered a large increase, and market interest rates declined

Repo transactions and interbank lending on the interbank market were brisk, with a large increase in trading volume. In the first quarter of 2012, the turnover of bond repos posted 30.7 trillion yuan, with a daily average of 502.5 billion yuan, up 40.5 percent year on year. The turnover of interbank lending posted 10.2 trillion yuan, with a daily average of 166.4 billion yuan, up 66.3 percent year on year. In terms of the term structure, market transactions were dominated by overnight products, with overnight bond repos and interbank lendings accounting for 76.1 percent and 84.8 percent of their respective turnovers, down 0.1 and 0.2 percentage points from the same period of the last year. The turnover of government securities repos on the stock exchanges soared 133.1 percent year on year to 6.9 trillion yuan.

In terms of financing by financial institutions, the flow of funds on the money market showed the following characteristics: first, domestically-funded large banks were the sole net fund providers, and their net lending increased rapidly to more than ten times that in the corresponding period of the last year; second, all 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 demand; third, in the interbank lending market, domestically-funded small and medium-sized banks and foreign-funded financial institutions became net borrowers; during the corresponding period of the last year they had been net lenders.

Table 4 Fund flows among financial institutions in Q1 2012

Unit: 100 million yuan

	Repo		Interbank Lending	
	Q1 2012	Q1 2011	Q1 2012	Q1 2011
Domestically-funded large banks ①	-115482	-75478	-21874	-2153
Domestically-funded small and medium-sized banks ②	49142	31774	7791	-5349
Securities and fund management companies	26664	13091	6945	2502
Insurance companies	11526	6493	-	-
Foreign-funded financial institutions	4792	3226	1620	-354
Other financial institutions ③	23359	20894	5518	5356

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 17 medium-sized banks, small-sized city commercial banks, rural commercial banks, rural cooperative banks, and village 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 amid fluctuations, but in general they remained higher than during the same period of the last year. The weighted average interest rate of bond-pledged repo and interbank borrowing posted 2.66 percent and 2.58 percent respectively in March, down 71 and 75 basis points from December of the last year, but up 68 and 65 basis points from the same period of the last year. At end-March, the 3-month and one-year Shibor rate stood at 4.88 percent and 5.15 percent, down 59 and 9 basis points from the end of last year. In January, due to seasonal factors, interest rates on the money market continued to rise in the run-up to the Spring Festival; thereafter, as large amount of cash flowed back into the banking sector and affected by open market operations and the decrease in the deposit reserve requirement ratio, liquidity supply was generally appropriate and since February market interest rates gradually declined.

Trading of RMB interest-rate swap and forward products decreased slightly. In the first quarter of 2012, the total notional principal of RMB interest-rate swaps registered 491.37 billion yuan, representing a decrease of 13.3 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 69.8 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 for 52.1 percent and 39.0 percent of the total respectively. Transactions of bond forwards posted 14.46 billion yuan, representing a decrease of 32.0 percent year on year.

Table 5 Transactions of interest-rate derivatives, 2006-Q1 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)
2006	103	355.7	398	664.5	-	-
2007	1978	2186.9	1238	2518.1	14	10.5
2008	4040	4121.5	1327	5005.5	137	113.6

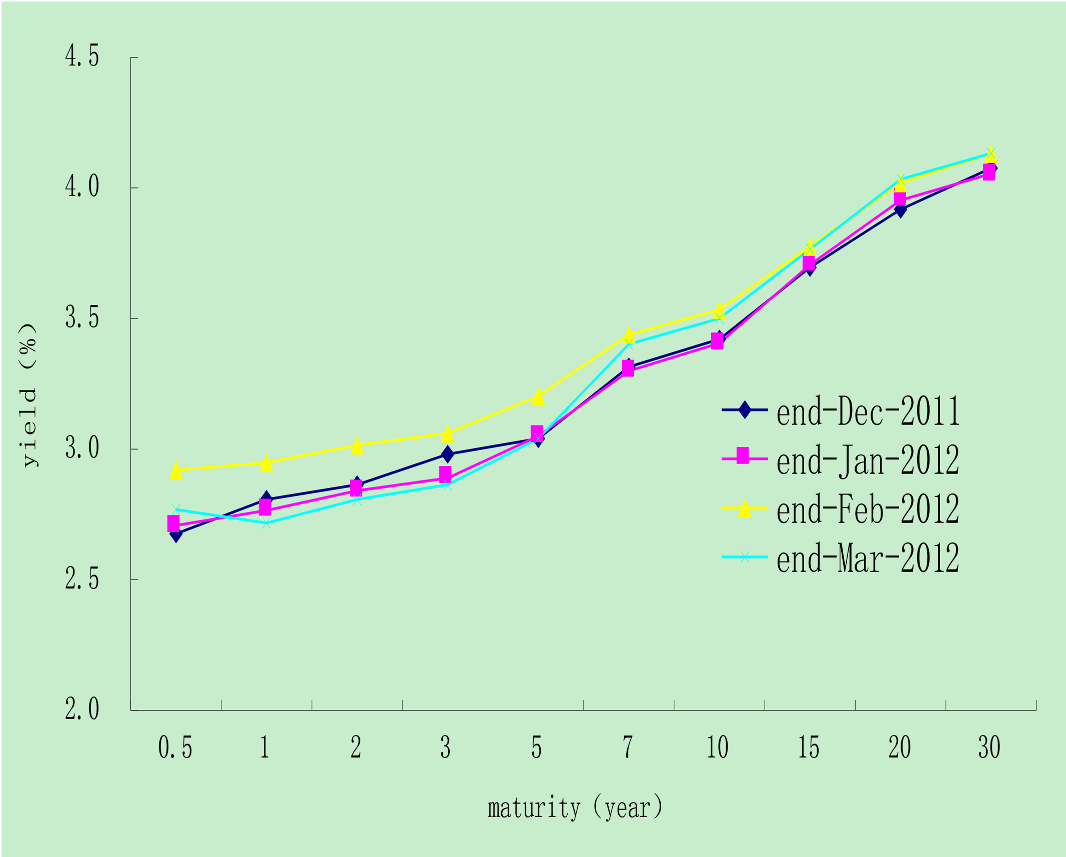
2009	4044	4616.4	1599	6556.4	27	60.0
2010	11643	15003.4	967	3183.4	20	33.5
2011	20202	26759.6	436	1030.1	3	3.0
Q1 2012	4317	4913.7	45	144.6	-	-

Source: China Foreign Exchange Trade System

2. Both bond market operations and bond issuance volume were stable

The turnover of spot bond transactions on the interbank market remained stable. In the first quarter of 2012, the turnover posted 14.9 trillion yuan of bonds, with a daily average of 243.4 billion yuan, up 15.7 percent year on year. In terms of market participants, domestically-funded banks and foreign-funded financial institutions were net purchasers on the interbank spot bond market, with net purchases of 99.1 billion yuan and 23.6 billion yuan respectively. Exchange-traded spot government securities transactions posted 23 billion yuan, 4.2 billion yuan less than during the same period of the last year.

Bond price indices moved slightly.. The China Bond Composite Index (net price) fell 0.09 percent from 101.23 points at the beginning of the year to 101.13 points at end-March; and the China Bond Composite Index (full price) rose 0.18 percent from 111.28 points at the beginning of the year to 111.49 points at end-March. The exchange-traded government securities index rose 0.77 percent, from 131.44 points at the beginning of the year to 132.46 points at end-March.



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

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

The yield curve of government securities on the interbank market shifted up slightly. At end-March, the yields of 6-month, 10-year, 20-year, and 30-year government bonds was 9, 6, 11, and 5 basis points higher respectively than that at the end of 2011. As the growth of the CPI slowed down since the beginning of 2012, the yields of government securities with a maturity of one to three years fell slightly from the end of 2011.

The volume of bond issuances was stable. In the first quarter of 2012, a total of 1.54 trillion yuan (excluding central bank bills) was issued, 34.2 billion yuan less than that during the same period of the last year. In particular, the volume of newly issued government securities, China Development Bank, and other policy financial bonds decreased slightly, while that of bank ordinary bonds increased. At end-March, a total of 21.7 trillion yuan of bonds was deposited with the China Government Securities Depository Trust and Clearing Co., Ltd., an increase of 8.2 percent year on year.

Table 6 Issuances of major bonds, Q1 2012

Types of bonds	Issuance	Year-on-year growth

	(100 million yuan)	(100 million yuan)
Government securities①	2179	-1081
Policy financial bonds issued by the China Development Bank and other policy banks	5272	-827
Bank subordinated bonds and hybrid bonds	44	-132
Bank ordinary bonds	1180	1160
Enterprise bonds②	6737	827
Of which: Short-term financing bills	1560	-1272
Super and short-term commercial paper	1100	1100
Medium-term notes	1356	-486
Corporate bonds	415	12

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.

