China Monetary Policy Report
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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In 2014 the Chinese economy performed within a reasonable range and made progress in terms of structural adjustments. The proportion of value-added of tertiary industry continued to increase. The income gap between rural and urban residents further narrowed, and consumption made a greater contribution to economic growth. Consumer prices picked up moderately, while employment remained stable. In 2014 GDP growth was 7.4 percent year on year and the consumer price index was up 2.0 percent year on year.

In accordance with the decisions and overall arrangements of the Party Central Committee and the State Council, the PBC has continued its sound monetary policy. In the complex environment with the combined effects from the economic slowdown, the structural adjustments, and the absorption of previously implemented policies, the PBC remained focused and proactive, continuing to supplement and improve its toolkit and to optimize the combination of policy measures, tackling salient issues in economic performance, and conducting pre-emptive adjustments and fine-tunings by way of structural adjustments. Against the background of the decline in the RMB equivalent of foreign-exchange purchase, the PBC took the initiative to enhance the capacity of the base money supply and made comprehensive use of various monetary policy tools, including open market operations, short-term liquidity operations, and the Standing-Lending Facility to maintain aggregate liquidity at an adequate volume. Medium-Term Lending (MLF) and Pledged Supplementary Lending (PSL) facilities were introduced to encourage financial institutions to provide low-cost financing for the real sector supported by national policies. The PBC also asymmetrically lowered the benchmark lending and deposit interest rates and increased the flexibility of the interest rates for open market operations to reduce the financing costs for the overall society. Targeted reserve ratio cuts were carried out on two occasions, management of desirability lending was improved, and a mechanism for a dynamic adjustment of the differentiated reserve ratio was employed for counter-cyclical purposes and credit guidance. The new tool of credit policy supporting central bank lending was introduced. A central bank collateral management framework was established, the quotas of central bank lending and discounts were increased, and the role of credit policy was enhanced to guide fund flows to the agricultural sector, rural areas, and farmers, small and micro enterprises, and other key areas and weak links in the economy. Various financial reforms progressed in an orderly fashion. The upper limit of the floating range for deposit interest rates was raised to 1.2 times the benchmark level, and the maturity brackets of the benchmark interest rates were simplified and consolidated. The floating band of the RMB against the US dollar on the inter-bank spot foreign-exchange market was enlarged from 1 percent to 2 percent and the limit on the spread between RMB/USD buying and selling prices offered by designated foreign-exchange banks to their clients was removed. Public opinion was solicited on the draft rules for the deposit insurance system. Furthermore, reform of the foreign-exchange management mechanism was further deepened.

Implementation of a sound monetary policy created a favorable financial environment for economic and social development, as reflected in the stable growth of money and credit, the continuous improvement in the loan structure, and the somewhat reduced financing costs for enterprises. At the end of 2014, broad money M2 was up 12.2 percent year on year. Outstanding RMB loans were up 13.6 percent year on year, registering an increase of 9.78 trillion yuan from the beginning of 2014, 890 billion yuan more than the increase during the corresponding period of 2013. All-system financing aggregates totaled 16.46 trillion yuan. In December, the weighted average loan interest rate offered to non-financial enterprises and other sectors was 6.77 percent, a reduction of 0.42 percentage point from the beginning of the year. The PBC has generally exited from regular foreign-exchange interventions and the RMB exchange rate has remained stable around the equilibrium level and with enhanced flexibility in two-way floating. At the end of the year, the central parity of the RMB against the US dollar was 6.1190 yuan per dollar, a depreciation of 0.36 percent from end-2013.

After the global financial crisis, the world economy has been undergoing a profound rebalancing. More evidence is indicative that the Chinese economy is adapting to the "new normal," as reflected in the moderation of growth rate, the structural adjustments, and the shift in drivers. In general, as a big and resilient economy with a broad market, China has a strong capability to resist risks and much room for maneuver. During recent years, macro-economic management has seen many innovations and improvements. Mass entrepreneurship and innovation are encouraged, and the supply of public goods and services has been increased. With these forming new twin engines for economic growth, the Chinese economy is expected to continue its sustained and sound growth. It should also be noted that during the global rebalancing, the economic performance and macro policies of the various countries and areas have been diverging, leading to increased spillover effects and a complicated international environment. The inherent dynamism of China's economic growth is yet to be strengthened. The economy will confront increased downward pressures and certain risk exposure during the structural adjustments. Meanwhile, the total debt level is still on the rise, insufficient supply coexists with supply surplus, and structural problems remain serious. Therefore, serious efforts are necessary to ensure steady growth, to make structural adjustments, to facilitate reform, and to improve the people's livelihood and to prevent risks.

The PBC will follow the strategic arrangements of the Party Central Committee and the State Council, adhere to the guidelines of seeking progress while maintaining stability and the overall principle of maintaining stable macro-economic policies, while also adopting flexible micro policies, taking initiatives to adapt to the new normal in the economy, placing more priority on the transformation of the development pattern and the structural adjustments, maintaining policy consistency and stability, continuing to implement a sound monetary policy that is neither too tight nor too loose, conducting timely and appropriate fine-tuning and preemptive adjustments, and creating a neutral, proper monetary and financial environment for the adjustment, transformation, and upgrading of the economic structure and to promote scientific and sustainable economic development. A combination of both quantitative and price-based monetary policy instruments will be employed, the macro-prudential policy framework will be improved, and the combination of policy measures will be further diversified and optimized to keep liquidity at an appropriate volume and to realize the opportune growth of money, credit, and all-system financing aggregates. There will be continued efforts to mobilize the stock of credit assets, optimize the structure of new loans, and improve the financing and credit structures. Numerous coordinated measures will be taken to address both the symptoms and the root problems of the high social financing costs. At the same time, innovations in reform will be emphasized and the reform measures will be integrated with the macro-economic management policies so that monetary policy will work closely with the reform measures to further tap into the decisive role of the market in resource allocations. In view of the financial deepening and the innovations in the financial markets, the conduct of policies, including that of its transmission mechanism, will be further improved. Efforts will be focused on solving the most difficult problems. The quality of financial services, the efficiency of the financial sector, and the capacity of the financial sector to provide services to the real sector will be improved. A comprehensive set of measures will be put in place to safeguard the bottom line so as to prevent the emergence of either systemic financial risks or regional financial risks.

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Part 1 Money and Credit Performance

In 2014 liquidity in the banking sector was sufficient, and money, credit, and all-system financing aggregates grew in a reasonable manner. The credit structure continued to be optimized, financing costs declined, and monetary and financial conditions were basically stable.

I. Monetary aggregates grew in a stable and reasonable manner, while the supply channel for base money underwent some changes

At the end of 2014, outstanding M2 stood at 122.8 trillion yuan, up 12.2 percent year on year on comparable terms, decelerating by 1.4 percentage points from the end of 2013. Outstanding narrow money (M1) stood at 34.8 trillion yuan, up 3.2 percent year on year, decelerating by 6.1 percentage points from the end of 2013. Currency in circulation (M0) stood at 6.0 trillion yuan, up 2.9 percent year on year, decelerating by 4.3 percentage points from the end of the last year. On a net basis, in 2014 the central bank injected 168.8 billion yuan in cash, a decline of 222.7 billion yuan year on year. Since the second half of 2014, the growth of money decelerated somewhat due to the acceleration of the structural adjustments, the decline in the off balance sheet financing, the strengthened regulatory measures, and changes in the balance-of-payments situation. However, currently, the growth of M2 is 3 percentage points higher than nominal GDP growth, basically meeting the effective demand of the real economy.

At the end of 2014, outstanding base money registered 29.4 trillion yuan, up 8.5 percent year on year and accelerating by 1.1 percentage points from the beginning of the year. This represented an increase of 2.3 trillion yuan from the beginning of the year. The money multiplier stood at 4.18, which was 0.10 higher than that at the end of 2013. The excess reserve ratio of financial institutions was 2.7 percent and that of rural credit cooperatives was 8.5 percent. The channels of base money supply underwent some changes in 2014. Monetary policy instruments of the PBC, such as open market operations, central bank loans and discounts, and other liquidity-support tools, replaced the RMB equivalent of foreign-exchange purchases as the main channel to supply base money. Throughout the year, the PBC supplied about 2 trillion yuan of base money by using central bank monetary policy tools, an acceleration of 2.1 trillion yuan year on year; the supply of base money via the RMB equivalent of foreign-exchange purchases was about 640 billion yuan, a deceleration of 2.1 trillion yuan year on year. In addition, fiscal deposits decelerated by more than 500 billion yuan year on year, contributing to a smaller year-on-year reduction in the base money supply.

II. The growth of deposits of financial institutions decelerated, with a declining volatility at the end of the seasons

At the end of 2014, outstanding deposits of domestic and foreign currencies in all financial institutions (including foreign-funded financial institutions, the same hereafter) posted 117.4 trillion yuan, up 9.6 percent year on year and a deceleration of 3.9 percentage points from end-2013. This was an increase of 10.2 trillion yuan from the beginning of the year and a deceleration of 2.5 trillion yuan year on year. Outstanding RMB deposits registered 113.9 trillion yuan, up 9.1 percent year on year and a deceleration of 4.7 percentage points from end-2013. This was an increase of 9.5 trillion yuan from the beginning of the year and a deceleration of 3.1 trillion yuan year on year. Due to the impacts of the rapid development of money-market mutual funds and off balance sheet wealth management business, as well as brisk trading on the stock market since October, the effects of deposit diversions were relatively obvious in 2014, and a larger share of RMB deposits[1] became money-market mutual fund deposits and deposits of other non-deposit-taking financial institutions. As the effects of the strengthened regulation of deposit diversions gradually unfolded, deposit volatility decreased in the third and fourth quarters. On the last days of September and December, deposits increased by 699.8 billion yuan and 328.8 billion yuan respectively, a deceleration of 434.2 billion yuan and 674.3 billion yuan year on year. Outstanding deposits in foreign currencies posted USD573.5 billion, up 30.8 percent year on year. This was an increase of USD108.4 billion from the beginning of the year and a year-on-year acceleration of USD80 billion. However, beginning in September deposits in foreign currencies have been on a decline, registering a cumulative decline of USD50.6 billion in the last four months of 2014, or a deceleration of USD54.7 billion year on year, due to the impacts of the quantitative easing exit by the U.S. Federal Reserve and the stronger expectations of a rise in the rates of the US dollar.

Broken down by sector, the growth of household deposits and non-financial corporate sector deposits moderated, while that of deposits of non-deposit-taking financial institutions were fairly rapid. At end-2014, outstanding household deposits posted 50.3 trillion yuan, up 8.9 percent year on year, a deceleration of 4.7 percentage points from the end of 2013; this was an increase of 4.1 trillion yuan from the beginning of the year and a deceleration of 1.4 trillion yuan year on year. Outstanding deposits of the non-financial corporate sector registered 37.8 trillion yuan, up 4.6 percent year on year and a deceleration of 5.8 percentage points from the end of 2013. This was an increase of 2.0 trillion yuan from the beginning of the year and a deceleration of 1.5 trillion yuan year on year. At the end of 2014, outstanding fiscal deposits registered 3.6 trillion yuan, an increase of 553.1 billion yuan from the beginning of the year and

[1] At the end of 2014, statistics on RMB deposits included deposits of households, deposits of non-financial enterprises, deposits of government entities, fiscal deposits, other deposits, and deposits of non-residents, and did not include deposits of non-deposit-taking financial institutions (aside from insurance companies and financial holding companies).

a deceleration of 23.5 billion yuan year on year. Outstanding deposits of non-deposit-taking financial institutions registered 9.4 trillion yuan, up 59.4 percent year on year and an acceleration of 27 percentage points from the end of 2013. This represented an increase of 3.5 trillion yuan from the beginning of the year and an acceleration of 2.5 trillion yuan year on year.

III. Growth of RMB loans of financial institutions hit a historic high

At end-2014, outstanding loans in domestic and foreign currencies of all financial institutions posted 86.8 trillion yuan, up 13.3 percent year on year. This was 10.2 trillion yuan more than that the beginning of the year and an acceleration of 822.3 billion yuan year on year. New RMB loans increased rapidly. At end-2014, outstanding RMB loans stood at 81.7 trillion yuan, up 13.6 percent year on year. Growth was on the rise for two consecutive months, 0.4 percentage point higher than that at end-October but 0.5 percentage point lower than that at the end of the last year. New RMB loans posted 9.78 trillion yuan in 2014, representing an acceleration of 890 billion yuan year on year and hitting a historic high.

In terms of the loan structure, growth of RMB loans to the household sector moderated from an elevated level, while the growth of loans to non-financial businesses and other sectors picked up and the share of new long- and medium-term loans in new loans increased. At end-2014, outstanding loans to the household sector registered 23.1 trillion yuan, up 16.6 percent year on year. This represented a deceleration of 6.5 percentage points from the end of the last year and also an increase of 3.3 trillion yuan from the beginning of the year, a deceleration of 421.8 billion yuan year on year. In particular, home mortgage loans increased by 1.6 trillion yuan from the beginning of the year, an acceleration of 36.8 billion yuan year on year. Outstanding loans to non-financial businesses and other sectors posted 58.3 trillion yuan, up 12.5 percent year on year. This represented an acceleration of 1.4 percentage points from the end of the last year, an increase of 6.5 trillion yuan from the beginning the year, and an acceleration of 1.3 trillion yuan year on year. In terms of the maturity brackets of RMB loans, new medium- and long-term RMB loans increased 6.1 trillion yuan from the beginning of the year, an acceleration of 1.5 trillion yuan year on year. The share of new medium- and long-term RMB loans in the total new loans was 62.0 percent, an increase of 10.4 percentage points from the last year. Outstanding short-term loans (including bill financing) increased by 3.4 trillion yuan from the beginning of the year, of which bill financing increased by 957.4 billion yuan, an acceleration 1.0 trillion yuan year on year. In general, loans of all kinds of financial institutions witnessed a year-on-year acceleration. In particular, Chinese-funded large-sized national banks and small- and medium-sized local banks registered a larger year-on-year acceleration.

Table 1 RMB Loans of Financial Institutions in 2014

Unit: 100 million

	2014		2013	
	New loans	Acceleration	New loans	Acceleration
Chinese-funded large-sized national banks ①	44,338	3,343	40,995	2,211
Chinese-funded small- and medium-sized national banks	28,824	1,026	27,798	4,596
Chinese-funded small- and medium-sized local banks③	17,478	4,933	12,545	-668
Small-sized rural financial institutions④	14,105	781	13,324	1,780
Foreign-funded financial institutions	772	386	386	-391

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

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

③Chinese-funded small- and medium-sized local banks refer to banks operating within a single province, with total assets of less than 2 trillion yuan, denominated in both domestic and foreign currencies.

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

Source: People's Bank of China.

The growth of foreign-currency–denominated loans moderated. At end-2014, outstanding foreign-currency loans of financial institutions posted USD835.1 billion, up 7.5 percent year on year and a deceleration of 6.2 percentage points from the end of 2013. This was an increase of USD58.2 billion from the beginning of the year and a year-on-year deceleration of USD35.3 billion. In terms of the loan structure, short-term ordinary loans and business overdrafts increased by USD35.5 billion, an acceleration of USD20.8 year on year; trade financing decreased by USD34.8 billion, a deceleration of USD56.8 billion; and outward loans increased by USD37.8 billion, a mild deceleration from the last year.

IV. All-system financing aggregates showed some structural changes

According to preliminary statistics, in 2014 all-system financing aggregates reached 16.46 trillion yuan, representing a decrease of 859.8 billion yuan from the last year and the second highest in history (a peak of 17.32 trillion yuan was registered in

2013).