Movements in bond issuance rates showed a diversified trend. In the first quarter, the issuance rates of government securities declined somewhat from the end of the last year. Taking 10-year government securities as an example, the issuance rate in March was 3.51 percent, down 6 basis points from those of the same maturity issued in December 2011. The volume of bond issuances by the China Development Bank and other policy banks was relatively large, and their issuance rates in general were higher than those at the end of the last year. The Shibor played a greater role in bond pricing. In the first quarter of 2012, 96 fixed-rate enterprise bonds issued on the primary bond market were all based on the Shibor, with a gross issuance volume of 167.6 billion yuan. In addition, a total of 92.6 billion yuan of short-term fixed-rate financing bills based on the Shibor was issued, accounting for 53.7 percent of the total issuances of short-term fixed-rate financing bills.

3. The volume of bill financing remained stable, and interest rates showed a downward trend

The bill acceptance business continued to grow. In the first quarter of 2012, commercial bills issued by enterprises totaled 4.0 trillion yuan, representing year-on-year growth of 10.4 percent; the total volume of outstanding commercial bills at end-March posted 7.2 trillion yuan, representing year-on-year growth of 21.6 percent. At end-March, outstanding commercial bills increased slightly from the beginning of 2012, and growth was lower than that during the same period of the last year. In terms of issuing industries, outstanding banker's acceptance bills were mainly issued by enterprises in the manufacturing, wholesale, and retail industries, and small and medium-sized enterprises issued about two-thirds of the total.

Bill financing increased slightly, while interest rates witnessed a downward trend. In the first quarter of 2012, the cumulative amount of commercial bills discounted by financial institutions posted 5.7 trillion yuan, and outstanding discounted bills at end-March stood at 1.8 trillion yuan. The outstanding balance of commercial bills at end-March increased by 257.5 billion yuan from the beginning of the year, with an acceleration of 519.8 billion yuan year on year and accounting for 3.1 percent of all categories of loans, an acceleration of 0.6 percentage points from the corresponding period of the last year. Both the supply and demand for bill financing were on the rise. With economic growth and growth of demand for long and medium-term loans slowing down, as bill assets are characterized by stable returns, strong liquidity, and low risks financial institutions tended to expand their bill financing business to maintain reasonable growth of credit aggregate. Under the current economic circumstances, some enterprises saw a prolonged period of selling their products and receiving payments, and some small and medium-sized enterprises used commercial bills as a deferred payment certificate. As bill discount rates went down, the demand of enterprises for bill discount business increased. In the first quarter of 2012, since liquidity in the banking system was generally abundant, interest rates on the money market showed a downward trend. Furthermore, as the supply increased by a large margin, interest rates on the commercial bill market declined month by month.

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

Stock indices edged up. The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 2263 points and 9410 points respectively at end-March 2012, up 63 and 491 points from the end of the last year. The Growth Enterprise Board (GEB) Index (Chinext Price Index) of the Shenzhen Stock Exchange continued to decline, closing at 679 points at end-March 2012 and shedding 51 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 Shenzhen Stock Exchange was 13.9 times and 22.6 times respectively, barely changed from the end of the last year.

The volume of transactions on the stock market declined by a large margin. In the first quarter of 2012, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 8.9 trillion yuan, a decrease of 34.4 percent year on year, and the daily turnover averaged 153.3 billion yuan, a reduction of 79.6 billion yuan from that during the same period of the last year. The turnover on the Growth Enterprise Board amounted to 598.5 billion yuan, an increase of 39.4 percent year on year. At end-March, the combined market capitalization of the Shanghai and Shenzhen Stock Exchanges increased 4.7 percent from the end of the last year to 17.3 trillion yuan, while the market capitalization of the Growth Enterprise Board increased 4.5 percent to 261.7 billion yuan.

Financing on the stock market declined notably. In the first quarter of 2012, a total of 110.4 billion yuan was raised by enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, additional offerings, and rights issues, 48 billion yuan less than that during the same period of the last year. Among this total, financing on the A-share market posted 99.3 billion yuan, 59.1 billion yuan less than that during the same period of the last year.

5. Total assets in the insurance industry registered steady growth

In the first quarter of 2012, total premium income of the insurance industry amounted to 483.5 billion yuan, and total claim and benefit payments increased 19.6 percent year on year to 117.2 billion yuan. Specifically, total claim and benefit payments in the property insurance sector increased 33.6 percent, whereas those in the life insurance sector increased 8.7 percent.

Total assets of the insurance industry registered steady growth. At end-March, total assets of the insurance industry posted 6.4 trillion yuan, an increase of 17.8 percent year on year. Among this total, bank deposits increased 27.3 percent while investment-linked assets increased 12.6 percent.

Table 7 Use of insurance funds, end-March 2012

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-March 2012	End-March 2011	End-March 2012	End-March 2011
Total assets	63679	54064	100.0	100.0
Of which: Bank deposits	20699	16257	32.5	30.1
Investments	38184	33899	60.0	62.7

Source: China Insurance Regulatory Commission

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

In the first quarter of 2012, the turnover of spot foreign exchange transactions totaled USD872 billion, representing an increase of 7.2 percent year on year. The turnover of RMB foreign exchange swap transactions totaled USD544.5 billion, representing an increase of 61.3 percent year on year; among this total, overnight RMB foreign exchange swap transactions amounted to USD272.6 billion, accounting for 50.1 percent of the total. The turnover on the RMB foreign exchange forward market totaled USD53.4 billion, a decrease of 10.2 percent year on year. In the first quarter, the turnover of foreign currency pair transactions amounted to USD22.8 billion, an increase of 8.8 percent year on year. In particular, the USD/HKD pair constituted the lion's share at 40.5 percent, down 9.5 percentage points from the same period of the last year. The number of participants on the foreign exchange market increased further. At end-March, there were 322 members on the foreign exchange spot market, 74 members on the foreign exchange forward market, 73 members on the foreign exchange swap market, and 28 members on the foreign exchange options market.

7. The gold market maintained stable performance

Turnover on the Shanghai Gold Exchange was stable. In the first quarter of 2012, a total of 846.41 billion yuan of precious metals was transacted on the Shanghai Gold Exchange, an increase of 18.7 percent year on year. Among this total, the trading volume of gold was 1660.4 tons, an increase of 16.5 percent year on year, and its turnover posted 571.01 billion yuan, an increase of 35.4 percent year on year; the trading volume of silver was 4.0 tons, a decrease of 1.3 percent year on year, and its turnover posted 270.79 billion yuan, a decrease of 5.2 percent year on year; the trading volume of platinum was 13.6 tons, a decrease of 13.5 percent year on year, and its turnover posted 4.62 billion yuan, a decrease of 24.7 percent year on year.

The price of gold fluctuated on the domestic market. In the first quarter of 2012, the fixing price on the London Gold Market reached a peak of USD1781 per ounce, and a trough of USD1598 per ounce. The highest gold price on the Shanghai Gold Exchange (AU9995) was 362.5 yuan per gram, and the lowest price was 325.6 yuan per gram. At end-March, the price of gold on the domestic market closed at 339.2 yuan per gram, up 6.1 percent from the end of the last year.

II. Institutional building in the financial market

1. An inter-ministerial coordination mechanism for corporate debenture bonds was established

With the approval of the State Council, an inter-ministerial coordination mechanism for corporate debenture bonds was established, which is led by the PBC and with the National Development and Reform Commission and the China Securities Regulatory Commission as member units. The inter-ministerial coordination mechanism will, under the existing legal framework, promote the relevant departments to strengthen regulatory coordination and information sharing in accordance with the law, and jointly push forward the reform and the healthy and rapid development of the corporate debenture bond market in an effort to further broaden direct financing channels for enterprises, optimize the financing structure, and put the role of the market in resource allocations into full play.

2. Further strengthening supervision of sponsors, and launching a new round of

reform of the IPO mechanism

Efforts were made to strengthen supervision of the business operations of sponsors. On March 16, the China Securities Regulatory Commission issued the *Opinions on Strengthening Supervision of the Sponsorship Business*, requiring sponsors to establish an accountability system for sponsor representatives and members of the sponsorship team. This measure is designed to help improve the mechanism to keep continuous track of the sponsored projects, achieve effective internal control of the sponsoring institutions, strengthen integrity constraints on the sponsors, and promote the reform of the new stock issue system and the accountability of market participants.