In terms of the financing structure, all-system financing aggregates in 2014 were characterized by the following: first, the share of RMB loans rose significantly. During the year, new RMB loans accounted for 59.4 percent of all-system financing aggregates, a rise of 8.1 percentage points year on year. Second, new foreign-currency–denominated loans declined year on year compared with that in 2013. New foreign- currency–denominated loans registered an equivalent of 355.4 billion yuan, a decrease of 229.4 billion yuan year on year and accounting for 2.2 percent of the all-system financing aggregates during the same period, down 1.2 percentage points from the last year. Nevertheless, foreign-currency–denominated loans increased by an equivalent of 54 billion yuan in December, reversing the declining trend during the previous five consecutive months. Third, both debt and equity financing increased notably, and the amount and share of direct financing reached historic highs. In 2014, the combined amount of financing via debt and equity offerings on the domestic market by non-financial enterprises posted 2.86 trillion yuan, an increase of 827.3 billion yuan year on year. This accounted for 17.3 percent of the all-system financing aggregates, a historic high and up 5.5 percentage points from the last year. Fourth, new off-balance sheet financing declined notably year on year. In 2014, the combined amount of new entrusted loans, trust loans, and undiscounted bankers' acceptances registered 2.90 trillion yuan, a decrease of 2.27 trillion yuan year on year, accounting for 17.5 percent of the all-system financing aggregates, down 12.3 percentage points from the last year. In December, off-balance financing regained its momentum and registered a total of 725.4 billion yuan, an increase of 696.6 billion yuan month on month and 173.7 billion yuan year on year, respectively. In particular, trust loans and undiscounted bankers' acceptances turned from negative growth during the preceding five months to positive growth in December.

Table 2 All-system Financing Aggregates

Unit: 100 million yuan

	All-system financing aggregates ①	Of which:						
		RMB loans	Foreign currency–denominated (RMB equivalent)	Entrusted loans	Trust loans	Undiscounted bankers' acceptances	Enterprise bonds	Financing by domestic institutions via the domestic stock markets
2013	173,169	88,916	5,848	25,466	18,404	7,756	18,111	2,219
2014②	164,571	97,816	3,554	25,070	5,174	-1,285	24,253	4,350

Notes: ① All-system financing aggregates refer to the total volume of financing provided by the financial system to the real economy during a certain period of time. It is an incremental value.
② Data for the current period are preliminary.

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

V. Loan interest rates of financial institutions declined and to some extent high corporate financing costs were reduced

In accordance with the overall arrangements of the State Council, the PBC, jointly with other relevant departments, has implemented a number of measures and has used quantity-based and pricing tools to guide the downward movement of financing costs. At the end of 2014, the yield-to-maturity of 3-year and 7-year AA-rated enterprise bonds on the inter-bank market posted 5.85 percent and 6.34 percent respectively, down 1.50 and 1.27 percentage points from the end of the last year. In December 2014, the weighted average loan interest rate offered to non-financial companies and other sectors was 6.77 percent, down 0.42 percentage point from the end of the last year. In particular, the weighted average loan interest rate was 6.92 percent, down 0.22 percentage point from the beginning of the year; the weighted average bill financing rate was 5.67 percent, down 1.87 percentage points from the beginning of the year. The weighted average home mortgage interest rate first increased and then declined, posting 6.25 percent in December, down 0.29 percentage point from the beginning of the year.

In 2014 the shares of loans with interest rates lower or higher than the benchmark rates rose, while the shares of loans offered at the benchmark rates declined. In December, the shares of loans with interest rates lower or higher than the benchmark rates were 13.10 percent and 67.26 percent respectively, up 0.63 and 3.86 percentage points from the beginning of the year, whereas the shares of loans offered at the benchmark rates were 19.64 percent, down 4.49 percentage points.

The deposit and lending rates of foreign currencies declined as compared with the beginning of this year due to fluctuations in interest rates on international markets and changes in the supply and demand for foreign currencies in China. In December, the weighted average interest rate of US dollar demand deposits and US dollar deposits with maturities within 3 months registered 0.14 percent and 0.64 percent respectively, down 0.04 and 1.34 percentage points from the beginning of the year. The weighted average interest rates of US dollar loans with maturities below 3 months and maturities of 3 to 6 months (including 3 months) posted 2.29 percent and 2.22 percent respectively, down 0.37 and 0.60 percentage point from the beginning of the year.

Table 3 Shares of Loans with Rates at, above, or below the Benchmark Rates, January through December 2014

Unit:%

Month	Lower than the benchmark	At the benchmark	Higher than the benchmark					
			Sub-total	(1,1.1]	(1.1, 1.3]	(1.3, 1.5)	(1.5, 2.0)	Above 2.0
January	8.20	22.81	68.99	17.90	27.39	11.00	9.78	2.92
February	7.56	24.96	67.48	20.61	26.09	10.13	8.05	2.60
March	8.35	21.40	70.25	18.81	27.69	11.17	9.56	3.02
April	6.14	20.60	73.26	20.20	28.47	11.93	9.69	2.97
May	7.35	19.81	72.84	20.45	28.12	11.97	9.52	2.78
June	9.32	21.57	69.11	20.24	26.71	11.19	8.42	2.55
July	8.23	19.68	72.09	19.35	27.78	12.46	9.69	2.81
August	7.50	18.80	73.70	18.28	29.35	13.21	9.81	3.05
September	8.31	20.43	71.26	19.01	28.18	12.29	9.00	2.78
October	8.91	20.43	70.66	18.55	27.29	12.08	9.63	3.12
November	9.44	19.94	70.63	18.73	26.84	12.32	9.55	3.19
December	13.10	19.64	67.26	18.87	24.89	11.26	9.22	3.02

Source: The People's Bank of China.

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

Unit: %

Month	Large-value deposits						Loans				
	Demand deposits	Within 3 months	3–6 months (including 3 months)	6–12 months (including 6 months)	1 year	More than 1 year	Within 3 months	3–6 months (including 3 months)	6–12 months (including 6 months)	1 year	More than 1 year
January	0.21	2.41	3.43	3.48	3.54	2.68	2.82	2.90	3.14	2.88	3.56
February	0.20	2.50	3.54	3.68	3.66	3.08	3.08	3.13	3.46	3.10	3.08
March	0.25	2.60	3.68	3.63	3.85	2.72	3.08	3.20	3.35	3.30	3.16
April	0.27	2.45	3.56	3.70	3.66	2.81	3.11	3.24	3.59	3.52	3.47
May	0.26	2.21	3.24	3.43	3.58	2.83	2.97	3.09	3.45	3.52	3.63
June	0.22	1.99	3.03	3.17	3.69	2.78	2.87	3.03	3.37	3.42	3.45
July	0.21	1.59	2.72	2.96	3.47	2.48	2.73	2.97	3.32	3.24	3.72
August	0.19	1.09	2.13	2.77	3.06	2.16	2.61	2.66	3.01	2.89	3.39

September	0.14	0.83	1.76	2.30	2.40	1.18	2.53	2.51	2.67	2.74	3.55
October	0.15	0.86	1.59	2.19	2.46	1.57	2.59	2.52	2.78	2.74	3.39
November	0.12	0.70	1.41	2.08	2.53	1.85	2.15	2.22	2.57	2.75	3.68
December	0.14	0.64	1.31	1.87	2.03	1.40	2.29	2.22	2.36	2.72	3.47

Source: The People's Bank of China.

VI. The RMB exchange rate fluctuated in both directions with enhanced flexibility

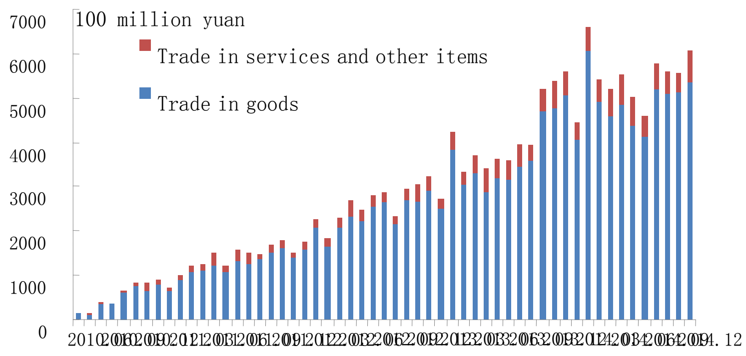
In 2014, the RMB exchange rate experienced a mild depreciation and moved in both directions, with much stronger flexibility and stable expectations. At the end of 2014, the central parity of the RMB against the US dollar was 6.1190 yuan per dollar, representing a depreciation of 221 basis points, or 0.36 percent, from the end of 2013. From the reform of the RMB exchange-rate regime in 2005 to the end of 2014, the RMB registered a cumulative appreciation of 35.26 percent against the US dollar. According to calculations by the BIS, in 2014 the NEER and REER of the RMB appreciated by 6.41 percent and 6.24 percent respectively, and from the RMB exchange-rate regime reform in 2005 to December 2014, the NEER and REER of the RMB exchange rate appreciated by 40.51 percent and 51.04 percent respectively.

VII. Cross-border RMB business maintained steady growth

In 2014 RMB settlements of cross-border trade and investments continued to grow in a stable manner. According to preliminary statistics, commercial banks processed 6.55 trillion yuan in RMB settlements of cross-border trade,[2] up 42 percent year on year. In particular, settlements of trade in goods registered 5.9 trillion yuan and settlements of trade in services and other items under the current account registered 0.65 trillion yuan. Actual RMB receipts and payments from cross-border trade registered 2.73 trillion yuan and 3.82 trillion yuan respectively, resulting in a receipt–payment ratio of 1:1.4. Bank settlements of cross-border direct investments in RMB totaled 1.05 trillion yuan. Specifically, outward direct investments settled in RMB totaled 186.56 billion yuan, up 118 percent year on year, and foreign direct investments settled in RMB totaled 862.02 billion yuan, up 92 percent year on year.

[2] Beginning from August 2014, statistics on entrepôt trade without custom declarations and clearances were adjusted from trade in services to trade in goods. Consequently, the statistics on trade in goods increased, whereas the statistics on trade in services decreased. The historical data have been adjusted accordingly.

Figure 1 Monthly RMB Settlements of Cross-border Trade



Source: The People's Bank of China.

Part 2 Monetary Policy Operations

Since the start of 2014, in the face of the complicated and changing economic and financial environments at home and aboard, the PBC has closely followed the overall arrangements of the CPC Central Committee and the State Council, continuing to make progress while maintaining stability, promoting reform and innovation, and maintaining the sound monetary policy. The PBC remained focused on the objectives of macro-economic management, took initiatives as called for, dealt with key economic-performance problems, continued to improve and optimize the combination of monetary policy instruments, and carried out pre-emptive adjustments and fine-tunings in a timely and appropriate manner.

I. Flexible open market operations were conducted

In 2014 capital inflows declined as the balance of payments and the RMB exchange rates moved closer to the equilibrium and the Fed gradually exited from the quantitative easing. As such, the impact of capital inflows on liquidity in the banking system was generally neutral, though at times fluctuations could still be observed. Meanwhile, with the rapid development of financial markets and innovations, seasonal, market, and regulatory factors became intertwined, adding to the uncertainty of liquidity in the banking system.

The PBC analyzed liquidity changes during various periods and conducted open market operations flexibly in line with the sound monetary policy. It appropriately combined various instruments and effectively managed liquidity in the banking system. It maintained aggregate liquidity at adequate levels and ensured the smooth functioning of liquidity and the money market. In the first half of 2014, liquidity provided through foreign-exchange purchases initially grew rapidly, but it later slowed down. Seasonal factors, such as the Spring Festival, had a notable influence on liquidity. Taking these factors into consideration, the PBC carried out open market operations in a flexible manner, using reverse repo operations as a major tool supplemented by repo operations and short-term liquidity operations (SLO) to ensure a reasonable overall liquidity level and a balanced distribution in the system. In the second half of the year, overall liquidity remained relatively abundant, but liquidity provided through exchange purchases slowed down and uncertainties accumulated. Thus, the PBC gradually reduced the intensity and frequency of reverse repo operations, leading to a temporary suspension of such operations. Meanwhile, the PBC injected adequate liquidity into the system in a timely manner as a result of the matured reverse repo operations and central bank notes, and fresh SLO operations. These measures, together with other measures, ensured steady growth in liquidity. Pre-emptive adjustments and fine-tunings were also enhanced to reduce short-term liquidity fluctuations. In 2014, a total of 3021.0 billion yuan of reverse repo operations and 525.0 billion yuan of repo operations were conducted. Through SLO operations, 1021.0 billion yuan of liquidity was injected into the system and 100.0 billion yuan was drained from the system. At the end of the year, outstanding repos and reverse repos both registered zero. Outstanding SLO for injecting and withdrawing liquidity posted 100.0 billion yuan and zero respectively. Outstanding central bank notes reached 422.2 billion yuan.

The PBC closely monitored the movements of market interest rates and enhanced the flexibility of open market operations when appropriate in order to effectively guide market expectations. In the first half of 2014, interest rates in open market operations generally remained stable. In the second half of the year, in line with the market interest-rate movements, 14-day reverse repo rates dropped on four occasions by a cumulative 60 basis points, while deposit and lending benchmark rates were also adjusted. These measures played an active role in reducing money-market interest rates and financing costs.

Central treasury cash management operations were conducted at appropriate times. In 2014 a total of 620.0 billion yuan of central treasury funds was deposited in commercial banks on 12 separate operations, including 380.0 billion yuan in three-month deposits, 150.0 billion yuan in six-month deposits, and 90.0 billion yuan in nine-month deposits. The outstanding amount of treasury deposits reached 270.0 billion yuan by the end of the year, an increase of 160.0 billion yuan from the end of the last year.

II. The Standing-Lending Facility (SLF) operated appropriately and a Medium-term Lending Facility (MLF) was launched

In order to strengthen liquidity management in the banking system, to keep liquidity at a reasonable volume, and to facilitate the smooth operation of the money market, the PBC launched a pilot SLF program in 10 provinces (municipalities) to provide short-term liquidity support to local financial institutions that met the prudential regulatory requirements. Immediately before the Spring Festival in 2014, the PBC headquarters and its branch offices in the pilot regions offered liquidity support to qualified financial institutions and explored the role of the SLF interest rates as the ceiling for the interest rates in the money market in order to stabilize market expectations and to facilitate smooth operations of the money market. The PBC, considering the overall liquidity situation in the money market, did not conduct SLF operations in the second quarter. The volume of outstanding SLF was zero by year-end.

In September 2014, the PBC introduced the MLF as an instrument to provide medium-term base money to commercial banks and policy banks that met the macro-prudential requirements. During the whole year, the PBC conducted MLFs in the amount of 1.14 trillion yuan and the outstanding MLF reached 644.5 billion by the end of the year. The maturity was three months, with an interest rate of 3.5 percent. In general, in a situation where liquidity provided through foreign-exchange purchases was declining, the MLF operations provided an avenue to pro-actively inject base money into the system. This was conducive to ensuring a reasonable growth of credit and total social financing. It also helped to create an appropriate level of overall liquidity to stabilize growth and to facilitate structural adjustments. In the MLF operations, the PBC guided financial institutions to beef up support to small and micro firms (SMFs), agriculture-related sectors, and other key areas and weak links in the economy and used the medium-term interest rate to lower the lending interest rates and the financing costs so as to better serve the real economy.

III. Reserve requirements were reduced in a targeted manner and adjustments were made to the scope of institutions holding required reserves

The PBC conducted targeted reductions of the reserve requirement on two occasions to provide incentives to financial institutions to increase lending to agriculture-related businesses and SMFs. In April and June of 2014, the PBC lowered the reserve requirements for county-level commercial banks in rural areas and rural cooperative banks by 2 and 0.5 percentage points respectively and reduced by 0.5 percentage point the reserve requirement for commercial banks, which met the prudential requirements and reached a certain ratio in their lending to agriculture-related businesses and SMFs. Moreover, the PBC lowered the reserve requirement by 0.5 percentage point for finance companies, financial leasing companies, and auto finance companies.

Taking into account the change in the channels for base money injections and seasonal factors, the PBC decided to lower the reserve requirement of financial institutions by 0.5 percentage point, beginning from February 5, 2015, in order to bridge the liquidity gap and to maintain an appropriate liquidity level. Meanwhile, in order to enhance the capability of financial institutions to support the structural adjustments, the SMFs, the agriculture-related sector, and the key irrigation projects, the PBC reduced the reserve requirement by 0.5 percentage point for urban commercial banks and for non-county-level commercial banks in the rural areas, as long as their lending to the SMFs reached a certain criteria; and additionally it cut the reserve requirement for rural development by the Bank of China by 4 percentage points.