Launching a new round of reform of the IPO system. On April 28, the China Securities Regulatory Commission issued the *Guidelines on Deepening the Reform of the New Stock Issue System*. The *Guidelines* specify that, by ensuring the authenticity, accuracy, adequacy, and completeness of disclosed information, efforts should be made to properly adjust the price enquiry range and the placement ratio, to increase free floats of newly listed companies, to strengthen supervision of IPO pricing of and speculation on new stocks, to improve the building of an information disclosure-based IPO system, to make prices of new stocks truly reflect the value of the firm, to promote the balanced and healthy development of the primary and secondary markets, and to protect the legitimate interests and rights of investors.

3. Improving institutional arrangements on the insurance market

Strengthening regulation over insurance clauses and premium rates of life insurance companies. The China Insurance Regulatory Commission issued the *Administrative Rules on Insurance Clauses and Premium Rates of Life Insurance Companies*. According to the *Rules*, insurance companies should formulate their insurance clauses and premium rates on a fair and reasonable basis, and assume the related responsibilities. For insurance clauses and premium rates of insurance products bearing on the interests of the general public and compulsory insurance products, the clauses and rates shall be submitted to the China Insurance Regulatory Commission for review and approval.

Improving the regulatory system for commercial motor vehicle insurance. In February, the China Insurance Regulatory Commission issued the *Administrative Rules for Payments of Motor Vehicle Insurance Claims*, in a bid to regulate and facilitate motor vehicle claim and payment services. In March, the China Insurance Regulatory Commission issued the *Circular on Strengthening Administration of the Clauses on Premium Rates for Motor Vehicle Insurance*. According to the *Circular*, efforts should be made to gradually establish an insurance clause and premium rate formation mechanism which is market-oriented and tailored to China's insurance industry, while property insurance companies that meet certain specified conditions are allowed to formulate a commercial motor vehicle insurance clause and can offer premium rates based on their own data.

In addition, the China Insurance Regulatory Commission issued the *Plan for the Establishment of China's Second-Generation Solvency Supervisory System*. According to the *Plan*, a solvency supervisory regime, which is aligned with international norms and compatible with the current developmental stage of China's insurance industry, within the span of three to five years will build a framework featuring internationally-accepted capital adequacy requirements, risk management requirements, and information disclosure requirements, i.e., the "three pillars."

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q1 2012, global prospects gradually strengthened but downside risks lingered. The U.S. economy showed positive signs with a slowly declining unemployment rate, but the problems of a sluggish housing market, and fiscal and trade deficits were still very much present. Shadowed by the European debt crisis, economic activities in the euro area continued to be disappointing. Factors such as reduced external demand put a brake on the growth of the Japanese economy. And the momentum of growth in most emerging market economies moderated, with some emerging markets facing risks of relatively high inflation and volatile short-term capital flows.

1. Economic developments in the major economies

The U.S. economy showed positive signs with a slowly declining unemployment rate, but the problems of a weak housing market and fiscal and trade deficits were still very much present. GDP growth picked up pace during Q4 2011. Unemployment stood at 8.2 percent in March, the lowest level since 2009. Year-on-year CPI growth moderated at 2.7 percent in March. In February, the trade deficit contracted a bit to USD 46.03 billion, and in March, the federal deficit dropped to USD198.2 billion, indicating improved fiscal conditions.

Shadowed by the European debt crisis, economic activities in the euro area continued to disappoint. In 2011, the growth of the euro area expanded by 1.5 percent but in Q4 quarter-on-quarter GDP growth decreased by 0.3 percent. In particular, year-on-year GDP picked up by 2.0 percent in Germany, increased by 1.4 percent in France, and dropped by 7.0 percent and 2.8 percent respectively in Greece and Portugal due to the deteriorating debt problem in these two countries. The year-on-year HICP edged up 2.7 percent in March, higher than the 2 percent target for 16 consecutive months.

Factors such as reduced external demand put a brake on the growth of the Japanese economy. In Q4 2011, quarter-on-quarter GDP dipped by 0.6 percent, or an annualized 2.3 percent. In March 2012, the core CPI rose 0.2 percent compared with the last year. The Japanese trade deficit registered 2.5 trillion yen in 2011, ending the record thirty-one years of a trade surplus. The trade deficit in the single month of January stood at a stunning 1.48 trillion yen, the highest recorded since such data were first collected in 1979.

Table 8 Macroeconomic and financial indices of the major economies

Country	Index	2011 Q1			2011 Q2			2011 Q3			2011 Q4			2012 Q1		
		Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar
United States	Real GDP Growth Rate (annualized quarterly rate, YOY, %)	0.4			1.3			1.8			3.0					
	Unemployment Rate (%)	9.1	9.0	8.9	9.0	9.0	9.1	9.1	9.1	9.0	8.9	8.7	8.5	8.3	8.3	8.2
	CPI (YOY, %)	1.6	2.1	2.7	3.2	3.6	3.6	3.6	3.8	3.9	3.5	3.4	3.0	2.9	2.9	2.7
	DJ Industrial Average (closing number)	11892	12226	12320	12811	12570	12414	12143	11613	10913	11955	12045	12218	12633	12952	13212
	NASDAQ (closing number)	2700	2782	2781	2874	2835	2774	2756	2579	2415	2684	2620	2605	2814	2967	3092
Euro Area	Real GDP Growth Rate (quarterly, YOY, %)	2.4			1.6			1.3			0.7					
	Unemployment Rate (%)	10.0	10.0	10.0	9.9	10.0	10.0	10.1	10.1	10.2	10.3	10.4	10.4	10.7	10.8	10.9
	HICP (YOY, %)	2.3	2.4	2.7	2.8	2.7	2.7	2.6	2.5	3.0	3.0	3.0	2.7	2.7	2.7	2.7

	EURO STOXX 50 (closing number)	2654	2713	2583	2661	2632	2561	2511	2238	2160	2318	2299	2370	2422	2477	2459
Japan	Real GDP Growth Rate (annualized quarterly rate. %)	-3.7			-2.1			5.6			-2.3					
	Unemployment Rate (%)	4.8	4.6	4.9	4.9	4.6	4.7	4.7	4.4	4.2	4.4	4.3	4.2	4.6	4.5	4.5
	CPI (YOY, %)	-0.8	-0.8	-0.7	-0.2	-0.1	-0.2	0.1	0.2	0.2	-0.1	-0.2	-0.1	-0.1	0.1	0.2
	NIKKEI225 (closing number)	10238	10624	9755	9850	9694	9816	9833	8955	8700	8988	8435	8455	8803	9723	10084

Sources: Statistical bureaus and central banks of the relevant economies

Numerous factors including a downward economic cycle and weakening external demand dampened growth of the major emerging market economies. In Q4 2011, India witnessed a year-on-year GDP growth of 6.1 percent, or a quarter-on-quarter decrease of 0.8 percent, the most acute decline in three years. In March 2012, India's CPI rose by 9.47 percent compared with the last year, or 0.87 percent compared with the last month. In 2011 Brazil scored a mere 2.7 percent expansion. Meanwhile, growth momentum also declined in other emerging market economies, including South Africa, Turkey, Indonesia, and Vietnam.

2. Global financial market development

The exchange rates of the major currencies fluctuated by large swings. When the European debt crisis was temporarily contained and boosted by prospects in the periphery markets, the euro climbed against the US dollar amidst fluctuations. Investor sentiment toward the Japanese yen was dampened due to the first trade deficit in Japan in 31 years and during Q1 the Japanese yen depreciated substantially. At the end of March, the exchange rate of the euro and the Japanese yen against the US dollar stood at 1.3343 US dollar per euro and 82.79 Japanese yen per US dollar respectively, representing an appreciation of 3.07 percent and a depreciation of 7.07 percent from the end of the last year.

The US dollar Libor floated downwards with the joint efforts of several central banks to provide cheap US dollar lending to European banks at the end of last year. On March 30, the 1-year Libor was 1.05 percent, down 0.08 percentage points from the end of last year. Due to the large amount of liquidity injected by the ECB through LTROs, the Euribor receded remarkably. On March 30, the 1-year Euribor was 1.42 percent, down 0.53 percentage points from the end of last year.

The yields of major government securities remained flat and low. From January to mid-March, the agreement on a Greek debt solution program eased market tensions, leading to a rising appetite for risky assets. As a result, yields of U.S., German, and Japanese bonds strengthened by various margins. However, news about a worse-than-expected fiscal deficit in Spain drove down the yields of U.S., German, and Japanese bonds in late March. At the end of March, the yields of 10-year Treasury bonds in the U.S., Japan, and Germany closed at 2.21 percent, 0.99 percent, and 1.81 percent respectively, up 33 basis points, 1 basis point, and down 2 basis points from the end of last year.

The major stock indices rallied. Due to the favorable economic data, stock markets in the U.S. and the euro area rose. At the end of March, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 13212, 3092, 2459, and 10084 respectively, up 8.1 percent, 18.7 percent, 3.8 percent, and 19.3 percent from the end of last year.

3. Housing market development in the major economies

There were signs of recovery in the U.S. housing market but uncertainties still remained. According to the U.S. Department of Commerce, sales of new single-family homes in March 2012 were at a seasonally adjusted annual rate of 328,000 units, up 7.5 percent year on year; in the same month, the median price of new homes stood at USD234,500 per unit, an increase of 9.6 percent year on year. According to the National Association of Realtors, in February 2012 sales of homes reached an annualized 4,590,000 units, up 8.8 percent compared with the same period of last year; and the median price of existing homes also moved up 0.3 percent to USD156,600 per unit.

The European housing market continued to be lackluster and housing prices continued to drift lower. In Q1, the UK Halifax Index contracted by 0.1 percent month on month or 0.6 percent year on year. In February, the start of new construction in France slid by 28.5 percent year on year to 1,967,000 square meters. Shadowed by the sluggish global recovery and the spread of the European debt crisis, housing markets in the EU periphery area remained subdued.

Supported by the demand for post-disaster reconstruction, the Japanese housing market showed signs of stabilization. According to the Ministry of Land, Infrastructure, Transport, and Tourism, starts of new housing picked up 5.0 percent year on year in March 2012; after an initial year-on-year increase of 24.6 percent in January; construction orders received by the 50 big construction companies decreased in both February and March by 1.8 percent and 0.3 percent year on year respectively. On January 1, 2012, the national average price of land in Japan declined by 2.6 percent, registering a four-year decline, though the downward trend was somewhat arrested. And 546 areas in Japan saw rising land prices, twice the number during last year.

4. The monetary policies of the major economies

Against the background of the acute sovereign debt crisis and the elevated financial risks, the central banks of the major advanced economies continued to adopt an accommodative monetary stance. On both January 25 and March 13, the US FOMC decided to keep the target range for the federal funds rate at 0 to 1/4 percent and indicated that the exceptionally low levels of the funds rate might be maintained until at least late 2014. On March 8, the ECB announced it would maintain unchanged the interest rate on the main refinancing operations at 1 percent. On February 29, the ECB resumed the three-year LTROs and injected a total of 529.5 billion euro into the market. The Bank of Japan kept the zero interest-rate policy unchanged and expanded its asset purchase program from 55 trillion yen to 65 trillion yen on February 14, and it also enlarged the growth-supporting funding facility from 3.5 trillion yen to 5.5 trillion yen on March 13. The Bank of England left the Bank Rate unchanged at 0.5 percent and increased its asset purchase program from GBP50 billion to GBP325 billion on February 9.

Based on the anticipated dimmed global growth prospects, some emerging market economies loosened their monetary stance. On January 24 and March 9, India cut its reserve ratio twice by a cumulative 1.25 percentage points to 4.75 percent, and on April 17 it reduced its repo rate by 0.5 percentage points to 8.0 percent. On January 18 and March 8, Brazil cut its benchmark interest rate by a cumulative 1.25 percentage points to 9.75 percent. Indonesia, Thailand, the Philippines, Vietnam, and Chile also reduced their official rates during Q1 while Russia, Mexico, the Republic of Korea, and Malaysia chose to keep their official rates unchanged.

Box 4 The unconventional monetary policy of the ECB

Since the outbreak of the global financial crisis in 2008, the ECB has carried out six kinds of unconventional monetary policy operations to stimulate and economic recovery and to safeguard financial stability. The first is longer-term refinancing operations. As a kind of reserve transaction the ECB provides long-term liquidity to counter parties through standard auctions; the second is a security markets program (SMP), through which the ECB purchases government bonds of heavily indebted EU member states; the third is a covered bond purchasing program, i.e., the ECB's purchase of euro- denominated covered bonds issued in the euro area in both the primary and secondary markets; the fourth is currency swaps with other central banks including the Fed and the Bank of England; fifth is the expansion of eligible collaterals; sixth is an increase in the range of qualified counter parties in its monetary policy operations.

With the development of the subprime crisis and the deterioration of the sovereign debt problem in the euro area, the size of the unconventional monetary policy of the ECB expanded, the measures became more aggressive, and the focus gradually shifted from price stability to financial stability. The first measure launched was a covered bond purchasing program, with the aim of improving liquidity conditions in the bond market and encouraging financial institutions to increase credit supply. The program was to be carried out in two phases. During the first phase, from July 2, 2009 until June 30, 2010, the ECB bought a cumulative 60 billion euros of covered bonds. During the second phase, from November 2011 to October 2012, the ECB planned to buy a total of 40 billion euros of covered bonds. According to the ECB, all the bonds purchased would be held until maturity. This program helped to ease market tensions and ensure abundant market liquidity, but it was inadequate to stop the deepening of the European debt crisis. In the first half of 2010 and against the background of the sharply exacerbating European debt crisis, yields of treasuries of the heavily indebted countries such as Greece and Portugal soared, and liquidity in the sovereign debt market almost dried up. The crisis spread to the interbank market, foreign exchange market, and stock markets. To stabilize financial markets, the ECB established the securities markets program (SMP) to purchase debt instruments issued by governments in the euro area and eligible marketable debt instruments issued by private entities. To satisfy the legal requirement that no direct financing should be provided to member state governments in the euro area and to distinguish them from quantitative easing policies, the SMP implemented specific weekly operations to re-absorb the injected liquidity and thereby ensure that the current and future monetary policy stance would not be affected. By March 30, the ECB had purchased a total of 214.2 billion euros of government bonds. However, the SMP failed to curb the spread of the European debt crisis. In the latter half of 2011, the yields of treasuries in those heavily indebted countries rocketed to a new high and the crisis began to loom in the EU core countries and their banking systems. Under such circumstances, the ECB extended the term of LTROs from three months to three years, and removed the limits on the auction amount in order to stabilize the financial market. On December 21, 2011 and February 29, 2012, the ECB injected a total of 1018.5 billion euro into the market through two rounds of LTROs with an unlimited auction amount. The two rounds of operations pumped liquidity adequate for three years of use into the banking system of the euro area and thereby lowered the possibility of a breakout of a banking crisis in the short run. At the same time, banks used part of the funds acquired to buy sovereign debts, controlling the soaring yields of sovereign debts and alleviating market panic. The European debt crisis was temporarily tamed.

Apart from the above-mentioned three unconventional monetary measures, currency swaps, expansion of the range of eligible collateral, and an increase in qualified counterparts also supplemented the tool box of the ECB to fight the crisis. To be specific, currency swaps gave the ECB easy access to the US dollar, which could readily be provided to the euro area banking system; during the crisis, the total eligible collateral assets accepted by the ECB expanded from 1 trillion euro to 3 trillion euro, enhancing financing through other monetary policy tools; and more qualified counter parties meant that liquidity could penetrate to extended areas and monetary policy transmissions would be more effective.

In general, the launch of an unconventional monetary policy by the ECB greatly improved the stability of the European financial market, curbed the yields of treasuries to within a sustainable range, and won precious time for a fundamental structural reform in Europe. However, the unconventional monetary policy operations came with a price, including potential damage to the credibility of the ECB and the impact caused by policy exit. During the crisis, the assets of the ECB bulged due to the lowering of the threshold for eligible collaterals, which to some degree compromised the credibility of the euro. As a result, the exchange rate of the euro fluctuated downwards. Because the assets purchased under the covered bond program and the SMP can be held until their maturity, and the time and scale of exit are thus fixed, the impact of the unwinding on the financial market will be small. The exit of the LTRO should be closely followed. Under the LTRO arrangement, banks could repay their lending before maturity. However there might be a so-called cliff effect caused by the large-scale repayment of lending upon maturity, leading to huge shocks to the financial market.

5. World economic outlook

In its *World Economic Outlook* published in April 2012, the IMF projected that global prospects would gradually strengthen in 2012 but downside risks would remain elevated. Global growth was projected to drop to about 3.5 percent in 2012, with the United States expanding by 2.1 percent and the euro area sliding to –0.3 percent. Due to the post-disaster recovery of the industrial chain, activities in Japan are projected to rebound to 2.0 percent and that of the emerging economies are projected to soften to 5.7 percent.

Looking further ahead, the challenges facing the global economy include: first, the possibility that European debt crisis will flare up again poses the greatest uncertainties to the global economy; second, the geopolitical risks caused by the Iranian nuclear impasse might lead to a hike in oil prices; third, the accommodative monetary policies in the major advanced economies may bring latent inflation risks and volatile capital flows; fourth, economic growth will generally weaken in the emerging market economies.