Moreover, starting from 2015, the PBC readjusted the coverage for the collection of deposit statistics. Certain types of deposits which had been absorbed by deposit-taking financial institutions and previously had been recorded under the inter-bank account item in the statistical coverage, such as deposits for securities transactions and settlements, deposits by banks for non-financing purposes, deposits by SPVs, deposits by other financial institutions, and deposits by overseas financial institutions, were included in the deposit data and the reserve requirement will be applied, though currently at zero.

IV. Macro-prudential management was strengthened and the dynamic adjustment mechanism of differentiated reserve requirements continued to play a role in counter-cyclical management and structural adjustments

The PBC continued to use the dynamic adjustment mechanism of the differentiated reserve requirements to strengthen macro-prudential management. In each of the four quarters of 2014, the PBC took into consideration the economic and financial developments at home and aboard, the soundness of financial institutions, and the implementation of credit policies, and accordingly adjusted the parameters of the above-mentioned mechanism and further improved its rules. Based on effective credit demand, the PBC adjusted the parameters to create a favorable environment for small- and medium-sized financial institutions which better support SMFs and agriculture-related businesses, and for financial institutions in the central/western and underdeveloped regions. Financial institutions were encouraged to increase the proportion of lending to SMFs and lending to agriculture-related businesses in central/western and underdeveloped regions among their total lending so as to guide appropriate credit growth.

V. Policy lending and other new tools were introduced and central bank lending and discounts were strengthened to optimize credit extensions

At the beginning of 2014, the PBC adjusted the classification of central bank lending. A new category of “credit policy supporting loans” was introduced, which included agriculture supporting loans and the newly-established SMF-supporting loans. In addition, the PBC also introduced Pledged Supplementary Lending (PSL) to adjust the credit structure to promote adjustments, strengthen financial institutions' credit support to key areas and weak links in the economy, such as agriculture-related businesses, SMFs, and shantytown renovations. Management was improved for credit policy– supporting loans and discounts, and the quota was increased on several occasions for agricultural-supporting and micro enterprise– supporting loans and discounts. By the end of 2014, outstanding agricultural-supporting loans reached 215.4 billion yuan, 47.0 billion more than that at the beginning of the year. Outstanding micro enterprise supporting loans registered 52.4 billion yuan, an increase of 52.4 billion yuan from the beginning of the year. The outstanding amount of discounts was 137.2 billion, an increase of 23.5 billion yuan from the beginning of the year.

Pilots were launched for credit asset collateralization and central bank internal ratings. In order to safeguard the creditor's right of the central bank, to prevent moral hazards of financial institutions, and to solve the problem of insufficient collateral held by small and medium-sized financial institutions, in 2014 the PBC launched pilot programs for credit asset collateralization and central bank internal ratings in Shandong and Guangdong. High-quality credit assets of financial institutions with central bank internal ratings were acknowledged as eligible collateral, thus improving the collateral management framework. So far, the basis system, operating procedures, and central bank internal-rating database have been established for central bank lending against credit asset collaterals in the pilot regions. Operations were conducted and experience was gained, which can be further applied to other regions. In 2015, the PBC will gradually expand the pilot program through its branches.

VI. Window guidance and credit policy guidance were strengthened

The PBC continued to use monetary policy, macro-prudential management, and credit policy to send signals and to guide structural adjustments, strengthened the coordination of credit policy and industrial policy, further improved assessments of the effects of credit policy guidance, and guided financial institutions to optimize their credit structure. The PBC encouraged banking financial institutions to make innovations in their organization, operating mechanisms, collateralization, and products and services in order to channel a larger proportion of their lending to key areas and weak links in the economy, such as the agriculture-related sector and the SMFs. Research was conducted on expanding the scope of collateral in rural areas and banks were encouraged to make innovations to provide customized financial services to new types of businesses, such as family farms and big specialized farming households. Financial support was strengthened to improve the people's livelihood. A financial services coordination mechanism was put in place in 14 contiguous and extremely impoverished areas. Financial services were enhanced to support employment, education, ethnic minorities, migrant workers, and college-graduate village officials, and to support reconstruction in quake-hit Ludian County of Yunnan province. Credit inputs were increased to advanced manufacturing industries with good market prospects, strategic emerging industries, modern IT industries and information consumption, the cultural industry, the services industry, the transformation and upgrading of traditional industries, and industries promoting green and environmentally friendly growth. The reasonable funding needs of key ongoing and follow-up projects were met and efforts were made to support major infrastructure and livelihood projects, such as the reconstruction of shanty dwellings, railway construction, irrigation systems, and underground pipe networks, in order to help improve the quality and efficiency of economic growth. As for industries with excess capacity, in line with the principle of "differentiated treatment and no one-size-fits-all approach," the PBC urged financial institutions to strengthen and improve credit management by way of absorbing, relocating, consolidating, and eliminating excess capacity. The differentiated housing credit policies were also improved and implemented. In addition, the role of capital markets was enhanced, with credit asset securitization promoted to help financial institutions manage their stock of credit assets. Qualified commercial banks were permitted to issue small and micro enterprise financial bonds, and efforts were made to launch the issuance of specialized financial bonds to support agriculture-related businesses.

As the various measures were put in place, the credit structure of financial institutions continued to improve and their support to the SMFs and the central/western regions was enhanced. First, loans to small and micro enterprise grew relatively rapidly, outpacing the growth of total loans. At the end of 2014, outstanding loans to the SMFs reached 15.26 trillion yuan, an annual increase of 15.5 percent. The growth rate was 1.3 percentage points higher than that in 2013 and 1.9 percentage points higher than the total loans in 2014. In 2014, newly increased loans to the SMFs registered 2.13 trillion yuan, an annual increase of 128.5 billion yuan. This accounted for 41.9 percent of the newly increased loans to enterprises and it was 18.1 percentage points higher than that of the large enterprises. Second, the growth of loans to the central/western regions remained higher than that to the eastern regions, as credit support continued to benefit the central/western regions. By the end of the year, outstanding loans to the western regions had increased 16.7 percent on a year-on-year basis, 0.9 percentage point higher than that to the central regions and 5.2 percentage points higher than that to the eastern regions. Third, mid-term and long-term loans to industries with excess capacity continued to fall. At the end of 2014, the annual growth of mid-term and long-term loans to industries with excess capacity was 3.9 percent, 3.6 percentage points lower than that at the end of 2013.

VII. Benchmark deposit and lending rates were reduced and the market-based interest-rate reform continued

In order to tackle the problem of a lack of access to financing and the high costs of financing in the real economy, and in view of the trend in price movements, on November 22, 2014, the PBC reduced the benchmark RMB lending and deposit rates of financial institutions in an asymmetric manner. The benchmark one-year lending rate was lowered by 0.4 percentage point to 5.6 percent, and the benchmark one-year deposit rate was lowered by 0.25 percentage point to 2.75 percent. Such adjustments were in accordance with the fall in inflation at the time, but it did not alter the sound monetary policy stance. The reduction in the benchmark deposit and lending rates was conducive to allowing them to play a greater role in reducing the market interest rates and the financing costs, such that the real interest rate would gradually move back to a reasonable level.

The market-based interest-rate reform continued to make important progress. First, control over the interest rates of financial institutions continued to be loosened in an orderly manner. On March 1, 2014, the PBC removed the ceiling on small-value foreign-exchange deposit interest rates in the China (Shanghai) Pilot Free Trade Zone. On November 22, 2014, when the PBC reduced the benchmark deposit and lending rates, it expanded the floating band of the deposit interest rates from 1.1 times the benchmark deposit rate to 1.2 times the benchmark deposit rate. It also simplified the brackets of the benchmark interest rate so that the pricing capacity of financial institutions was further improved. Second, the self-regulatory market interest-rate pricing mechanism continued to be improved. Membership in the mechanism continued to expand. A total of 93 financial institutions became new members and self-regulation in the mechanism was enhanced. Third, the trading of inter-bank certificates of deposit was steadily promoted. The scope of issuers of deposit certificates was further expanded and issuances became more frequent. This enhanced the management of liability and the pricing capacity of the banks, and provided valuable experience for the issuance of certificates of deposit to enterprises and individuals. In 2014, 89 financial institutions issued 998 certificates of deposit in the inter-bank bond market, with a total amount of 898.6 billion yuan. Among them, 423.1 billion yuan of the certificates were traded in the secondary market. All of the certificates of deposit were based on the Shibor rates. The relatively rapid development of the market for certificates of deposit provided a basis for quoting the medium- and long-end Shibor rates. In December, the weighted average interest rate of three-month deposit certificates was 5.01 percent, which was 43 basis points higher than the 3-month Shibor rate.

Box 1 Changes in the pricing of the deposit and lending rates by financial institutions after the PBC adjusted its interest-rate policies

On November 22, 2014, the PBC reduced the benchmark deposit and lending rates of financial institutions in an asymmetric manner, thus further promoting the market-based interest-rate reform. After this adjustment, the lending rate of financial institutions began to move downward, deposit rate pricing became more market-oriented, and the policy effects became more obvious.

For loan rate pricing, after the PBC policy adjustments, financial institutions quickly adapted to the new benchmarks and lowered their quotes of lending rates and adjusted the parameters in their pricing system. Thus bank customers enjoyed lower lending rates. The impact of the lower benchmark rates on reducing the real interest rates became more obvious. Currently, the Loan Prime Rate (LPR) quote is 5.51 percent, 0.25 percentage point lower than that prior to the policy adjustments. In December, the weighted average rate of loans (not including discounts) to non-financial enterprises and other sectors was 6.92 percent, 0.44 percentage point lower than before the policy adjustments (October 2014, the same hereinafter). In December, due to the fluctuations in the money-market rates, the bill financing interest rates rose, which to some extent helped mitigate the decline in the lending rates. In December, the weighted average rate of loans to non-financial enterprises and other sectors was 6.77 percent, a reduction of 0.11 percentage point from the pre-reduction level.

After the policy rate adjustments, financial institutions are basically able to price their lending rates by considering funding costs and the risk premium based on the principle that profits should cover the costs of the risks. The lending rates for different customers became increasingly differentiated. According to surveys, the weighted average lending rates of state-owned financial institutions and joint stock commercial banks were lower than those of local financial institutions, such as rural cooperative financing institutions, reflecting the differentiated pricing practices for different customers. The lending rates for large, small, and medium enterprises also declined. Due to the different risk premiums for various customers, there was a difference in the spread between their lending rates and the benchmark rate. The larger enterprises tended to enjoy lending rates that were lower than those of the smaller enterprises.

After the policy rate adjustments, the deposit rate quotes by financial institutions generally declined. The floating band of deposit rates for various maturities was expanded, but it still remained within the 1.2 time limit. According to surveys, in December the weighted average rates for demand deposits and for 3-month, 6-month, 1-year, 2-year, and 3-year deposits were 0.37 percent, 2.74 percent, 2.98 percent, 3.23 percent, 3.92 percent, and 4.61 percent respectively. Except for the demand deposit rate, which remained unchanged, and the 3-year deposit rate, which increased slightly, all other deposit rates declined. In general, the weighted average deposit rates of various terms was 1.17 times that of the benchmark deposit rate.

After the policy rate adjustments, the pricing strategies of financial institutions began to diversify and a multi-layered deposit rates began to develop. The deposit rate quotes offered by state-owned commercial banks were the lowest and those of local financial institutions were generally higher. The rates offered by joint stock commercial banks were in the middle between the two. At the same time, state-owned commercial banks and joint stock banks generally delegated more pricing power to their branches to price the deposit rates according to their business strategies, competition in the respective localities, and the profiles of their customers so as to properly manage their funding costs.

In brief, with the policy rate adjustments and the continuing market-based interest-rate reform, the pricing capacity of financial institutions was enhanced and real deposit rates declined. These measures have played an active role in reducing the financing costs of enterprises, enhancing the pricing capacity of financing institutions, and improving the market-based interest-rate formation and transmission mechanism. Considering that such policy rate adjustments have been fairly recent and that the deposit rate decline may also be influenced by factors such as the financing costs of financial institutions, the pricing adjustments at the beginning of the year, and the risk premium of the lending rates, more observation is needed before an assessment of the effectiveness of the policy rate adjustments is made.

VIII. The RMB exchange-rate regime was further improved

The market-based RMB exchange-rate regime was further improved in a self-initiated, controllable, and gradual manner, while the RMB exchange rate was kept basically stable at an adaptive and equilibrium level. On March 15, 2014, the PBC announced that the floating band of the RMB spot rate against US dollar would be expanded from 1 percent to 2 percent. On July 2, the PBC removed the regulation over the spread between USD selling and buying rate quotes of banks. Market supply and demand are playing an increasingly important role in the RMB exchange-rate formation, the flexibility of the RMB exchange rate has been enhanced, and market expectations have begun to diversify. The central bank has basically exited from its regular interventions on the foreign-exchange market so as to develop a managed floating exchange-rate regime.

In 2014 the highest and lowest central parity of the RMB against US dollar were 6.0930 and 6.1710 respectively. Among the 245 trading days, the RMB appreciated on 107 days and depreciated on 138 days. The largest daily appreciation was 0.37 percent (225 basis points) and the largest daily depreciation was 0.18 percent (111 points).

The RMB appreciated against other major international currencies, including the euro and the Japanese yen. At the end of 2014, the central parity of RMB against the euro and the Japanese yen was 7.4556 yuan per euro and 5.1371 yuan per 100 yen respectively, an appreciation of 12.92 percent and 12.46 percent respectively from the end of the last year. From the start of the reform of the RMB exchange-rate regime in 2005 until the end of 2014, the RMB appreciated against the euro and the yen by 34.32 percent and 42.22 percent respectively.

To facilitate bilateral trade and investment, the PBC continued to promote the RMB direct trading between RMB and other currencies. In 2014, the direct RMB trading against the New Zealand dollar, the British pound, the euro, and the Singapore dollar was launched on the inter-bank foreign exchange market, and the direct trading between the RMB and the Kazakh tenge was launched in the regional inter-bank foreign-exchange market. Direct trading between the RMB and foreign currencies in the inter-bank foreign-exchange market was active and market liquidity increased notably, thus helping to lower the costs of currency conversion in the economy.

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

Unit: 100 million yuan

Currency	USD	euro	Japanese yen	HKD	GBP	Australian dollar	New Zealand dollar	Singapore dollar	Canadian dollar	Malaysian ringgit	Russian ruble	Thai baht	Kazakh tenge
Trading volume	239942	3155	4551	2031	1377	1486	281	838	14	12	255	2	3

Source: China Foreign Exchange Trade System.

Box 2 The steady development of direct trading between the RMB and other currencies

Since the beginning of the pilot program of cross-border RMB business in 2009, the RMB has been more widely used throughout the world. After the international financial crisis, fluctuations in the value of the major currencies increased. Thus, in order to reduce currency conversion costs, economic entities had higher demand for trading between RMB and emerging market currencies. In order to meet such a demand, the PBC began to explore direct trading between the RMB and the emerging market currencies in the inter-bank foreign-exchange market. In 2010, direct RMB trading with the Malaysian ringgit and the Russian ruble were launched simultaneously in China's inter-bank foreign-exchange market and in the corresponding countries. With the increased acceptance of RMB globally and the development of the direct trading market, some advanced economies also showed interests in direct trading with the RMB. By the end of 2014, direct trading between the RMB and 8 foreign currencies had been launched in the inter-bank foreign-exchange market.

Overseas direct RMB trading markets have developed greatly. Direct trading between the RMB and other currencies became increasingly active, with the trading volume growing rapidly. In 2014, direct trading between the RMB and other currencies registered 1048.2 billion yuan, accounting for 4.7 percent of the spot trading in the inter-bank foreign-exchange market. By comparison, before 2010 the trading volume of the RMB against non-USD currencies was only 0.5 percent. From the launch of direct trading between RMB and non-USD currencies until the end of 2014, the daily average of RMB trading registered 10.222 billion yuan, which is 8.4 times the daily average of 1.212 billion yuan in the year before the launch of direct trading.