II. Analysis of China's macroeconomic performance

China’s economy grew steadily in the first quarter of 2012. Agricultural production was bumper, industrial production remained stable, imports and exports continued to grow, and household income grew relatively fast. In March, the major economic indicators such as the industrial added value of statistically large enterprises, and the growth of retail sales rebounded from January and February. In general, price levels declined. In the first quarter, the Gross Domestic Product (GDP) registered 10.8 trillion yuan, up 8.1 percent year on year, representing an acceleration of 1.6 percentage points from the same period of last year and up 1.8 percent quarter on quarter. The Consumer Price Index (CPI) was up 3.8 percent year on year, a decrease of 1.2 percentage points from the same period of last year. The trade surplus posted US$670 million.

1. Consumer demand grew steadily, and investment growth moderated from an elevated level

Supported by the rapid income gains of urban and rural residents, domestic consumer demand increased steadily. In the first quarter, the per capita disposable income of urban households posted 6,796 yuan, representing year-on-year growth of 14 percent and price-adjusted real growth of 9.8 percent. The per capita cash income of rural households registered 2,560 yuan, up 17 percent in nominal terms or 12.7 percent in real terms. The PBC survey of urban depositors in the first quarter shows that the residents' income index was up by 1.0 percentage points from the previous quarter to reach 51.9 percent; the confidence index in income gains fell by 0.4 percentage points from the previous quarter to 54.9 percent. The propensity to spend on vehicles, large-value goods, and tours increased, whereas the propensity to invest in real estate continued to pull back. In the first quarter, retail sales of consumer goods totaled 4,931.9 billion yuan, a year-on-year increase of 14.8 percent and a deceleration of 1.5 percentage points, or up 10.9 percent in real terms and a deceleration of 0.7 percentage points. Broken down by urban and rural areas, retail sales in urban areas registered 4,268.8 billion yuan, up 14.9 percent year on year, whereas retail sales in rural areas grew 14.6 percent year on year to 663.1 billion yuan.

The growth of fixed-asset investments moderated from an elevated level. In the first quarter, fixed-asset investments (excluding investments by rural households) totaled 4,786.5 billion yuan, up 20.9 percent year on year, representing a deceleration of 4.1 percentage points from the same period of last year. The price-adjusted real growth posted 18.2 percent. Among the total, investments by state-owned and state shareholding enterprises grew 9.0 percent year on year to 1,519.1 billion yuan. Broken down by region, growth in the central and western regions notably outpaced that in the eastern region, with growth in the eastern, central, and western regions registering 18.9 percent, 27.1 percent, and 26.9 percent respectively. Broken down by industry, fixed-asset investments in the primary, secondary, and tertiary industries grew 35.8 percent, 24.6 percent, and 17.6 percent respectively, representing an acceleration of 25.0, -0.2, and -8.0 percentage points respectively from the same period of the previous year.

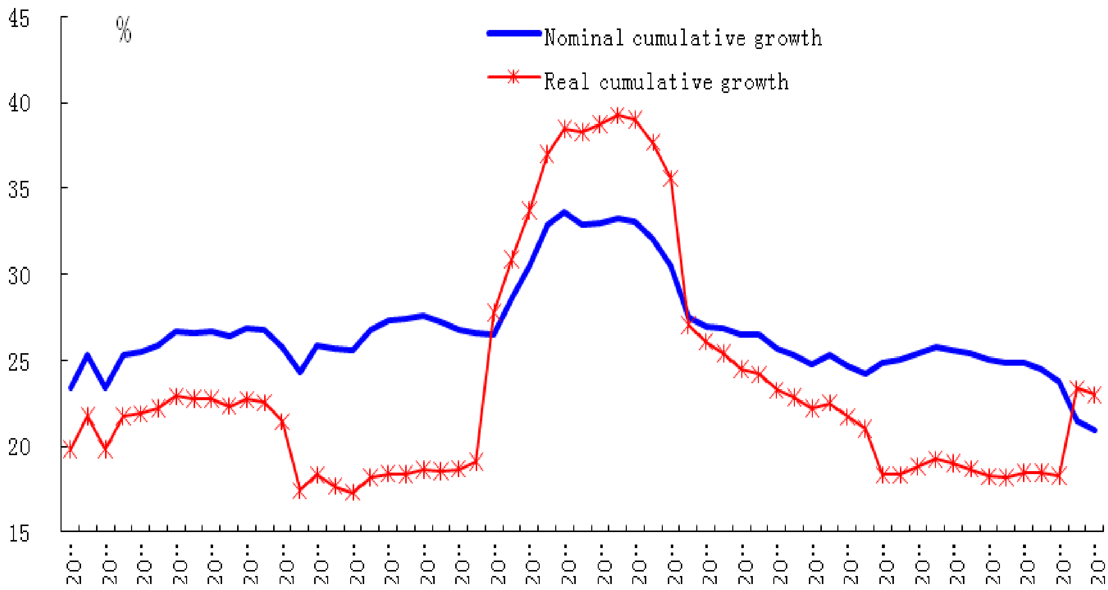


Figure 3 Growth of fixed-asset investments

Sources: National Bureau of Statistics, People's Bank of China

Imports and exports continued to grow. In the first quarter, exports increased by 7.6 percent year on year to USD 430 billion, and imports were up 6.9 percent year on year to USD 429.4 billion, resulting in a trade surplus of USD670 million. Exports of mechanic and electric products grew by 9.0 percent year on year, 1.4 percentage points faster than the growth of all exports in the same quarter of last year; exports of labor-intensive products posted year-on-year growth of 3.3 percent, about 4.3 percentage points slower than the overall export growth. The quantities and prices of major imported commodities presented a mixed picture in the first quarter. The import volume of iron ore was up by 6.0 percent year on year, whereas the average price dropped by 12.6 percent; the import volume and average price of crude oil registered year-on-year growth of 11.4 percent and 20.1 percent respectively; imports of crude copper and copper products increased by 50.5 percent, whereas their average price fell by 13 percent year on year.

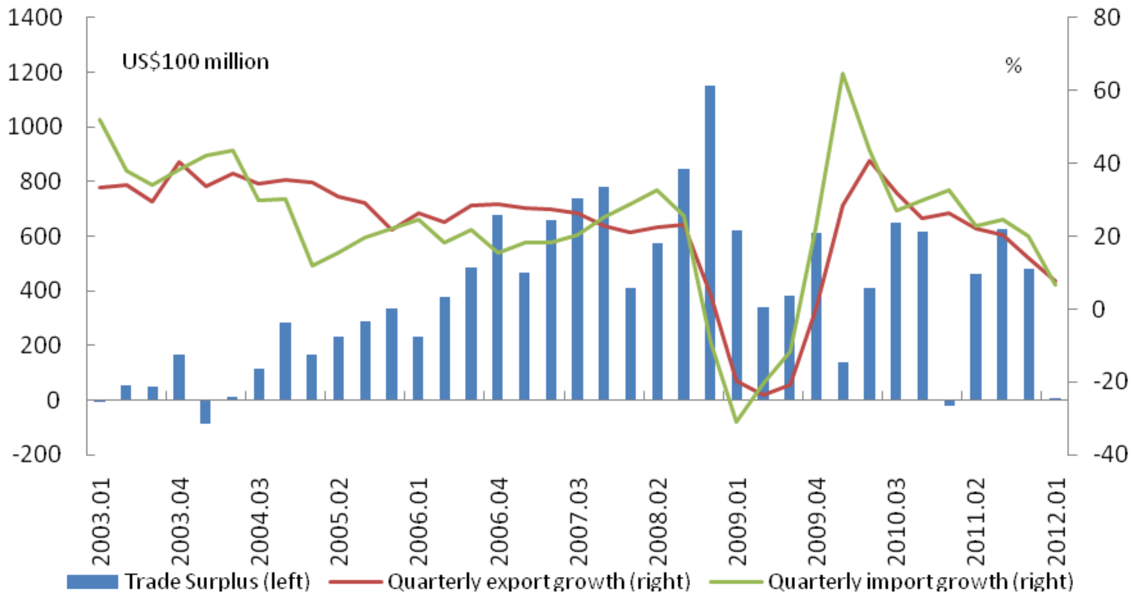


Figure 4 Import and export growth and the trade balance

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

2. Agricultural production performed well and industrial production accelerated moderately

In the first quarter, the value-added of the primary, secondary, and tertiary industries reached 692.2 billion yuan, 5,145.1 billion yuan, and 4,962.2 billion yuan respectively, up 3.8 percent, 9.1 percent, and 7.5 percent. The shares of the three industries in GDP were 6.41 percent, 47.64 percent, and 45.95 percent respectively.

Agricultural production went well. The survey of 70,000 rural households shows that the sowing area for spring crops in 2012 remained stable, and grain output continued to grow. In particular, the sowing area of early-season rice will reach 5.8 million hectares, up 50,000 hectares from 2011, and the area of maize will continue to increase. In the first quarter, the total output of meat (including pork, beef, mutton, and poultry) posted 22.27 million tons, up 3.9 percent year on year. In particular, pork production grew by 4.0 percent to reach 15.11 million tons.

Growth of industrial production rebounded, whereas corporate profits slid. In March, the value-added of statistically large enterprises grew by 11.9 percent year on year, representing an acceleration of 0.5 percentage points from January and February. In March, the seasonally adjusted industrial value-added was up by 1.22 percent month on month, representing an acceleration of 0.59 and 0.38 percentage points respectively from January and February. The profitability of industrial enterprises fell modestly. In the first quarter, the profits of statistically large enterprises posted 1,044.9 billion yuan, down by 1.3 percent year on year. Industrial production and sales were well connected, as 97.5 percent of all industrial products were sold in the first quarter, at a par with the same period of last year. The survey of 5,000 industrial enterprises conducted by the PBC in the first quarter reveals that the business index dropped by 3.2 percentage points from the previous quarter to 64.4 percent. Market demand continued to slide. The export orders index and the domestic orders index registered 46.9 percent and 50.5 percent respectively, down by 1.8 and 2.6 percentage points respectively from the fourth quarter of 2011. Affected by the slowing growth of sales, the inventory index of finished products posted 54.4 percent, up by 1.1 percentage points from the previous quarter. Corporate profitability weakened, as the profitability index went down by 4.4 percentage points from the previous quarter to 51.2 percent.

3. The hike in consumer prices moderated, and the increase in producer prices fell markedly

Growth of the general price level pulled back steadily due to stable economic performance, the improved supply of food items, and the significant drop in prices of upstream products.

In general, the hike in consumer prices moderated. In the first quarter, the CPI gained 3.8 percent year on year, decelerating by 0.8 percentage points from the previous quarter. In quarter-on-quarter terms, the CPI was up by 0.5 percent, at a par with the average level in the same time period from 2005 to 2011. The CPI grew 4.5 percent, 3.2 percent, and 3.6 percent year on year respectively in the three months of the first quarter respectively. Excluding the base period factor, the new price rising factor remained basically stable. Within the CPI basket, prices of food items grew 8.0 percent year on year in the first quarter, driving the CPI up by 2.6 percentage points; the counter-seasonal price increase of fresh vegetables in March at 6.1 percent in month-on-month terms was the major contributor to the recovery of the food price increase; prices of non-food items gained 1.8 percent, shoring up the CPI by 1.2 percentage points; affected by the oil price hike on the international market, prices of transportation, water, electricity, and fuel rebounded somewhat, causing prices of transportation, communications, and accommodations to increase by a magnitude greater than the historical average in quarter-on-quarter terms during the first quarter.

Growth of producer prices decelerated markedly. In the first quarter, ex-factory producer prices of industrial products grew 0.1 percent year on year, representing a deceleration of 3 percentage points from the fourth quarter of last year. Monthly growth presented a downward trend, posting 0.7 percent, 0.0 percent, and -0.3 percent in the three months respectively. Prices of capital goods dropped by 0.3 percent year on year, whereas prices of consumer goods gained 1.7 percent year on year. The industrial producer purchasing price index posted 2.0 percent, 1.0 percent, and 0.1 percent in the three months respectively, averaging 1.0 percent and representing a deceleration of 4.5 percentage points from the previous quarter. The Corporate Goods Price Index (CGPI) was up 0.7 percent in year-on-year terms, representing a deceleration of 3.1 percentage points from the previous quarter. With regard to monthly movements, the year-on-year growth of the CGPI index decelerated for 8 consecutive months, and posted 1.3 percent, 0.6 percent, and 0.3 percent respectively year on year in the three months of the first quarter. Broken down by the production stage of the goods in the CGPI basket, prices of primary products posted the sharpest slowdown, with an increase that was 14 percentage points lower than that during the same period of last year. Broken down by the application of the goods in the CGPI basket, the prices of capital goods registered the most significant slowdown, with an increase that was 7.8 percentage points lower than that during the same period of last year. In the first quarter, growth of producer prices of the major agricultural products was up 9.2 percent year on year, 0.2 percentage points higher than the price index of agricultural capital goods.

Import prices grew in quarter-on-quarter terms, but the growth rate declined year on year. Affected by geopolitical tensions and other factors, the prices of crude oil and other commodities increased modestly. In the first quarter, the average price of crude oil futures on the New York Mercantile Exchange increased by 9.5 percent quarter on quarter, and 9.0 percent year on year. The average Brent crude oil spot price in the first quarter gained 8.5 percent quarter on quarter, and 12.6 percent year on year. The average prices of spot copper and aluminum on the London Metals Exchange grew 10.9 percent and 4.2 percent respectively quarter on quarter. Affected by the high base period factor in 2011, growth in import prices continued to decelerate year on year. In the first quarter, import prices gained 7.0 percent, 5.4 percent, and 0.0 percent in the three months respectively, averaging 4.1 percent. Export prices were up by 6.9 percent, 5.1 percent, and 2.1 percent in the three months respectively year on year, averaging 4.7 percent.

The GDP deflator fell modestly. GDP registered 10.8 trillion yuan in the first quarter, up 8.1 percent year on year in real terms. The change in the GDP deflator (as a ratio of nominal GDP versus real GDP) was 2.9 percent, down 4.2 and 4.6 percentage points from the same period of last year and the annual figure in 2011.

Reform of the resource products pricing mechanism was advanced steadily. Having approved the *Opinions on Advancing Key Economic Reforms in 2012* proposed by the National Development and Reform Commission, the State Council decided to continue to push ahead steadily with the electricity tariff reform, to implement the reform program of tiered pricing of electricity for the household sector, and to improve the pricing mechanism for hydro power, nuclear power, and power generated by renewable resources. The State Council also decided to deepen the market-oriented pricing reform of oil products, and will finalize a reform agenda when appropriate. In addition, efforts will be made to deepen the pilot scheme for the natural gas pricing mechanism, and to set out and adjust the criteria for charging a water resources fee.

4. Growth of fiscal revenue growth slowed down considerably, whereas fiscal expenditures grew rapidly

In the first quarter, fiscal revenue (excluding debt income) surged by 14.7 percent year on year to 2,997.6 billion yuan, representing a deceleration of 18.4 percentage points from the same period of the previous year, whereas fiscal expenditures registered 2,411.8 billion yuan, up 33.6 percent year on year, representing an acceleration of 7.6 percentage points from the same period of the previous year. As a result, revenue was 585.8 billion yuan more than expenditures.

As for the structure of fiscal revenue, tax revenue posted 2,585.8 billion yuan for the first quarter, up 10.3 percent year on year and representing a deceleration of 22.1 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 5.4 percent, 13 percent, 20.5 percent, 7.6 percent, 15.1 percent, and -6.2 percent respectively year on year. Revenue from these six tax items accounted for 77.46 percent of total national fiscal revenue.

As for the structure of fiscal expenditures in the first quarter, the five fastest growing spending items included transportation, government-subsidized housing, diplomatic affairs, medical services, and environmental protection and energy conservation, up by 102.1 percent, 74.7 percent, 70.1 percent, 68.2 percent, and 64.8 percent respectively year on year. In the expenditure basket, the five largest items were social security and employment, education, general public services, agriculture, forestry and water related issues, and urban and rural communities, accounting for 15.7 percent, 14.5 percent, 10.2 percent, 8.8 percent, and 7.5 percent respectively of fiscal expenditures, and up by 33.2 percent, 34.7 percent, 19.8 percent, 38.0 percent, and 40.8 percent respectively year on year.

5. The balance of payments improved further

In 2011, though posting a twin surplus, China's balance of payments (BOP) continued to improve. The current account surplus declined by 15 percent year on year to USD201.7 billion, the capital and financial account surplus was down by 23 percent year on year to USD221.1 billion. The share of the current account in GDP stood at 2.8 percent, a drop of 1.2 percentage points from 2011.

The stock of external debt increased rapidly, and the share of short-term external debt rose. As of end-2011, the stock of China's external debt stood at USD695 billion, up 26.6 percent year on year. Among this total, the stock of registered external debt posted USD445.8 billion, up 32 percent year on year; short-term external debt posted USD500.9 billion, a year-on-year increase of 33.3 percent accounting for 72.1 percent of the total, and an acceleration of 3.7 percentage points from end-2011.