There are several features of the direct RMB trading. First, a direct exchange-rate formation mechanism, without the use of cross rates, has been established. Before the introduction of direct trading, banks usually converted their non-USD positions to USD in the inter-bank foreign-exchange market, and then traded the USD for RMB. After direct trading was established, banks no longer had to do this. They now only have to clear their positions by direct trading in the inter-bank foreign-exchange market, helping form direct exchange rates. Based on this progress, the central parity of RMB against other currencies are not calculated by using dollar exchange rates with the two currencies; the central parity are calculated from the quotes of market-makers in the direct trading market. The market exchange rate is determined mainly by supply and demand in the bilateral local currency settlements and the international exchange market conditions.

Second, the structure of the market-makers has been improved. Each of the currencies under direct trading has its own independent market-making system, which covers different types of market-makers. This reflects the diversified market demand for different currencies. Among the market-makers, there are both Chinese banks with adequate branches and offices and foreign banks with rich market-making experience. The former include large national commercial banks and local banks in areas where cross-border trade is active. The latter include internationally active banks and branches of foreign banks from countries that issue the directly-traded currencies.

Third, more currencies can be traded directly with the RMB. During the past 5 years, in line with market needs, direct RMB trading has started from RMB against ringgit and the ruble, and expanded to include the major reserve currencies, such as the euro, the pound sterling, the Japanese yen, and other convertible currencies including the Australian dollar, the New Zealand dollar, and the Singapore dollar. An initial network of direct RMB trading has been developed, in tandem with the development of the international use of the RMB.

Fourth, direct trading markets at home and abroad have developed hand in hand. In developing direct RMB trading markets, the PBC attached great importance to the principle that direct RMB trading should be launched simultaneously at home and abroad in order to ensure interaction between the domestic and overseas markets and to boost mutual development. For currencies with certain convertibility restrictions, such as the Korean won, direct trading was first launched in the overseas market. Currently, off-shore direct RMB trading markets with relatively large trading volumes have been established in Moscow, London, Frankfurt, Singapore, Australia, and so forth. These off-shore markets facilitate direct trading between the RMB and the foreign currencies and create economies of scale.

The benefits of direct RMB trading have become increasingly obvious. First, the currency conversion costs have been reduced. By clearing their foreign-currency positions in one transaction, banks can reduce their exchange costs and the exchange rate in the transaction can be transmitted to the exchange rate quotes offered to customers through internal pricing mechanism. From the exchange rate quotes offered by the banks to individual customers, it can be seen that the spread between the buying and selling rates has been narrowed from 0.8 percent to 0.7 percent, so that the conversion cost is reduced by 12.5 percent. As enterprises have certain bargaining powers, they can actually save more. Second, price transparency has been increased. Before direct trading, economic entities had no access to information on the RMB exchange rate against some currencies. Direct trading creates a bilateral exchange rate of the RMB against these currencies, thus helping lower the research and friction costs. Third, international use of the RMB has been promoted. In recent years, direct trading between RMB and the local currency has grown to fairly large volumes in Russia and Korea. Take the direct trading between the RMB and ruble in the Russian foreign-exchange market as an example. The trading volume of the RMB against ruble on the Moscow Inter-bank Currency Exchange (MICEX) in 2014 was 7 times that the volume in 2013. Fourth, direct trading facilitates the development of foreign-exchange markets and supports the real economy. Direct trading in the inter-bank market provides liquidity for the sale and purchase of foreign exchange at bank counters and more currencies can be quoted at the counters. These measures facilitate foreign-exchange transactions and provide support to the real economy. Fifth, direct trading helps promote the reform of a market-based foreign-exchange rate regime.

As the economic and trade ties between China and the rest of the world continue to grow, the demand for direct trading between RMB and the local currency will gradually increase. The PBC will continue to promote the development of direct RMB trading markets to support bilateral economic and trade ties and to provide effective and low-cost financial services to facilitate trade and investment.

In 2014 under the bilateral local currency swap agreements signed by the PBC and the relevant foreign monetary authorities, PBC conducted swaps in a total amount of 1130.550 billion yuan with counterparty monetary authorities. The amount of RMB actually used was 38.007 billion yuan and the outstanding amount was 15.801 billion yuan. This has played an active role in facilitating bilateral trade and investment.

IX. Reforms of financial institutions were deepened

The PBC solicited public comments on the *Regulations on Deposit Insurance (Consultative Document).* In 2014 the State Council Executive Meeting reviewed and adopted the *Report of the PBC on Plans to Establish a Deposit Insurance System*. It was then decided that a deposit insurance system will be established covering all deposit-taking financial institutions, and the insurance limit will be 500,000 yuan per account. Initially, the premium rate will be low and a deposit insurance fund will be established gradually. On December 30, 2014, the PBC completed the public consultation process. A deposit insurance system is an important institutional arrangement to protect depositors and to improve the financial safety net in a market economy. It will help define the respective roles of the government and the market, deepen the financial reforms, maintain financial stability, and increase the competitiveness of the financial industry. The insurance limit of 500,000 yuan per account will provide full coverage for 99.6 percent of the depositors and will be adequate to maintain confidence and stability.

Reforms of financial institutions continued to be deepened. In July of 2014, the Housing Financing Department of the China Development Bank (CDB) was established. Meanwhile, the CDB continued to support the renovation of shantytown areas and to provide legally-compliant, convenient, reasonably-priced, and stable funding. In 2014 the CDB provided 408.6 billion yuan of new loans for shantytown renovation, which was 302.6 billion yuan more than that in the last year, or a 286 percent increase. In principle, the reform plan of the Agricultural Development Bank of China, which clarified the general target and main measures of the reform, was approved by the 63rd Executive Meeting of the State Council. Reform of the CDB and the Export-Import Bank of China was accelerated and their policy roles were enhanced. The transformation and reform of asset management companies also made progress. In August, China Huarong Asset Management Co. Ltd. signed cooperation agreements with eight strategic investors, with a total investment of 14.54 billion yuan, accounting for 21.0 percent of its equity after the capital increase. Reform of the rural credit cooperatives (RCCs) also proceeded smoothly, with constant improvements in their business operation, financial performance, and agriculture-related financial services. At the end of 2014, the average NPL ratio of RCCs was 3.8 percent, an annual decline of 0.3 percentage point. Their capital adequacy ratio was 13.2 percent, 2.8 percentage points higher than that in the last year. The provision coverage ratio was 135.2 percent, up by 8.7 percentage points. Total profits registered 233.9 billion yuan in 2014. Agriculture-related loans and loans to farmers were 7.1 trillion yuan and 3.4 trillion yuan respectively, up by 13.4 percent and 12.0 percent year on year. By the end of 2014, a total of 1,484 RCCs with legal person status at the county (municipality) level had been established nationwide, and the number of rural commercial banks and rural cooperative banks had reached 665 and 89 respectively. In general, the RCCs have established a governance framework consisting of a general meeting of stockholders, a board of directors, a board of supervisors, and senior management, as well as relevant rules and policies. With these arrangements in place, the internal management of RCCs has improved.

X. Reform was promoted in foreign-exchange administration

Progress was made in streamlining administrative procedures, delegating powers, and facilitating trade and investment. First, the number of items requiring administrative approval was further reduced. In 2014, 5 items were removed from the list, and 88 foreign exchange administrative regulations were revoked. Second, more measures were taken to support the steady growth of trade. Reforms were promoted in trade related foreign-exchange management, thus further facilitating border trade and trade business run by individuals. Administrative approval on border trade accounts was removed and documentation requirements for trade business run by individuals were streamlined so as to promote the development of all kinds of trade. Third, a pilot program for foreign exchange payment business for cross-border e-commerce was launched. The 22 enterprises in the pilot program have processed a total of USD1.0 billion in cross-border receipts and payments to support the development of new types of businesses, including e-commerce.

Convertibility of the capital account has been constantly improved. First, the pilot program of centralized foreign-exchange fund management by multinational companies has been expanded nationwide. More than 200 enterprises, including state-owned, private, and foreign enterprises, are allowed to manage their foreign exchange fund in a centralized manner, which concretely reduces the financial costs for large enterprises and multinational companies. Second, another pilot program was launched to allow foreign-invested enterprises to sell their foreign-currency denominated capital funds to banks on a voluntary basis. In line with the philosophy of negative-list management, the PBC launched the program in 17 national economic and financial reform pilot zones, including the China (Shanghai) Free Trade Zone and the Tianjin Binhai New Area, where firms are allowed to sell their foreign-exchange denominated capital funds on a voluntary basis. Third, more channels were developed for funds to "go global." Foreign-exchange management for overseas investments has been largely streamlined. Foreign exchange can be purchased for establishment and operation of special purpose vehicles in overseas markets, and the restrictions on lending to such companies have been removed. Fourth, the two-way opening up of the capital market has been promoted. The quota management of the RMB Qualified Foreign Institutional Investors (RQFIIs) has been streamlined and the pilot program of the Qualified Domestic Limited Partner (QDLP) was launched in certain areas. Fifth, measures have been put in place to facilitate transactions under the capital account. All ex-ante approvals for cross-border guarantees have been removed and external guarantee policies for domestic lending of the domestic and foreign-invested enterprises have been unified. Approval requirements in certain procedures for external debts to be transformed into funds for lending have been removed. In some regions, pilot program were launched whereby foreign invested enterprises can manage a proportion of their external debt on a self-disciplined basis in order to reduce their funding costs.

In addition, efforts were made to improve the statistics and monitoring system for cross-border capital flows, enhancing the capability of monitoring, early warnings, and management of capital flows, and further developing the statistical system for the balance of international payments.

Part 3 Financial Market Analysis

In 2014 China's financial market performed in a sound manner. The money market traded briskly, while market rates were generally stable; the volume of bond issuances increased significantly, and the yield curve of bonds shifted downward; both the stock indices and equity financing rose significantly. Reforms of the financial market proceeded steadily. Innovations in financial products deepened, the institutional framework in the financial market gradually improved, and the financial market played a greater role in lowering the financing costs and facilitating the development of the real economy.

I. Financial market analysis

1. The money market traded briskly and market interest rates were generally stable

Growth of repo transactions on the inter-bank market accelerated, while the turnover of inter-bank borrowing increased rapidly year on year. In 2014 the turnover of bond repos on the inter-bank market totaled 224.4 trillion yuan, representing an average daily turnover of 897.7 billion yuan, up 41.9 percent year on year and an acceleration of 30.7 percentage points from the previous year. The turnover of inter-bank borrowing reached 37.7 trillion yuan, with an average daily turnover of 150.7 billion yuan, up 6.0 percent year on year and representing an acceleration of 30.3 percentage points from the last year. In terms of the maturity structure, overnight products still dominated the bond repos and inter-bank borrowing transactions, accounting for 78.1 percent and 78.3 percent of their respective turnovers in 2014. The turnover of government securities repos on the stock exchanges rose 37.2 percent year on year to 90.72 trillion yuan.

The flow of funds among financial institutions displayed the following characteristics. First, large banks remained net fund providers, and the amount of their net lending increased 87.1 percent year on year, an acceleration of 111.8 percentage points from the previous year. Second, small- and medium-sized banks, and securities and fund management companies remained net fund borrowers, with their net borrowing increasing by 114.8 percent and 90.7 percent respectively from the last year. In particular, during the third and fourth quarters the net borrowing of small- and medium-sized banks increased rapidly, accounting for 73.9 percent of the total net borrowing in 2014.

Table 6 Fund Flows among Financial Institutions in 2014

Unit:100 million yuan

	Repos		Inter-bank borrowing	
	2014	2013	2014	2013
Chinese-funded large banks①	-816,890	-439,669	-63,213	-30,650
Chinese-funded small-	314,746	152,761	-41,619	-25,633

and medium-sized banks ②				
Securities and fund management companies	299,378	158,905	76,852	38,354
Insurance companies	89,564	55,543	180	25
Foreign-funded financial institutions	50,404	12,679	6,806	1,598
Other financial institutions and vehicles ③	62,798	59,780	20,994	16,307

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

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

③Other financial institutions and vehicles include urban credit cooperatives, rural credit cooperatives, finance companies, trust and investment companies, financial leasing companies, asset management companies, social security funds, investment companies, corporate annuities, and other investment vehicles. Some of these financial institutions and vehicles do not participate in the inter-bank funding market.

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

Source: China Foreign Exchange Trade System.

Money-market interest rates were stable. In general, money-market interest rates declined in the first half of the year, fluctuated somewhat due to seasonal factors in June and July, and then went up in December, though they were still lower than during the same period of the last year. Due to the frequent issuances of new stocks, on-going buoyant trading on the stock market, declines in the RMB equivalent of foreign- exchange purchases on a net basis, and increases in provisional funds of commercial banks at year-end, interest rates on the money market went up slightly in December and the weighted average interest rate of inter-bank borrowing and bond-pledged repos both posted 3.49 percent, down 67 and 79 basis points respectively from the same period of the last year. At end-2014, the overnight and 7-day Shibor rates posted 3.53 percent and 4.64 percent respectively, up 38 basis points and down 61 basis points from the end of the last year; and the 3-month and 1-year Shibor rates were 5.14 percent and 4.73 percent respectively, down 42 and 23 basis points from the end of the last year.

Transactions of interest-rate derivatives increased rapidly. In 2014 the total notional principal of RMB interest-rate swaps amounted to 4.03 trillion yuan, up 47.9 percent year on year. In terms of the term structure, RMB interest rates with maturities within one year traded most briskly and their aggregate notional principal posted 3.18 trillion yuan, accounting for 78.9 percent of the total. In terms of the reference rates, the base rate of the floating end of the RMB interest-rate swaps mainly included the 7-day fixing repo rate (FR007) and the Shibor, and their notional principal accounted for

81.1 percent and 18.2 percent of the total respectively. To meet the increasing demand of market participants to hedge interest-rate risks and to promote the balanced development of the spot and derivative markets, the China Foreign Exchange Trade System (CFETS) launched in November 2014 four kinds of standard products for interest-rate derivatives on the inter-bank market, based on the FR007, the Shibor, and other benchmarks. By the end of 2014, a total of 212 standard products of interest-rate derivatives had been traded, with a gross turnover of 41.35 billion yuan.

Table 7 Transactions of Interest-rate Derivatives

	Interest-rate swaps		Bond forwards		Forward-rate agreements	
	Number of deals (lots)	Amount of notional principal (100 million yuan)	Transactions (lots)	Amount (100 million yuan)	Transactions (lots)	Amount of notional principal (100 million yuan)
2013	24,409	27,277.8	1	1.0	1	0.5
2014	43,019	40,347.2	—	—	—	—

Source: China Foreign Exchange Trade System.

2. Bond issuances expanded rapidly, and the yield curve of bonds shifted downward by a larger margin

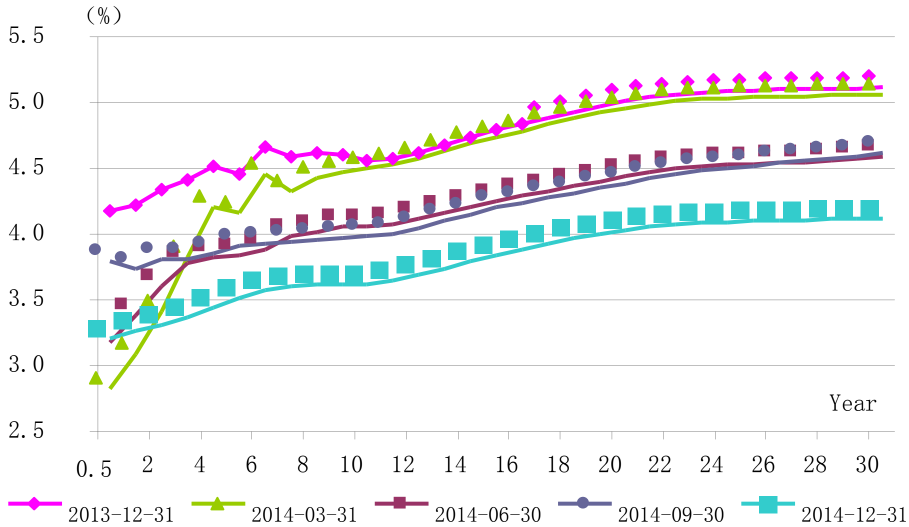
The spot bond trading volume on the inter-bank market came close to the level of the last year. In 2014 a total of 40.36 trillion yuan of bonds was traded, with a daily average of 161.4 billion yuan, down 3 percent year on year. In terms of the trading entities, Chinese-funded small- and medium-sized banks were mainly net bond sellers, with total net spot bond sales of 1.11 trillion yuan in 2014; other financial institutions and vehicles, and foreign-funded financial institutions were mainly net bond purchasers, with net spot bond purchases of 598.8 billion yuan and 418.6 billion yuan respectively. Large Chinese-funded banks turned from net bond sellers during the first three quarters to net bond purchasers in the fourth quarter, with net bond purchases of 39.7 billion yuan for the entire year. In terms of trading products, a total of 5.88 trillion yuan of spot government securities was traded, accounting for 14.6 percent of the spot bond transactions on the inter-bank market; the turnover of spot financial bonds and corporate debenture bonds was 18.46 trillion yuan and 15.89 trillion yuan respectively, accounting for 45.7 percent and 39.4 percent. A total of 2.81 trillion yuan of government securities was traded on the stock exchanges in 2014, up 61.6 percent year on year.

Bond indices on the inter-bank markets moved upward. In 2014 the China Bond Composite Index (net price) rose from 96.07 points at the beginning of the year to 101.42 points at year-end, up 5.57 percent, while the China Bond Composite Index (full price) rose from 107.47 points to 114.50 points, up 6.54 percent. The Government Securities Index on the stock exchanges rose 4.36 percent, from 139.52

points early in the year to 145.60 points at year-end.

The yield curve of government securities on the inter-bank market moved downward by a large margin. At end-2014, the yields of 1-year, 3-year, 5-year, 7-year, and 10-year government securities declined by 96, 105, 95, 98, and 93 basis points respectively from the end of 2013, while the spread between 10-year and 1-year government securities widened by 3 basis points to 36 basis points from the end of 2013. The reasons for the downward movements of the yield curve were as follows. First, as the growth of the Chinese economy slowed down, the hike in the CPI moderated. Second, after regulation of the inter-bank business of commercial banks was strengthened, the released funds gradually flowed back to the bond market. Third, as the PBC used a mix of monetary policy tools to strengthen macro controls, volatilities in the demand and supply of funds declined and the demand for bond investments increased accordingly.

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



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

The volume of bond issuances expanded significantly. In 2014 a total of 10.98 trillion yuan of bonds (including central bank bills) was issued, 2.12 trillion yuan more than that in the previous year, among which the issuances of debt-financing instruments of non-financial businesses and financial bonds registered a larger year-on-year increase. At end-2014, outstanding bonds of all kinds posted 35.32 trillion yuan, up 17.8 percent year on year.

Some innovative products, such as project-revenue bills and carbon emission revenue bonds were launched. Project-revenue bills are issued by the project companies and use cash flows from the project operations as the main source of repayment. The launch of project-revenue bills helps to establish a transparent and regulated investment and financing mechanism for urban construction, to effectively control and mitigate the risks of local government debts, and to provide funding for the construction of urbanization. The carbon emission revenue bonds are priced based on fixed plus floating rates. In particular, the floating rate is based on the yield of the specific carbon emissions project of the issuer. This creates a precedent whereby the pricing of debt-financing instruments is connected to "unconventional targets" and the concept of low carbon is promoted. This is of great significance for improving the low-carbon economy, developing a financial eco-system, and promoting industrial transformation and upgrading.

Table 8 Bond Issuances in 2014

Type of bond	Issuances (100 million yuan)	Year-on-year growth (100 million yuan)
Government securities①	21,747	1,517
Central bank bills	0	-5,362
Financial bonds②	36,552	10,242
Of which: Financial bonds issued by the China Development Bank and policy financial bonds	23,201	3,390
Corporate debenture bonds③	51,516	14,817
Of which: Debt-financing instruments of non-financial enterprises	41,812	13,124
Enterprise bonds	8,260	2,008
Corporate bonds	1,028	-367
Total	109,815	21,214

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

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

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

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

Coupon rates declined notably. The coupon rate of 10-year government bonds issued in December was 3.77 percent, down 31 basis points from those of the same maturity issued in November of 2013. The coupon rate of 10-year financial bonds issued by the China Development Bank in December was 4.37 percent, down 67 basis points from that of the same maturity issued in December 2013. The coupon rates of corporate debenture bonds issued in December rebounded somewhat, though they were still lower than those of the same maturity issued in the last year. The average coupon rate of short-term financing bills (rated A-1) issued by AAA-rated enterprises was 5.3 percent, up 26 basis points from September and down 129 basis points from the same period of the last year; the average coupon rate of 5-year medium-term notes (rated AAA) issued by AAA-rated enterprises was 5.67 percent, up 18 basis points from September and down 81 basis points from the same period of the last year. The Shibor played a greater role in bond pricing. In 2014 2 floating-rate bonds were issued based on the Shibor, with a gross issuance volume of 8 billion yuan; 582 fixed-rate enterprise bonds were issued based on the Shibor, with a gross issuance volume of 689.2 billion yuan; and a total of 1034.1 billion yuan of fixed-rate short-term financing bills was issued based on the Shibor, accounting for 98 percent of all fixed-rate short-term financing bills.

3. The volume of bill financing increased rapidly and interest rates showed a downward trend

The bill acceptance business increased slightly. In 2014 commercial bills issued by enterprises totaled 22.1 trillion yuan, up 8.9 percent year on year; outstanding commercial bills posted 9.9 trillion yuan at end-2014, up 9.3 percent year on year. In the first half of the year, the balance of bill acceptances continued to increase, and at end-June they reached a historical high of 10.2 trillion yuan. In the second half of the year, the balance of bill acceptances fluctuated by a small margin, and at end-2014 they had increased by 800 billion yuan from the beginning of the year. In terms of the issuing entity, outstanding bankers' acceptances were mainly issued by enterprises in the manufacturing, wholesale, and retail industries, with small- and medium-sized enterprises issuing about two-thirds of the total. The steady growth in bill acceptances has provided financing support to the real sector, in particular to small- and medium-sized enterprises.

The outstanding balance of bill financing increased rapidly and interest rates on the bill market showed a downward trend. In 2014, commercial bills discounted by financial institutions totaled 60.7 trillion yuan, up 33.0 percent year on year; the outstanding balance of bill discounts stood at 2.9 trillion yuan, up 48.9 percent year on year. The outstanding amount of bill financing increased rapidly, growing by 960 billion yuan from the beginning of the year; the share of outstanding bill financing in the total outstanding loans stood at 3.6 percent, up 0.84 percentage point year on year. In 2014, as overall liquidity in the banking system was reasonable and appropriate, interest rates on the money market showed a downward trend. Due to the downward movement of discount rates as a result of central bank discount rate adjustment, movements of the money-market interest rates, and changes in the supply and demand in the bill market, interest rates declined amid fluctuations on the bill market.

4. Both the stock indices and equity financing increased notably

The stock indices rebounded steadily in the first three quarters and rose rapidly in the fourth quarter. At end-2014, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 3,235 points and 11,015 points, up 52.9 percent and 35.6 percent respectively from the end of 2013. The Growth Enterprise Board (GEB) Index (Chinext Price Index) closed at 1,472 points, up 12.8 percent from the end of 2013. The weighted average P/E ratio of the A-share market of the Shanghai Stock Exchange rose from 11.0 times at end-2013 to 16.0 times at end-2014, while during the same period that of the Shenzhen Stock Exchange rose from 28.0 times to 34.6 times.

Turnover on the stock markets increased rapidly. In 2014 turnover on the Shanghai and Shenzhen stock exchanges totaled 74.24 trillion yuan, up 58.6 percent year on year, and the daily turnover averaged 303 billion yuan, up 54.1 percent year on year. In particular, turnover in the fourth quarter increased rapidly, with an average daily turnover of 549.4 billion yuan, up 172 percent year on year. Turnover on the GEM Board amounted to 7.8 trillion yuan in 2014, up 52.5 percent year on year. At end-2014 the combined market capitalization of the Shanghai and Shenzhen exchanges posted 31.56 trillion yuan, up 58.1 percent year on year; the market capitalization of the GEM Board posted 1.31 trillion yuan, up 59.1 percent year on year.

The amount of equity financing increased rapidly. In 2014 a total of 706 billion yuan was raised by enterprises by way of IPOs, additional offerings, rights issuances, and warrant exercises, representing an increase of 319.3 billion yuan year on year. Among this total, 484.2 billion yuan was raised on the A-share market, an increase of 203.9 billion yuan from the last year.

5. Assets in the insurance industry grew rapidly

In 2014 total premium income in the insurance industry amounted to 2.02 trillion yuan, representing year-on-year growth of 17.5 percent and an acceleration of 6.3 percentage points over the last year; total claim and benefit payments amounted to 721.6 billion yuan, representing year-on-year growth of 16.1 percent. Specifically, total claim and benefit payments in the property-insurance sector increased 10.2 percent, while those in the life-insurance sector increased 23.6 percent.

The growth of insurance assets accelerated. At end-2014, total assets in the insurance industry posted 10.16 trillion yuan, representing year-on-year growth of 22.6 percent and an acceleration of 9.9 percentage points from the end of 2013. Among this total, bank deposits increased 11.8 percent year on year, while investment-linked assets increased 25.4 percent.

Table 9 Use of Insurance Funds, End-2014

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-2014	End-2013	End-2014	End-2013
Total assets	101,591	82,887	100	100
Of which: Bank deposits	25,311	22,641	24.9	27.3
Investments	68,004	54,232	66.9	65.4

Source: China Insurance Regulatory Commission.

6. Swap and forward transactions on the foreign-exchange market increased rapidly

In 2014 the turnover of spot RMB/foreign-exchange transactions totaled USD4.12 trillion, up 1.2 percent year on year. Turnover of RMB/foreign-exchange swap transactions totaled USD4.49 trillion, up 32.1 percent year on year, among which overnight RMB/USD swap transactions amounted to USD2.36 trillion and accounting for 52.6 percent; turnover on the RMB/foreign-exchange forward market totaled USD52.9 billion, up 63.5 percent year on year. Turnover of foreign currency pair transactions amounted to USD60.6 billion, down 5.7 percent year on year. In particular, USD/HKD transactions accounted for the lion’s share, or 35 percent, of the total.

The number of participants on the foreign-exchange market increased further. At end-2014, there were 465 members on the foreign-exchange spot market, 98 members on the foreign-exchange forward market, 97 members on the foreign-exchange swap market, 84 members on the currency swap market, and 39 members on the foreign-exchange options market. In addition, there were 31 market-makers on the spot market and 27 market-makers on the forward and swap markets.

7. The price of gold saw large fluctuations

In 2014 the price of gold rallied and then declined. The price of gold on the international market peaked at USD1,385.0 per ounce and reached a trough of USD1,142.0 per ounce, closing at USD1,199.25 per ounce at end-2014 and representing a decline of USD2.25 per ounce, or 0.2 percent, from the end of the last year. The movement of domestic gold prices kept pace with that on the international market. During the year, the highest price of gold (AU9999) on the Shanghai Gold Exchange was 273.6 yuan per gram, and the lowest price was 223.0 yuan per gram. At end-2014, the price of gold closed at 240.59 yuan per gram, representing an increase of 4.13 yuan per gram, or 1.8 percent, from the end of the last year. For the whole year, the weighted average price recorded 249.51 yuan per gram, down 10.4 percent from the last year.

The Shanghai Gold Exchange performed in a stable manner, while its trading volume increased significantly. In 2014 the trading volume of gold was 18,500 tons, an increase of 59.2 percent year on year, and turnover posted 4.6 trillion yuan, an increase of 42.8 percent year on year. The trading volume of silver was 500,000 tons, an increase of 16.1 percent year on year, and turnover posted 1.9 trillion yuan, down 3.9 percent year on year. The trading volume of platinum was 64.9 tons, a decline of 28.1 percent year on year, and turnover posted 18.77 billion yuan, down 31.4 percent year on year.

II. Institutional building in the financial markets

1. The bond market was regulated to promote innovation and to build a multi-tiered market system

Efforts were made to promote the building of a multi-tiered bond market and to guide non-legal-person private equities, such as eligible trust products, asset management schemes of securities firms, rural financial institutions, and eligible non-financial institutions, to invest in the inter-bank bond market, thus further broadening the investor base. Continued efforts were made to promote innovation in financial products. Project-revenue bills, M&A bonds, supply chain bills, and carbon-emission bonds were launched. The pilot scheme of credit asset securitization was further expanded, and the product variety of the bond business on commercial bank counters was expanded to include other government-sponsored entity bonds, such as financial bonds issued by the China Development Bank, policy financial bonds, bonds issued by the China Railway Corporation, and so on. Efforts were made to promote the issuance of highly-rated bonds by the China Development Bank and other institutions simultaneously on the inter-bank bond market and the exchange market. In December 2014 bond pre-issuance trading business was launched to improve the transparency and competitiveness of bond issue pricing, to improve the bond yield curve, and to buoy up bond trading on the secondary market.

2. The foreign-exchange market developed based on regulation, and the opening-up of the gold market was promoted steadily

The principle of business regulation and the principle of bank operations were combined to regulate the development of the foreign-exchange derivative business. There is a larger variety of risk-hedging instruments, such as foreign-exchange options. Limit on the spread of banks' quotations of RMB/USD buying and selling rates to clients were lifted and banks can now price their quotation rates independently. The *Administrative Rules on Banks' Purchase and Sale of Foreign Exchange* and its implementation rules were amended to lower the market access threshold and to support access of non-banking financial institutions to the inter-bank foreign-exchange market. The *Guidelines on the Code of Conduct and Conventions in the Inter-bank Foreign-Exchange Market* were issued to strengthen self-disciplining in the foreign-exchange market.

Institutional building of the gold market was promoted on a gradual basis. The Shanghai Gold Exchange amended and improved a number of rules on OTC transactions, agency business, and so forth, and issued the *Master Agreement on Gold Leasing Business (2013 version)*. A market-making system of OTC gold trading was established on a trial basis, OTC gold options were launched, and the gold market had more participants. The Shanghai Gold Exchange launched the international gold board in the China (Shanghai) Free Trade Zone to welcome international investors to the market and to steadily promote the opening-up of the gold market.

3. Remarkable achievements were made in the reform and opening-up of the securities market

In May 2014 the State Council issued *Several Opinions on Further Promoting the Healthy Development of the Capital Market* (State Council Document [2014] No.17), laying out a roadmap for the next stage of capital market development. In 2014 remarkable achievements were made in the institutional building of the securities market. First, the *Administrative Rules for the Pilot Program of Preferred Stocks* were issued, and the program was steadily promoted. During the year, a total of five listed companies issued preferred stocks and raised 103 billion yuan. The launch of the preferred stock program has supported the M&A and restructuring activities of enterprises, increased the varieties of securities products, and provided investors with diversified investment channels. Second, the Shanghai-Hong Kong Stock Exchanges Connect Mechanism (SHSECM) was formally launched. The connect mechanism will foster closer ties between capital markets in Mainland China and in Hong Kong and will promote the development of capital markets in the two places, as well as the internationalization process of the RMB. In April, the securities authorities in the Chinese mainland and Hong Kong published a joint announcement regarding approval in principle of the establishment of the Shanghai-Hong Kong Stock Exchanges Connect pilot program. In June, the CSRC issued *Several Guidelines on the Pilot Program of the Shanghai-Hong Kong Stock Exchanges Connect Mechanism*, specifying the coverage of the connect business, the share of foreign ownership, the clearing and squaring approach, and stipulating the requirements for investor protection, supervision, management, and so forth. In November, with the approval of the State Council, the Shanghai-Hong Kong Stock Exchanges Connect Mechanism (SHSECM) was formally launched, and the securities markets in mainland China and

Hong Kong performed in a stable manner. Third, *Several Guidelines on Reforming, Improving, and Strictly Implementing the Delisting System of Listed Companies* were issued. The launch of the delisting system of listed companies indicated the market-orientation, legalization, and normalization of the delisting of listed companies. Fourth, the *Rules on Regulation of Futures Companies* were issued, appropriately lowering the market access threshold and establishing regulations on the scope of business, investor protection, and so forth.