6. Sectoral analysis

Industrial profits declined year on year, but at a slower pace. In the first quarter, profits of statistically large industrial enterprises reached 1,044.9 billion yuan, down by 1.3 percent year on year; however, the decline was 3.9 percentage points less than that in the first two months of the year. Furthermore 27 out of the 41 industrial sectors reported a year-on-year growth in profits, whereas 11 sectors experienced a year-on-year decline in profits. Among industries, the profits of the oil and natural gas exploration industry, the agricultural products processing industry, and the electricity generation, heating industry, and power distribution industry grew by 10.6 percent, 17.7 percent, and 28.3 percent respectively year on year; the profits of the chemical raw materials and chemical products manufacturing industry, and the ferrous metals smelting and rolling industry fell by 23.1 percent and 83.5 percent respectively year on year; the oil refinement industry and the coking and nuclear fuel-processing industry became loss-making. Growth of coal, electricity, petroleum, and transportation slowed down. In the first quarter, coal production grew 5.6 percent year on year to reach 861 million tons, power generation increased 6.58 percent year on year to reach 1,139.1 billion kilowatt hours, crude oil output was down by 1.51 percent year on year to reach 50.7 million tons, and the volume of cargo transportation rose 11.8 percent year on year to reach 9.06 billion tons.

(1) The real estate sector

In the first quarter of 2012, the real estate market continued to stabilize. More cities experienced year-on-year declines in housing prices. Investment in real estate development moderated. The growth of real estate loans extended by the major financial institutions continued the declining trend. Credit to government-subsidized housing increased continuously.

More cities witnessed year-on-year declines in housing prices. In March, the prices of newly built commercial residential housing dropped year on year in 38 out of 70 large- and medium-sized cities, 29 more than in December 2011; prices fell month on month in 46 cities, remained flat in 16 cities, and rose in 8 cities. Among the cities with month-on-month price hikes, no cities reported growth higher than 0.2 percent. The price of pre-owned residential housing fell in year-on-year terms in 49 cities, 20 cities more than in December; prices dropped in month-on-month terms in 42 cities, remained flat in 12 cities, and rose in 16 cities.

Sales of commercial real estate went down year on year. In the first quarter, the sold floor area of commercial real estate posted 152.39 million square meters, down 13.6 percent year on year, compared to 4.9 percent in 2011. Sales of commercial real estate were down 14.6 percent year on year to 867.2 billion yuan, compared to 12.1 percent in 2011. In particular, the sold floor area and sales value of commercial residential housing accounted for 87.8 percent and 81.9 percent of the sold floor area and sales value of commercial housing.

Real estate development investment slowed down gradually. In the first quarter, investment in real estate development totaled 1,092.7 billion yuan, up 23.5 percent year on year (or 20.7 percent in real terms), representing a deceleration of 4.4 percentage points from the previous year. In particular, investment in residential housing reached 744.3 billion yuan, accounting for 68.1 percent of the total investment in development. In the first quarter, the floor area of newly built housing grew 0.3 percent year on year to 400 million square meters, a deceleration of 15.9 percentage points from 2011. The floor area of housing under construction grew 25.0 percent year on year to 4.09 billion square meters, a deceleration of 0.3 percentage points from 2011. The floor area of completed housing stood at 180 million square meters, up 39.3 percent year on year and representing an acceleration of 26.0 percentage points from 2011.

Growth of real estate loans continued to decelerate, and new loans decreased. As of end-March, outstanding real estate loans of the major financial institutions (including foreign financial institutions) posted 11.0 trillion yuan, an increase of 10.1 percent year on year and a deceleration of 3.8 percent from end-2011. Among this total, outstanding land development loans were down 8.0 percent year on year to 771 billion yuan, representing an acceleration of 0.1 percentage points from end-2011. Outstanding housing estates development loans grew by 11 percent year on year to 2.83 trillion yuan, decelerating by 6.1 percentage points from the end of the previous year. Outstanding mortgage loans registered 7.3 trillion yuan, up 12.1 percent year on year, a deceleration of 3.4 percentage points from end-2011 and marking the 23rd successive month of decline since May 2010. As of end-March, outstanding land and housing loans accounted for 19.7 percent of total outstanding loans, 0.4 percentage points less than that at end-2011. In terms of new loans, in March new real estate loans reached 85.3 billion yuan, a decrease of 81.5 billion yuan year on year. In the first quarter, new loans to the real estate sector accounted for 10.2 percent of total new loans, down 7.3 percentage points from the annual figure in 2011.

Credit support to government-subsidized housing was gradually reinforced. It is planned that in 2012 7 million units of government-subsidized housing and renovations of shanty housing will break ground, out of which 5 million units will be completed. As of end-March, outstanding loans for government-subsidized housing reached 430.6 billion yuan, accounting for 15.2 percent of the total real estate development loans (starting from 2012, real estate development loans for renovation of shanty housing are included in the statistics on development loans for government-subsidized housing). This figure represents an increase of 39.1 billion yuan in the first quarter, accounting for 47.1 percent of the new loans to real estate development during the same period. Moreover, the pilot program too use housing provident fund loans to support the construction of government-subsidized housing was advanced steadily. As of end-March, loan approvals amounted to 39.92 billion yuan, out of which 28.85 billion yuan in loans was disbursed by commercial banks in 29 cities entrusted by the Housing Provident Fund Management Center.

(2) The oil industry

Oil is an important strategic resource for economic development. As a developing country, China has been consuming a growing amount of oil as its economy has been developing. The *National Mineral Resources Planning (2008-2015)* predicts that China's oil consumption will break the 500 million tons threshold by 2020. Compared to demand, production capacity is apparently insufficient. Crude oil output in 2011 was merely 204 million tons. The huge demand gap has to be filled by imports; however, the fact that excessive dependence on imported oil will make economic development vulnerable to imported inflationary pressures and energy safety issues has attracted wide attention.

Growth of oil production slowed down. CNOOC's production has not resumed its normal level since the oil leak accident of ConocoPhilips; as a result, crude oil output declined, and the growth of crude oil processing and output of oil products decelerated. In the first quarter, crude oil output registered 50.704 million tons, down by 1.5 percent year on year, compared to an increase of 6.7 percent in the same period of 2011. The volume of processed crude oil and the output of oil products (including long-steam diesel) grew by 3.1 percent and 5.6 percent respectively year on year to 114.908 million tons and 69.146 million tons, representing a deceleration of 7.0 and 4.8 percentage points from the same period of the previous year. In the first quarter, industrial added value of the oil and natural gas exploration industry and the coking and nuclear fuel processing industry gained 2.6 percent and 6.1 percent respectively in cumulative terms year on year, a deceleration of 5.6 and 4.9 percentage points compared with the first quarter of 2011.

Rapid growth of oil imports increased China's dependence on foreign output. In 2011, China overtook the U.S. as the largest oil importer and consumer. In the first quarter of 2012, China's crude oil imports reached a new record high of 70.61 million tons, up by 12.7 percent year on year.

Rising oil prices have added to the cost pressures on the oil processing industry. At end-March, affected by geopolitical uncertainties, the prices of the WTI and Brent crude oil futures posted 103 and 123 dollars per barrel respectively, up 4.24 percent and 4.43 percent from the end of 2011. At the same time, the average price of imported crude oil has been on the rise for 18 successive months, exerting more pressures on the refinery industry. Since the latter half of 2010, though the National Development and Reform Commission raised the ex-factory prices of oil products on seven occasions, growth of the cumulative profits in the oil processing and the coking and nuclear fuel processing industries has remained in the negative zone for 12 consecutive months, and since February 2012 annual cumulative profits have turned into losses.

A new way of thinking is needed during the 12th Five-Year Plan period in order to reduce reliance on imported oil and to promote healthy economic development. First, efforts should be made to diversify energy sources, to promote energy and oil efficient technologies, to promote energy recycling, and to adjust the energy consumption structure appropriately. Second, an oil reserve system should be set up expeditiously at four levels, namely at the national strategic level, the local government level, the level of SOEs directly affiliated with the central government, and the small and medium-sized enterprises level, which, combined with strengthened international cooperation in pursuit of import diversification, can effectively deal with short-term oil supply shocks. Third, the market-based oil products pricing reform should be improved, and the pilot program to reform natural gas pricing should be deepened. Efforts should be made to advance the tax reform of oil and natural gas resources, and to adjust the criteria for levying a special tax on oil-related income in order to make oil prices reflective of the economic, environmental, and safety costs as accurately as possible based on the market mechanism. Fourth, the Chinese government should prudently promote the building of a market for commodity futures trading, including crude oil futures, and should become involved in rules making in order to influence the international oil price formation process to the extent that the price reflects market demand and supply in China and reflects China’s national interests.