4. Efforts were made to improve institutional arrangements in the insurance market

In 2014 the State Council in succession issued *Several Opinions on Accelerating the Development of a Modern Insurance Service Industry* and *Several Opinions on Accelerating the Development of Commercial Health Insurance*, further clarifying the development plan for the insurance industry. Efforts were made to steadily promote the institutional building on the insurance market, through the market-based reform, risk prevention, consumer rights protection, and so forth. First, the market-based reform of the use of insurance funds was advanced. Supervision of the proportional use of insurance funds was improved, and the investment channels for insurance funds were broadened. Insurance funds can establish private equity fund and can be invested in preferred stocks, venture capital funds, and companies listed on the GEM Board. In addition, the China Insurance Asset Management Association was established, the reform of market access and exit mechanisms for insurance companies was deepened, and the administrative rules on the M&A of insurance companies were developed. Second, risk prevention for insurance companies was strengthened, post-investment management of insurance funds was improved, and management of the reputational risks of insurance companies was included in the comprehensive risk management system. The sales volume, rate limit, and capital regulation of high cash-value products were clarified to promote the healthy development of high cash-value products. Third, the *Opinions on Strengthening the Protection of Rights and Interests of Insurance Consumers* were issued. Qualifications and business standards for the sale of non-insurance financial products by insurance companies and insurance sales agents were stipulated to prevent misleading sales and to protect the rights and interests of consumers.

Part 4 Macro-economic Analysis

I. Global economic and financial developments

In 2014 the global economy was still in a period of deep rebalancing, with a modest recovery and an insufficient growth momentum. The economic performance and macro policies in the major economies clearly diverged, with higher volatility in the international financial market and in commodity prices, and more shocks from non-economic factors, including higher geopolitical risks. Specifically, the U.S. economic recovery was stronger than that in the other major economies, and conditions improved in the U.S. labor market. Growth in the euro area was weak, and there were tremendous downward pressures on inflation. In Japan, economic performance was significantly affected by policy volatility. Growth in the emerging market economies generally slowed down, with fluctuations in several financial markets.

1. Developments in the major economies

The economic growth momentum continued to strengthen in the U.S. GDP growth recorded 2.4 percent for the entire year of 2014, the fastest growth for the past four years. Real GDP growth contracted by 2.1 percent quarter on quarter (annualized) during the first quarter, hurt by the severe weather conditions. Since the second quarter, business investment, consumption, exports, and the real estate sector continued to move up, and the real estate market developed steadily. The annualized GDP growth in the second and third quarters posted 4.6 percent and 5.0 percent respectively. The CPI was relatively lower than the 2 percent inflation target set by the Fed during most of 2014, mainly due to the appreciation of the US dollar and the falling oil prices. In addition, in 2014 more new jobs since 1999 were created, with an average monthly increase of 208,000 new jobs. The unemployment rate dropped from 6.7 percent at the end of 2013 to 5.6 percent at the end of 2014.

Economic growth in the euro area was weaker than expected, with tremendous downward pressures on inflation. Since the second quarter of 2014, growth again slowed down and investments were still weak. A series of loose monetary policies launched by the European Central Bank (ECB) did not fundamentally speed up the real economy. The annualized GDP growth rates in the second and third quarters were merely 0.1 percent and 0.2 percent respectively. Inflation continued to move downward in 2014. In December, the Harmonized Index of Consumer Prices (HICP) declined by 0.2 percent year on year in the euro area, revealing the tremendous downward pressures on inflation. The unemployment rate remained high, registering about 11.4 percent by end-2014.

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

Country	Index	2013Q4			2014Q1			2014Q2			2014Q3			2014 Q4		
		Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
United States	Real GDP Growth Rate (annualized quarterly rate, %)	3.5			-2.1			4.6			5.0			2.6 (primary estimate)		
	Unemployment Rate (%)	7.2	7.0	6.7	6.6	6.7	6.7	6.3	6.3	6.1	6.2	6.1	5.9	5.7	5.8	5.6

	CPI (YOY, %)	0.9	1.2	1.5	1.6	1.1	1.5	2.0	2.1	2.1	2.0	1.7	1.7	1.7	1.3	0.8
	DJ Industrial Average (closing number)	15237	16086	16577	15699	16322	16458	16581	16717	16852	16563	17098	17043	17391	17828	17823
Euro Area	Real GDP Growth Rate (annualized quarterly rate, %)	0.2			0.3			0.1			0.2			…		
	Unemployment Rate (%)	11.9	11.9	11.8	11.8	11.8	11.7	11.6	11.6	11.6	11.6	11.5	11.5	11.5	11.5	11.4
	HICP (YOY, %)	0.7	0.9	0.8	0.8	0.7	0.5	0.7	0.5	0.5	0.4	0.4	0.3	0.4	0.3	-0.2
	EURO STOXX 50 (closing number)	2774	2901	2919	2853	2968	2916	2978	3033	3228	3115	3044	3067	2998	3076	2990
Japan	Real GDP Growth Rate (annualized quarterly rate, %)	-1.5			5.8			-6.7			-1.9			…		
	Unemployment Rate (%)	4.0	3.9	3.7	3.7	3.6	3.6	3.6	3.5	3.7	3.8	3.5	3.5	3.5	3.5	3.4
	Core CPI (YOY, %)	1.1	1.5	1.6	1.4	1.5	1.6	3.4	3.7	3.6	3.4	3.3	3.2	2.9	2.4	2.4
	NIKKEI225 (closing number)	14328	15662	16291	14915	14841	14828	14304	14632	15162	15621	15425	16174	16414	17460	17451

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

Japan's economic performance was significantly affected by its policies. Economic growth showed a sharp rebound in the first quarter and then dropped significantly in the second quarter due to the increase in the consumption tax rates since April 1. In the last quarter of 2014, the manufacturing PMI data rebounded slightly and the foreign trade data improved somewhat, but consumer and investor confidence remained weak. The consumer confidence index has been under 40 since September. In addition, due to falling oil prices, inflation in Japan again faced great downward pressures, which made it more difficult to achieve the inflation targets.

Growth in the emerging market economies generally slowed down, with several financial markets experiencing volatile fluctuations. With the Fed normalizing its monetary policy, the increasing geopolitical risks, and the sharply falling international oil prices, some emerging market economies with structural problems are facing risks of capital outflows. Countries such as Russia, Brazil, and Malaysia, which are highly dependent on commodity exports, have felt the brunt of these shocks. Some Asian economies, including Indonesia, felt the pinch due to their structural problems.

2. Developments in global financial markets

Since the beginning of 2014, affected by such factors as monetary policy divergences in the major economies, geopolitical risks, the sharp decline in international oil prices, and so forth, global financial markets experienced large fluctuations. The stock markets in some advanced economies rallied with a zig-zag path and the yields of government securities declined sharply. The financial markets in some emerging market economies fluctuated and local currencies depreciated substantially.

The USD appreciated against most major currencies. At the end of 2014, the exchange rate of the USD/EUR closed at 1.2097 dollar per euro, a depreciation of 11.99 percent from the end of 2013. The exchange rate of the GBP/USD and the JPY/USD closed at 1.5573 dollar per pound and 119.7 yen per dollar respectively, representing a depreciation of 5.9 percent and 12.02 percent respectively from the end of 2013. At the same time, most of the emerging market currencies depreciated. Among them, the Russian ruble, the Argentina peso, the Chilean peso, the Mexican peso, and the Brazilian real depreciated against the USD by 43.34 percent, 23.69 percent, 13.37 percent, 11.61 percent, and 11.11 percent respectively.

Money-market rates fluctuated at subdued level. Due to the tapering of the quantitative easing monetary policy by the Fed, the USD Libor in the London Inter-bank Market rose slightly. At the end of 2014, the 1-year dollar Libor posted 0.6288 percent, an increase of 4.58 basis points from the end of 2013. After the further easing of monetary policies by the ECB, the Euribor declined markedly. At the end of 2014, the 1-year Euribor registered 0.325 percent, a decrease of 23.1 basis points from the end of 2013.

Government bond yields in the major developed economies dropped substantially, though the yields in some emerging market economies rose considerably. At the end of 2014, 10-year government bond yields in the U.S., Germany, and Japan closed at 2.174 percent, 0.541 percent, and 0.326 percent respectively, down by 83, 140, and 41 basis points respectively from the end of 2013. The yields of 10-year government bonds in some emerging market economies continued to rise. By the end of 2014, the yields of 10-year government bonds in Russia had shot up by 511 basis points from the end of 2013.

The stock indices in the major advanced economies rallied, but the stock indices fluctuated wildly in most of the emerging market economies. At the end of 2014, the Dow Jones Industrial Average Index, the STOXX50 Index, and the Nikkei 225 Index closed at 17,823, 2,990, and 17,451 points respectively, up by 7.5 percent, 2.4 percent, and 7.1 percent respectively from end-2013. The stock markets in most of the emerging market economies went up, but with larger volatility than last year. The stock indices in India, Indonesia, and Turkey surged by 29.9 percent, 22.3 percent, and 32.1 percent. In contrast, affected by the crisis in Ukraine and the decline in its economy, the stock index in Russia went down significantly, dropping by 45.2 percent throughout the year.

3. Monetary policies in the major economies

Since the beginning of 2014, the monetary policies in the major advanced economies diverged further. The Federal Open Market Committee (FOMC) of the Federal Reserve (Fed) maintained the current 0 to one-quarter percent target range for the federal funds rate. From January to October, it made a series of further measured reductions in its asset purchases. The FOMC decided to conclude its asset-purchase program in October. In addition, in an effort to make adjustment in the forward guidance, the FOMC said that “it can be patient in beginning to normalize the stance of monetary policy" in the statement released after its December regular meeting,, instead of “it likely will be appropriate to maintain the 0 to one-quarter percent target range for the federal funds rate for a considerable time."

The European Central Bank (ECB) further relaxed monetary policies at its regular meetings in June and September. In September, the ECB announced it would lower interest rates on the main refinancing operations (MROs), the marginal lending facility, and the deposit facility respectively to 0.05, 0.3, and -0.2 percent, and, from the fourth quarter of 2014, it would launch a two-year asset-purchase plan to buy asset-backed securities (ABS) and covered bonds. On January 22, 2015, to meet its inflation target, the ECB announced to expand asset-purchase program to include bonds issued by governments and institutions in the euro area in the program. The combined monthly purchases of public and private sector securities will amount to €60 billion and the program is intended to be carried out until the end of September 2016.

The Bank of Japan (BOJ) expanded the scale of its quantitative and qualitative monetary easing policy. On October 31, it announced it would increase injections of base money from 60 to 70 trillion yen per year to 80 trillion yen per year, increase Japanese government bond (JGB) purchases by 30 trillion to 80 trillion yen per year, extend the average remaining maturity of JGB purchases to about 7 to 10 years (an extension of a maximum of about 3 years compared with that in the past), and increase the purchase of exchange-trade funds (ETFs) and Japan real estate investment trusts (J-REITs) by a large margin.

The Bank of England (BOE) maintained the Bank Rate at 0.5 percent and the scale of asset purchases at GPB375 billion. Affected by the ECB’s actions to expand its asset-purchase program, the central banks in Canada, Switzerland, Denmark, Australia, and other countries have cut their policy rates since the beginning of 2015. In addition, the Swiss National Bank (SNB) discontinued the minimum exchange rate of CHF 1.20 per euro.

The monetary policies in the emerging market economies have diverged as well, and the policy challenges have been more difficult. On the one hand, some countries tightened monetary stance in response to inflationary pressures, capital outflows, and depreciation pressures. The Central Bank of Brazil increased the benchmark interest rate on five occasions, by a total amount of 175 basis points to 11.75 percent. The Central Bank of Argentina raised the interest rates of short-term central bank bills twice, by a total of 930 basis points to 28.8 percent. The South African Reserve Bank raised the policy rate on two occasions, by 75 basis points to 5.75 percent. In response to the substantial depreciation of the local currency, the Central Bank of Russia raised the benchmark rate on six occasions, by a total of 1150 basis points to 17 percent. The National Bank of Ukraine raised its policy rate on two occasions, by a total of 450 basis points, to 14 percent. In addition, some emerging market economies intervened in the foreign-exchange markets to maintain a stable exchange rate.

On the other hand, some emerging market economies relaxed their monetary policies in order to boost economic growth. The Central Bank of the Republic of Turkey lowered the 1-week repo rate on three occasions, by 175 basis points in total to 8.25 percent. The Central Bank of Chile lowered the policy rate on six occasions, by a total of 150 basis points to 3 percent. The Bank of Korea lowered its benchmark rate on two occasions, by a total of 50 basis points to 2 percent. The Bank of Mexico lowered benchmark rate by 50 basis points to 3 percent. In January 2015 the Central Bank of Russia lowered the benchmark rate by 200 basis points to 15 percent to stimulate growth, and the central banks in India and Turkey also lowered their policy rates respectively.

4. The global economic outlook and major challenges

The pace of the global recovery is expected to accelerate in 2015. In its *World Economic Outlook* released in January 2015, the International Monetary Fund (IMF) revised downward the projection for global growth in 2015 by 0.3 percentage points to 3.5 percent, but this was an increase of 0.2 percentage point from the previous year. Projections for growth in the U.S. were revised upward by 0.5 percentage point to 3.6 percent, an increase of 1.1 percentage points from the previous year; projections for growth in the euro zone and Japan were both revised downward by 0.2 percentage point to 1.2 percent and 0.6 percent respectively, 0.4 and 0.5 percentage point higher than the growth in 2014; growth in the emerging market and developing economies was projected to be 4.3 percent in 2015, representing a downward adjustment of 0.6 percentage point from the previous projection and a deceleration of 0.1 percentage point from the growth registered in 2014. Overall, the global economy still faces the following challenges.

First, the economic performance and monetary policies in the major economies may continue to show increased divergences and higher volatility. With the successful deleveraging in the private sector and developments in new energy, new technology, and the manufacturing industries, the U.S. economy is expected to improve further. Due to the slow progress in structural reforms, recovery in Europe and Japan still face many uncertainties, such as weak economic growth and downward pressures on inflation. Some emerging economies are also facing structural adjustment pressures. While recovery in the major economies has diverged in the process of the global rebalancing, geopolitical risks and tensions have further intensified. Tensions between Russia and Ukraine, the mutual sanctions between Russia on the one hand, the U.S. and the European countries on the other, extremist activities, and social uncertainties caused by the widening gap between the rich and poor might take their toll on market confidence and have adverse effects on the global economy and trade and financial activities, thus increasing the complexity and uncertainty of the global economic recovery.

Second, affected by the divergence in the economic performance and the macro-economic policies of the major economies, volatility in global financial markets might increase further. The Fed is considering the timing of normalizing its stance on monetary policy, and the federal funds rate may gradually go up in 2015. However, the ECB and the BOJ are likely to further expand the scale of the quantitative easing monetary policy. There are many uncertainties in the timing and pace of the implementation of these monetary policies. Global assets may be reallocated on a wider scale driven by divergence in the economic performance and macro-economic policies across countries, and may increase the uncertainties and volatility in the direction of cross-border capital flows and exchange-rate movements. This may place pressures on those economies with vulnerable financial systems, making it more difficult for them to effectively implement the macro-economic policies.

Third, uncertainties in oil prices may pose new risks to global growth. The plummet in international oil prices since June 2014 impacted the world economy in two direction. On the one hand, it helped to increase global consumer demand by improving the terms of trade of oil-importing countries and providing opportunities for reductions in energy subsidies and tax reform. On the other hand, it had a strong negative impact on fiscal revenue and economic growth in some oil-exporting countries. There are different assessments on the future development of oil prices. Analysis by the IMF suggest that current oil prices may have fallen too much and may rebound sharper or sooner than expected. Uncertainties in international commodity prices further complicate the international economic environment.