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

I. Outlook for the Chinese economy

At present, given the favorable conditions and many positive factors, the Chinese economy is likely to continue its steady growth. In terms of international circumstances, the U.S. economic recovery has become more pronounced, the building of a firewall in the euro area and the long-term refinancing operations conducted by the ECB have contributed to an easing of the European debt crisis, and the OECD comprehensive leading index has continued to rise since November 2011. In general, external demand conditions have improved somewhat. In terms of the domestic situation, localities are keen to promote urbanization, industrialization, and balanced regional development, growth in the central and western regions has accelerated, and there is great potential for industrial upgrading and development in the services sector. As a result, the momentum for long-term stable growth remains unchanged. The adoption of a series of fine-tuning and preemptive macroeconomic measures since 2012 has helped maintain the momentum of steady economic growth. The growth of industrial production, electricity generation, and money and credit aggregates all quickened in March, and start-up projects increased by a large margin in the first quarter. According to the PBC’s survey of enterprises, bankers, and urban depositors in Q1 2012, the bankers’ macroeconomic confidence index and the enterpreneurs' macroeconomic confidence index were up by 5.6 and 1.8 percentage points respectively from the previous quarter; the enterpreneurs' market demand expectation index and the domestic and external order expectation indices all registered gains; and the household employment expectation index was also up by 0.7 percentage points from the previous quarter. However, it should be noted that the current domestic and external economic situations are still very complicated and unstable. The European debt issue remains to be solved, and the prospects for a global recovery are uncertain. The uneven, unbalanced, and unsustainable problems remain obvious in China's economic performance, aggregate demand faces both upside and downside pressures, stable export growth is difficult to achieve, the profitability of some enterprises has declined moderately, the real estate market is in the course of adjustment, and the process of economic restructuring may have some short-term impact on economic growth. Therefore, potential risks in the real economy and financial sectors should not be neglected.

The hike in the general price level pulled back steadily, but it still remains unstable, and the upside risks to future price spikes merit attention. At present, the reasonable growth of aggregate demand and supply, relatively favorable monetary stance, and the relatively stable external and liquidity conditions on the domestic market are contributing to price stability. According to the PBC's survey of urban depositors in Q1 2012, the price expectation index posted 62.1 percent, falling 3.3 percentage points from the previous quarter; the proportion of respondents who expected prices to rise in the next quarter fell 5.4 percentage points; and expectations for future housing price hikes also slowed down. In the meantime, the relationship between economic growth and price levels is changing, and compared with previous periods the latter have become more sensitive to the expansion of aggregate demand. As the Lewis turning point is approaching and labor supply in the domestic market is gradually tightening, the upward pressures of prices of labor-intensive agricultural products, services, and resource products remain. Once aggregate demand expands, an upward momentum may potentially reemerge. Furthermore, imported inflationary pressures from the volatility in commodities prices on the international market are looming. The moderated growth of the general price level in the latter half of 2011 was the outcome of many measures, and as the price situation eases, the prices of those goods whose price hikes had been constrained in previous periods may resurge. Although the year-on-year growth of the CPI may continue to moderate in the short run, this is partly related to the high base in the corresponding period of the previous year, and more attention should be paid to the seasonally adjusted month-on-month CPI growth.

In general, the current economic growth and employment situations are relatively stable, the balance of payments has become more balanced, and growth of the general price level is declining precariously and is very sensitive to any rebound in economic growth. Therefore, efforts should be made to maintain the current relatively balanced economic performance. Due to the changing demographic structure, intensifying resource and environmental constraints on economic growth, and shifting economic growth patterns, the relationship among economic growth, employment, and inflation may have changed significantly from past years. To better manage the relationship between economic growth and inflation, efforts should be made to improve supply management, increase production efficiency, reduce transaction costs, and improve income distribution. Maintaining stable economic growth while promoting economic restructuring and the shift in the growth pattern will contribute to healthy and sustainable economic growth in the medium to long term, and will be conducive to greater potential in long-term economic growth.

II. Monetary policy in the next stage

Going forward, the PBC will follow the overall arrangements of the Central Economic Work Conference, the National Financial Work Conference, and the Report on the Work of the Government, take sustainable development as the central theme, and acceleration in the shift of the growth pattern as the core of its policy conduct, strive for steady improvement, maintain the consistency and stability of macroeconomic policies, and properly handle the relationship among economic growth, restructuring, and price levels. Efforts will be made to continually implement a prudent monetary policy, closely monitor economic and financial developments at home and abroad, pay attention to structural changes in aggregate demand, enhance the targeted, flexible, and forward-looking nature of macroeconomic measures, initiate fine-tuning and preemptive adjustments as appropriate, improve the quality of financial services to the real sector, effectively mitigate systemic financial risks and maintain stability in the financial sector, and keep overall price levels generally stable, so as to promote stable and fairly rapid economic growth.

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

Second, credit resource allocations will be optimized to support economic restructuring and to better serve the real sector. The coordination of credit and industrial policies will be enhanced, evaluations of the effect of credit policy will be advanced, and the role of the dynamic adjustment mechanism of the differentiated deposit reserve requirement ratio in optimizing the credit structure will be put into full play, so as to guide financial institutions to manage the pace and structure of credit extensions and to implement a differentiated credit policy. A multi-layered, diversified, and competitive rural financial service system will be built to better serve agriculture, rural areas, and farmers. Financial institutions will be encouraged to make innovations in financial products and services to increase effective credit inputs to enterprises that comply with industrial policies, in particular micro and small enterprises, and on-going key national projects and their follow-up projects. Emphasis will be placed on supporting people's welfare projects, under-developed regions, emerging strategic industries, modern services industries, high-end manufacturing sectors, the cultural industry, tourism industry, and so on. Continued efforts will be made to render credit support to the construction of government-subsidized housing projects and the purchase of ordinary commercial housings by first-time home-owners. Lending to high energy-consuming and highly polluting industries and those with excess capacity will be strictly controlled. The PBC will guide and urge commercial banks to establish a philosophy of "sound performance while earnestly supporting the real economy" to strengthen internal management and to rectify the supplemental clauses that include additional conditions and the charge of improper fees in their financial services.

Third, the market-based interest rate reform and the RMB exchange-rate regime reform will be advanced, and efforts will be made to improve the efficiency of resource allocations and to perfect the macroeconomic management mechanism. Measures will be taken to cultivate a system of market base rates to encourage financial institutions to enhance their risk-pricing capacity. The PBC will explore an effective approach for advancing the market-based interest rate reform, and the central bank's capacity to guide market rates will be further improved. 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 continually improve its foreign exchange operations model, reduce the frequency of interventions, and enhance the flexibility of its policy conduct so that market demand and supply will 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 settlements in cross-border trade and investments will be expanded, and the channel for inflows and outflows of RMB funds will be broadened. Further progress will be made in opening the interbank foreign exchange market for trade with the emerging market currencies against the RMB to facilitate RMB settlements of cross-border trade. 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, the sound development of the financial market will be promoted, and the reform of financial institutions will be deepened. Efforts will be made to step up support for direct financing, to promote innovations in financial markets, and to broaden the financing channels for small and micro enterprises. Emphasis will be placed on the role of the market mechanism, and measures will be adopted to consolidate and strengthen the building of a market infrastructure, and to enhance supervision and management and awareness of risk prevention, so as to promote the healthy and sound development of financial markets. The reform of large commercial banks will be advanced to continually improve corporate governance, the modern financial enterprise system, and internal governance and risk management, and to increase their innovative and development capacity and international competitiveness. The PBC will follow the progress and provide guidance to the pilot program for the reform of the County Area Banking Division of the Agricultural Bank of China and encourage the Agricultural Bank of China to improve its financial services to the agricultural sector. The 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 specific guidance. The reform of the Postal Savings Bank of China will be deepened, and the commercial transformation of asset management companies will be advanced. Efforts will be made to implement the tasks of Wenzhou's pilot financial reform scheme and to promote the healthy development of private financing based on the laws and regulations. Private capital will be encouraged to take part in the reform of local financial institutions, and the development of new types of financial organizations will be advanced.

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 run their businesses soundly. Financial institutions will be urged to strengthen internal control and risk management, and monitoring and management of lending to local government financing platforms, financial institutions, off-balance sheet business, and the financing of the real estate sector will be strengthened. Measures will be adopted to prevent cross-sector and cross-market risks, and to prevent risks from spreading from the informal financial sector and related sectors to the 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.