II. Analysis of China’s macro-economic performance

In 2014 the Chinese economy continued to perform within a reasonable range, with positive developments in its structural adjustments. Consumption registered stable growth, and exports and imports stabilized after a slowdown. Investments grew at a more moderate pace, and final consumption contributed 51.2 percent to GDP growth, 3 percentage points higher than in the previous year. Employment was basically stable. Consumer prices registered moderate growth. It is estimated that China’s GDP in 2014 registered 63.6 trillion yuan, growing by 7.4 percent year on year. The growth rate in the four quarters was 7.4 percent, 7.5 percent, 7.3 percent, and 7.3 percent respectively year on year, and 1.6 percent, 1.9 percent, 1.9 percent, and 1.5 percent quarter on quarter. The consumer price index (CPI) rose 2.0 percent year on year, and the trade surplus reached USD382.5 billion.

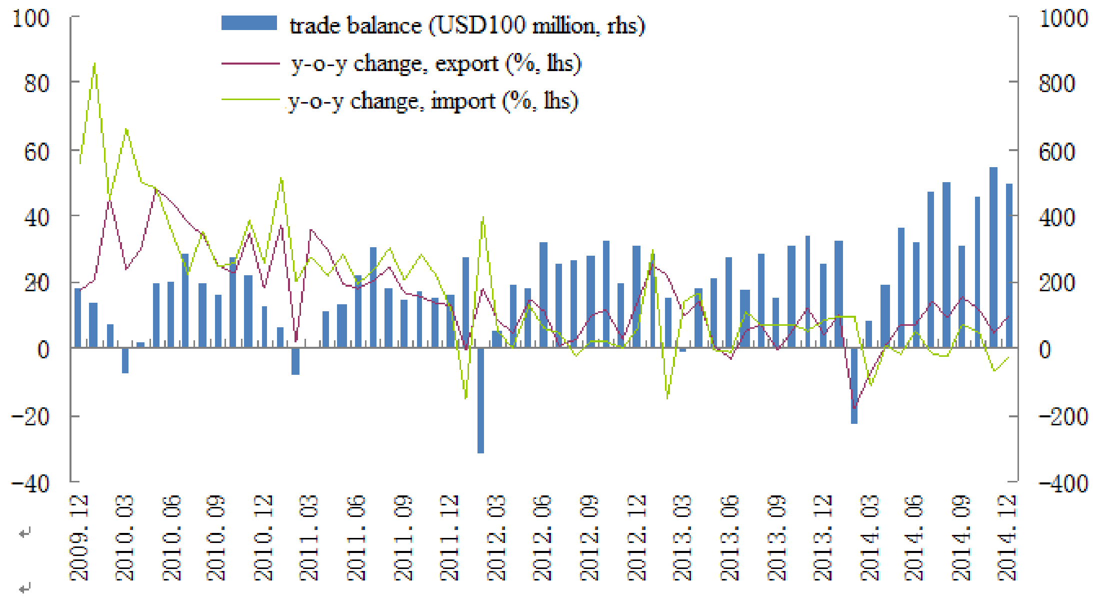
1. Consumption registered stable growth, while investment growth moderated and exports and imports stabilized amidst a slowdown

The income of urban and rural residents continued to rise. Consumption contributed more to promoting growth, and consumption based on new types of business operation registered higher growth. In 2014 per capita disposable income of urban residents stood at 28,844 yuan, increasing by 9.0 percent year on year in nominal terms and 6.8 percent in real terms. The per capita cash income of rural residents posted 9.892 yuan, growing by 9.2 percent in real terms. As indicated by the Q4 Urban Depositors' Survey conducted by the People's Bank of China, current income sentiment of urban residents registered 49.2 percent, which was flat with the previous quarter. Consumption sentiment registered stable growth, with residents inclined to consume more accounting for 18.7 percent, which is 0.7 percentage point more than that in the third quarter. In 2014, retail sales of consumer goods totaled 26.2 trillion yuan, up 12.0 percent year on year in nominal terms and 10.9 percent in real terms. Specifically, retail sales of consumer goods in urban areas totaled 22.6 trillion yuan, increasing by 11.8 percent, while retail sales of consumer goods in rural areas stood at 3.6 trillion yuan, growing by 12.9 percent year on year. Online retail sales in China maintained rapid growth, registering at 2.8 trillion yuan, up by 49.7 percent year on year. The growth of consumption of telecommunications equipment, recreation, and sports products grew more rapidly, and mass consumption and services consumption picked up. In 2014 the revenue of statistically small catering businesses rose by 13.2 percent, which was 11 percentage points higher than that of statistically large catering business. For the first time in history, the number of overseas trips made by Chinese residents exceeded 100 million last year.

Growth of fixed-asset investments slowed down. In 2014 fixed-asset investments (excluding those by rural residents) reached 50.2 trillion yuan, growing by 15.7 percent year on year in nominal terms and 15.1 percent in real terms, a deceleration of 3.9 percentage points and 4.1 percentage points from the previous year respectively. Broken down by industries, investment in the primary industries registered rapid growth, while the growth of investment in the tertiary industries slowed down due to the declining growth of real estate investment and other factors. In 2014 investment in the primary, secondary, and tertiary industries reached 1.2 trillion yuan, 20.8 trillion yuan, and 28.2 trillion yuan respectively, up 33.9 percent, 13.2 percent, and 16.8 percent year on year. Planned investments for on-going construction projects totaled 96.9 trillion yuan, up by 11.1 percent year on year, while planned investments for new projects rose 13.6 percent, reaching 40.6 trillion yuan.

Imports and exports stabilized amidst a slowdown. In 2014 imports and exports totaled 26.4 trillion yuan, up 2.3 percent year on year. Among this total, exports, displaying a trend of rebounding growth, posted 14.4 trillion yuan in 2014, up 4.9 percent year on year; while imports, as a result of a plummeting of commodity prices and a lower demand for imports in the processing trade, declined 0.6 percent year on year to 12.0 trillion yuan. In 2014 the trade surplus rose 45.9 percent year on year to 2.35 trillion yuan. In US dollar terms, the total value of exports and imports grew 3.4 percent to USD4.3 trillion. The share of general trade increased 1 percentage point year on year to 53.8 percent. The trade structure continued to improve. The share of the export value of manufactured goods increased for three consecutive years, and the equipment manufacturing industry was an important driver for export growth. The growth of exports of high-tech products, such as bio-technology products, aeronautics and astronautics products, and computer-integrated manufacturing products, was all above 15 percent, and consumer goods increased as a share of imports. China's trading partners further diversified. Trade with the developed economies registered stable growth, while the share of exports and imports with the developing countries gained 0.4 percentage points compared with the previous year. In 2014 actually utilized foreign direct investments rose 1.7 percent year on year to USD119.56 billion, and cumulative non-financial outbound direct investments increased 14.1 percent to USD102.89 billion.

Figure 3 Export and Import Growth and the Trade Balance



Source: General Administration of Customs

2. Agricultural production was in good shape, and the performance of industrial production was within a reasonable range

The value-added growth of the tertiary industries outpaced that of the secondary industries, and accounted for a greater share. The value-added of the primary, secondary, and tertiary industries was 5.8 trillion yuan, 27.1 trillion yuan, and 30.7 trillion yuan respectively, growing by 4.1 percent, 7.3 percent, and 8.1 percent year on year and accounting for 9.2 percent, 42.6 percent, and 48.2 percent of GDP respectively. The share of the tertiary industries was 1.3 percentage points higher than that in the previous year, and 5.6 percentage points more than the share of the secondary industries.

Total grain production increased 0.9 percent year on year to 6.0710 trillion tons. Among this total, production of cereals reached 5.5727 trillion tons, growing by 0.8 percent year on year. The combined output of pork, beef, mutton, and poultry rose 2.0 percent year on year to 85.4 million tons, among which the output of pork grew 3.2 percent to 56.71 million tons.

Industrial production remained basically stable. In 2014 the value-added of statistically large enterprises, if calculated at comparable prices, grew by 8.3 percent year on year. Broken down by sectors, the value-added of the mining industry, manufacturing industry, electricity, heat, gas, and water production and supply industry increased by 4.5 percent, 9.4 percent, and 3.2 percent respectively. A total of 97.8 percent of the products supplied by statistically large enterprises was sold out. In 2014 the profits of statistically large enterprises rose 3.3 percent year on year to 6471.53 billion yuan, and the profit margin of their main businesses registered 5.91 percent. Among the 41 industrial categories, 28 earned more profits than in the previous year. In particular, gross profits in the manufacturing, railway, shipping, aeronautics and astronautics and other transport equipment industries, the electricity and heat production and supply industries, the, automobile manufacturing industry, and the computer manufacturing, and telecommunications and other electronic equipment industries grew rapidly, by 20.5 percent, 19.1 percent, 18.1 percent, and 17.1 percent respectively. According to the PBC Survey of 5,000 Industrial Enterprises, in the fourth quarter business operations were facing headwinds, but remained profitable. The indices of export orders and domestic orders both fell; the business climate index was 54.5 percent, continuing a moderate decline; the profit index registered 55 percent, which was flat with the previous quarter.

3. Overall price levels remained stable but grew more moderately

In 2014 major price indicators generally fell after rising. In the first 3 quarters, the growth of consumer prices was basically stable, and the decline in producer prices narrowed. In Q4, as a result of the accelerated plunge of crude oil prices, the growth of consumer prices slowed down significantly and the decline in producer prices widened.

The growth of consumer prices slowed down, of which the slowdown in food prices was more significant. In 2014 the CPI rose 2.0 percent year on year, decelerating by 0.6 percentage points. CPI growth for the four quarters registered 2.3 percent, 2.2 percent, 2.0 percent, and 1.5 percent respectively. Broken down by categories, food prices slowed down by a large margin, while the slowdown of non-food prices was more moderate. Food prices rose by 3.1 percent, decelerating by 1.6 percentage points year on year; non-food prices increased by 1.5 percent, decelerating by 0.1 percentage point compared with the last year. The price of consumer goods slowed down more significantly than that of services. The price of consumer goods grew by 1.8 percent, decelerating by 0.7 percentage point year on year; service prices rose by 2.5 percent, decelerating by 0.4 percentage points.

The decrease in producer prices was on a par with that in the previous year. In 2014 producer prices fell by 1.9 percent year on year, which remained the same as that in the previous year. Producer prices in the four quarters fell by 2.0 percent, 1.5 percent, 1.3 percent, and 2.7 percent respectively. The price of capital goods dropped by 2.5 percent, narrowing by 0.1 percentage point year on year, while the price of consumer goods registered zero growth, a deceleration of 0.2 percentage point year on year. Producer purchasing prices fell by 2.2 percent year on year, which was 0.2 percentage point more than the decrease in the previous year, and the decline in the four quarters stood at 2.1 percent, 1.9 percent, 1.5 percent, and 3.2 percent respectively. The price of agricultural capital goods dropped by 0.9 percent, which was larger than the 0.2 percent decline in the producer prices of agricultural products. In 2014 the corporate goods price index (CGPI) fell 2.2 percent year on year, decreasing by 2.0 percent, 1.6 percent, 1.6 percent, and 3.7 percent respectively in each quarter. The price of primary commodities plummeted, and the decline in investment products exceeded the drop in the price of consumer goods.

As a result of the plunge in crude oil prices and the overall slide in commodity prices in international markets, import prices continued to decrease. From Q1 through Q4, the average price of Brent Crude oil futures on the Intercontinental Exchange moved by -1.4 percent, 1.7 percent, -5.7 percent, and -25.5 percent quarter on quarter respectively, which amounted to a cumulative tumble of 29.5 percent; the average price of copper on the London Metal Exchange increased by -1.6 percent, -3.6 percent, 3.0 percent, and -5.3 percent on a quarter-on-quarter basis, which amounted to a cumulative decline of 7.4 percent. In 2014 import prices decreased 3.4 percent year on year, which was 1.6 percentage points more than the decline in the last year. From Q1 to Q4, import prices fell by 5.1 percent, 1.1 percent, 1.7 percent, and 5.5 percent respectively. Export prices dropped by 0.7 percent year on year, which was 0.1 percentage point more than the decline in the previous year, and grew by -1.8 percent, -2.0 percent, 0.6 percent, and 0.5 percent respectively in the four quarters.

The GDP deflator decreased. In 2014 the GDP deflator (the ratio of nominal GDP to real GDP) was 0.8 percent, down by 0.9 percentage point from the same period of the last year.

The price reform continued. First, the *Guiding Opinion on Establishing a Ladder Price System for Gas for Residents*, requiring local authorities to draft local implementation plans which should meet residents' demands for gas, reflect the scarcity of resources, cover the costs of supply, and guarantee fair burden-sharing. Second, the pilot program for target prices of cotton in the Xinjiang Uyghur Autonomous Region and that of soybeans in Northeast China and in the Inner Mongolian Autonomous Region was launched, where the target prices were calculated as a sum of the production costs and the basic profits. The temporary storage policy was cancelled. Producers are to sell cotton and soybeans at market prices, while the government will provide subsidies based on the price differentials, the acreage of the plantations, and the volume of production or sales. Third, an ad valorem tax reform on coal was launched nationwide, and the relevant funds established with revenues from various fees and charges were straightened out. Fourth, the pricing of a number of goods and services were deregulated and are now decided by the market.

Box 3 Movements of International Commodity Prices and Monetary Policy

The appreciation of the US dollar and the plummet of oil prices are two prominent recent phenomena in the global economy. It is necessary to study and analyze the implications of these developments and how macro-economic policy may respond.

International commodities include energy, basic raw materials, and agricultural commodities. Mostly priced in US dollars and affected by global demand, the different international commodities usually follow similar patterns in the movement of prices, but sometimes they may vary due to their respective supply and demand factors. As an important international commodity, oil prices demonstrate a typical pattern of volatility, and such volatility exerts a significant influence on the economy, which is a focus of all the relevant parties. The several oil crises in the twentieth century were characterized by a sudden rise and fall in oil prices, leading to higher inflation and lower production in the oil-importing countries, or so-called stagflation. As tightening macro-economic policies designed to address the inflation would cause further cuts in output, there was a consensus that monetary policy should not over-respond to the volatility in oil price, due to the following reasons: first, oil prices fluctuate quite often; second, monetary policy is more efficient in adjusting demand, but it has limited effects when responding to supply shocks. However, if it is an adjustment in fundamentals on the demand side that causes the change in oil prices, or if the change in oil price causes notable changes in inflationary expectations and is transmitted to core inflation, macro-economic policy should respond accordingly.

Since the second half of 2014, international oil prices tumbled from USD120 per barrel in June 2014 to below USD50 per barrel in January 2015. Behind such a plummet there were both demand and supply factors. On the one hand, lower potential growth in some economies caused slower growth in demand; on the other hand, increased shale gas (oil) capacity in the United States and the decision of the Middle Eastern countries not to reduce production led to a rise in aggregate supply. According to IMF research, lackluster demand was the main factor behind the oil price dive before Q4 2014, whereas thereafter the supply side played a bigger role. Moreover, the diverging recovery trajectories of the major economies and significant dollar appreciation as a result of the normalization of the Federal Reserve monetary policy also aggravated the plunge in oil prices, which are denominated in US dollars.

The tumbling oil prices have varying influences on different economies. For oil exporters, lower oil prices cut income and lead to higher fiscal and balance-of-payment pressures and a local currency depreciation. For oil importers, such a dive helps improve the terms of trade, reduces import expenditures, and may lead to an expansion of the trade surplus and the current account surplus. Meanwhile, lower oil prices also help lower the costs of intermediate inputs, facilitate further use of labor and capital, and promote national income and employment, which in general are positive factors. In an open economy, however, oil exporters and importers are closely connected, and thus an oil price plunge may also be risky for the importing countries. For example, financial institutions in oil-importing countries may have risk exposures to oil-exporting countries; enterprises in oil-importing countries have large investments in oil exporting countries; the huge fluctuations in the real economy or financial markets of some oil exporters due to structural problems may heighten uncertainties in the international economy and financial markets. In addition, price signals may serve as a negative incentive for the development of new energy.

A plunge in oil prices may also lead to lower price levels and even induce deflationary pressures. Such implications require an objective and comprehensive analysis. First, falls in oil prices mainly have an impact on the supply side and may not necessarily lead to lower demand. With steady consumption demand, lower raw material costs may help to reduce production costs in the corporate sector, and better performance in the corporate sector may enhance the residents' income and promote final demand. Second, a plunge in international oil prices provides an opportunity to reform the pricing system of resource products (including the relevant taxation and subsidy schemes). Further reform of the pricing of resource products will buffer the impact of oil price falls on general price levels.

As a result of heightened volatility in commodity prices and the exchange rates of the major currencies, and various supply and demand factors, uncertainty mounts regarding cross-border capital flows. The picture is made ever more complicated due to the diverging performance and the diverging policy responses in the different economies and the related spillovers. Therefore, a sound monetary policy stance should be maintained. The instruments for short-term demand management should mainly target changes in demand as well as changes in expectations and the behavior of market participants. Meanwhile, macro-prudential instruments can be adopted to mitigate pro-cyclical movements in the financial system and external shocks from non-fundamentals. In addition, the oil-related risks to financial assets should be closely watched and measures should be taken when necessary to mitigate such risks.

4. The growth of fiscal revenue and expenditures edged up

In 2014 fiscal revenue rose 8.6 percent to 14.04 trillion yuan, decelerating by 1.6 percentage points from the increase in the last year. Fiscal expenditures reached 15.17 trillion yuan, up 8.2 percent year on year, a deceleration of 2.7 percentage points from 2013. Fiscal revenue exceeded expenditures by 1.13 trillion yuan, which was 71.1 billion yuan than in the previous year.

In terms of the structure of fiscal revenue, tax revenue rose 7.8 percent year on year to 11.92 trillion yuan, and non-tax revenue registered 2.12 trillion yuan, up 13.5 percent year on year. Among this total, the corporate income tax and personal income tax grew by 9.8 percent and 12.9 percent year on year, and the domestic value-added tax, domestic consumption tax, and business tax rose by 7.1 percent, 8.2 percent, and 3.2 percent respectively, while the value-added tax on imported goods and the excise tax increased by 3 percent. As for the structure of fiscal expenditures, fiscal expenditures for urban and rural community affairs, traffic and transportation, and affordable housing grew relatively rapidly, increasing by 15.4 percent, 10.9 percent, and 10.9 percent respectively.

5. The employment situation was generally stable

At end-2014 total nationwide employment rose by 2.76 million year on year to 772.53 million, of which 393.1 million were employed in the urban areas, an increase of 10.7 million year on year.

A statistical analysis by the China Human Resources Market Information Monitoring Center indicates that market demand and supply were basically balanced in Q4 2014, and the ratio of job seekers to job vacancies was 1.15, an increase of 0.05 compared with Q3 of this year and Q4 of 2013. Broken down by industry, demand for labor in sectors such as the health industry, social security and social welfare, and the production and supply of electricity, gas, and water rose slightly, while demand for labor in other sectors went down. In terms of job seekers, there were fewer job seekers among young people who had just entered the labor market, fresh college graduates, the unemployed who formerly were employed, local rural residents, and migrants from other provinces. As for demand, 59.9 percent of job vacancies required a certain level of professional or technical qualifications. The demand for labor with preliminary professional levels increased by 27.6 percent, but the demand for a workforce with medium or high skill levels declined by 7.1 percent and 7.4 percent respectively.

6. International payments and expenditures were generally balanced

It is estimated that the current account surplus in 2014 was USD213.8 billion. The current account surplus to GDP ratio was 2.1 percent, remaining within a sustainable range as acknowledged by the international community. The capital and financial account registered a deficit of USD96 billion in 2014. After taking into account the changes in the exchange rate and asset prices, total reserve assets increased by USD118.8 billion in real terms in 2014 but declined by USD29.3 billion in Q4. In the second half of 2014, China’s balance-of-payments position shifted to a pattern of a current account surplus combined with a deficit in the financial and capital account. The volatility in two-way cross-border capital flows was more keenly felt. These developments were related to various factors including the U.S. monetary policy normalization, stronger dollar, the structural adjustments in the Chinese economy, and the accelerated global capital reallocation, which also significantly affected the supply and demand for liquidity in China.

The total external debt continued to grow. As of end-September 2014, the outstanding external debt posted USD894.8 billion, up 3.7 percent year on year. Among this total, the stock of registered outstanding external debt posted USD561.3 billion, an increase of 6.6 percent year on year and accounting for 62.7 percent of the total; the outstanding short-term external debt posted USD709 billion, an increase of 4.8 percent year on year and accounting for 79.2 percent of the total.

7. Sector analysis

(1) The real-estate sector

In 2014, nationwide turnover of commercial real estate declined and more cities reported lower real-estate prices. The growth of investment in real-estate development slowed down, while growth in loans in the real-estate sector moderated. Since the beginning of the fourth quarter, the decline in sales and the price of real estate have narrowed.

Sales of commercial real estate continued to fall. In 2014 the nationwide floor area of sold commercial real estate posted 1.21 billion square meters, down 7.6 percent year on year, which was 1.0 percentage point less than the decline in the first three quarters of the year. The sales value of commercial real estate declined 6.3 percent year on year to 7.6 trillion yuan, which was 2.6 percentage points less than the decline during the first three quarters of the year. Among this total, the sold floor area and the sales value of commercial residential housing accounted for 87.2 percent and 81.8 percent of the total sold floor area and the turnover in commercial real estate respectively.

More cities reported lower real-estate prices compared with the beginning of the year. In December 2014 the price of newly-built commercial residential housing dropped in 66 out of 70 nationwide large- and medium-sized cities, 60 more than in January, but the decline in prices narrowed in 60 cities in comparison with that in September; the price of newly-built commercial residential housing fell year on year in 68 cities, representing an increase of 67 from January. The price of pre-owned residential housing declined in 60 cities, which was 47 more than that in January but 10 less than that in September. Compared with last year, the price of pre-owned residential housing declined in 67 cities, 66 more cities than that in January.

The growth of investment in real-estate development continued to decline. In 2014 nationwide investment in real-estate development totaled 9.5 trillion yuan, up 10.5 percent year on year, a deceleration of 9.3 percentage points compared with the previous year. In particular, investment in residential housing posted 6.4 trillion yuan, growing 9.2 percent year on year and decelerating by 10.2 percentage points from 2013 and accounting for 67.7 percent of total investment in real-estate development. The floor area of newly started real-estate projects declined 10.7 percent year on year to 1.8 billion square meters, in comparison with an increase of 13.5 percent in 2013. The floor area of real-estate projects under construction grew 9.2 percent year on year to 7.26 billion square meters, representing a deceleration of 6.9 percentage points year on year. The floor area of completed real-estate projects posted 1.07 billion square meters, representing year-on-year growth of 5.9 percent, an acceleration of 3.9 percentage points from the previous year.

The growth in real-estate loans moderated. As of end-2014, outstanding real-estate loans of major financial institutions (including foreign-funded financial institutions) stood at 17.4 trillion yuan, up 18.9 percent year on year, which was 0.2 percentage point less than that at end-2013 and 0.6 percentage point more than that at end-November 2014. Outstanding real-estate loans accounted for 21.3 percent of the total outstanding loans, which was 0.3 percentage point higher than that at the end of 2013. In particular, outstanding mortgage loans rose 17.6 percent year on year to 10.6 trillion yuan, a deceleration of 3.4 percentage points from end-2013 but an acceleration of 0.4 percentage point from end-November; outstanding housing-development loans gained 24.4 percent year on year to 3.3 trillion yuan, an acceleration of 8.6 percentage points from end-2013; outstanding land-development loans rose 25.7 percent year on year to 1.3 trillion yuan, an acceleration of 15.9 percentage points from end-2013. In 2014 new real-estate loans registered 2.7 trillion yuan, an increase of 405.7 billion yuan year on year and accounting for 28.1 percent of total new loans, which was flat with end-2013.

More credit support was provided for the construction of welfare housing. At end-2014 outstanding loans for welfare-housing development posted 1141 billion yuan, up 57.2 percent year on year, which was 35.5 percentage points higher than the growth of housing-development loans and accounted for 35 percent of the total outstanding real-estate development loans. In addition, the pilot program of using housing provident fund loans to support the construction of affordable housing proceeded steadily. At end-2014 355 welfare-housing projects in 81 cities passed loan approvals and received 77.74 billion yuan in loan disbursements based on the construction progress, and 32.33 billion yuan of the principal was repaid.

(2) High-speed railway sector

As a vital infrastructure and one of the most important forms of mass transit, railways constitute arteries for the Chinese economy and play an indispensable role in economic and social development. Railways with a design speed of more than 250 kilometers enjoy advantages, such as high speed, large capacity, low pollution, and sound security. Such high-speed railways provide convenient transportation among cities along the line and play a positive role in supporting coordinated regional development, optimizing resource allocations and industrial layouts, and putting in place an efficient transportation system, lowering logistical costs, and so forth.

In recent years, the high-speed railway industry witnessed rapid growth. In terms of technological development, the Guangzhou-Shenzhen Express, which started operations in 2004, was the “test field” for the development of China’s high-speed railway. On August 1, 2008, the Beijing-Tianjin inter-city high-speed railway, which was the first high-speed railway line with independent intellectual property rights, began operations. On December 26, 2009, the Wuhan-Guangzhou high-speed railway started operations, which was the world’s longest high-speed railway completed under one project and which involved the most complicated types of engineering. Currently, the high-speed railway industry in China has completed the phase of importing, digesting, and absorbing technologies, and has entered the stage of independent innovation. The industry is now equipped with world-class high-speed railway design, production, and engineering technologies. During such development, the high-speed railway technologies in China have also gone global and participated in international competitions. In terms of development of the network, the speed hike on six occasions and the inauguration of

CRH (China Railway High-Speed) kick-started the high-speed era in China. The construction of high-speed railways accelerated, and the carrying capacity continued to increase. From 2009 to 2014, the total mileage of the high-speed railway grew from 6,552 kilometers to 160,000 kilometers. In 2014 a total of 3.16 billion passengers were transported by high-speed railways, accounting for 38.5 percent of the total passengers, which represented significant growth from the 4.8 percent in 2007.

During the next stage, efforts will be made to enhance the quality and efficiency of high-speed railways, optimize the layout of railway networks, improve the technology and the safety coefficient, and minimize environmental pollution and ecological disruptions. Meanwhile, the investment and financing mechanisms for high-speed railways should be diversified, optimized, and better-regulated so as to solve the debt problems of the high-speed railway sector.

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

I. Outlook for the Chinese economy

After the global financial crisis, the world economy entered a period of profound rebalancing. The Chinese economy is switching gears and undergoing structural adjustments while at the same time absorbing the effects of the stimulus policy adopted during the previous period. More evidence is showing that the economy is adapting to a “new normal,” reflected in a moderation in the speed of growth, structural adjustments, and a shift in drivers. Together with the slowdown in the traditional growth engine and the shift of gears in economic growth, there are also new trends and obvious signs of structural adjustments in the economy, such as the rise of the emerging and service industries, generally stable employment conditions, the rapid growth in consumption, the increased contribution of the service industries and the tertiary industries to growth, the booming of entrepreneurship, and the acceleration of Chinese investment in global assets. In general, as a big economy, China has much room for maneuver by facilitating a new type of industrialization, the application of IT technology, urbanization, and modernization of the agricultural industry in a coordinated way. The Chinese market is quite large and resilient. In order to release its huge growth potential and to push the economy to enter a more advanced stage of development with a more sophisticated division of labor and a more optimized structure, the structural reforms should continue. Rich experiences have been gained through innovations and improvements in the management of the macro economy over the past several years, and more emphasis has been put on targeted adjustments within a framework of range management, and measures to facilitate reform, adjust the structure, and improve the people's livelihood have been given priority in adjusting short-term demand. On the one hand, in order to build a new growth engine, the market has been given a bigger role in resource allocations and mass entrepreneurship and innovation have been encouraged; on the other hand, in order to transform and upgrade the traditional growth engine, the role of government has been improved and the supply of public goods and services has increased. These new twin engines will provide strong support for the sustained and healthy growth of the economy and will stabilize employment. As indicated by the Urban Depositors' Survey conducted by the People's Bank of China, in the fourth quarter the future income sentiment index and the future employment expectation index of urban residents went up by 0.9 percentage point and 0.2 percentage point from that in the previous quarter. The willingness to purchase cars, housing, and big-ticket consumer products in the following three months increased. In terms of the external environment, the momentum in the global economy has further diverged. Yet, the global economy remains on the track of a mild recovery, and the external environment is generally stable.

It should be noted that the economy faces both historical legacies and new problems. In terms of international conditions, economic performance and macro policies are diverging across various areas during the global economic rebalancing. Boosted by the rebound of the U.S. economy, the US dollar will enter an interest rate hike cycle, yet with unclear timing and pace. While the monetary policies in the EU and Japan will remain loose, the intensity and pace of the easing are uncertain. With the increased spillover effects from the diversified policy measures, the exchange rates between the major currencies and cross-border capital flows might experience more fluctuations. There might also be multiple non-economic shocks, including geopolitical shocks. All of these will lead to a complicated and constantly changing international environment. In terms of domestic conditions, the endogenous drivers of growth have yet to be strengthened. The investment behavior of the entire society will be affected by the reform of the fiscal, taxation, investment, and financing systems. With the acceleration of the structural adjustments, there inevitably will be higher downward pressures and more risk exposure. Meanwhile, the overall debt level is still on the rise, insufficient supply coexists with surplus supply, and structural problems remain serious. Therefore, strenuous efforts are needed to ensure steady growth, adjust the economic structure, facilitate reform, improve the people's livelihood, and prevent risks.

Price growth has moderated due to a number of reasons. In recent months, the price growth of consumer goods continued to slide and that of industrial products dropped by an even larger margin. This round of a decline in price growth is closely linked with the softening demand caused by the acceleration of the structural adjustments and the freefall of international commodity prices. Lower commodity prices led to reduced costs and had a direct impact on the supply of the importing countries. According to the Entrepreneur Survey conducted by the People's Bank of China, in the fourth quarter the product sales index and the raw material purchase price index fell by 1.5 percentage points and 3.8 percentage points respectively from the last quarter. Furthermore, the fresh capacity gain in the overcapacity industries will intensify downward pressure on prices, especially those of manufactured goods. In the near future, factors such as weak external demand, a domestic economy under the simultaneous impacts of moderated economic growth, structural adjustments, absorption of the effects of the previous policies, increasing downward pressures from the structural adjustments, and low international commodity prices will continue to weigh on prices. Since the last round of price hikes is still in the memory of residents, price expectations will be mixed. Overall, price movements face the concerted effects of demand, supply, and economic structural adjustments. Taking into consideration the impact of the decline of prices on market expectations and the behavior of market participants, we should make a comprehensive and objective analysis, closely monitor possible changes in prices, and take differentiated yet targeted, multiple yet coordinated approaches in response.

In general, the Chinese economy has entered a state of a new normal, with changed development conditions and a changed environment. At the core of all these changes is the transformation of the development pattern and the economic structural adjustments. Against such macro-economic background, it is necessary to properly handle the relationship between adjustments to the economic structure and aggregate policies. First, the growth gears are shifting from high speed to medium-to-high speed. The direction and intensity of macro policy should be properly handled and the flexibility of the adjustments should be improved. When there are significant changes in the fundamentals, timely and proper adjustments will be made to balance between the prevention of an inertia slowdown in economy and an excessive stimulus which might lead to structural distortions and push up the debt and leveraging levels. Second, the economy may go through a long process of upgrading and structural adjustments, in which a slowdown in the traditional growth engine will occur along with the booming of the emerging industries. Thus we face the dual tasks of removing excess capacity and facilitating the development of the emerging industries. While economic aggregates will be maintained at a stable level, the structure of the economy will be further optimized so as to solve the outstanding problems in economic performance in a targeted way. The stock of credit assets will be revitalized and the use of new loans will be optimized to support the structural adjustments, transformation, and upgrading of the economy. Third, increased risk exposures will be inevitable in the process of the structural adjustments. On the one hand, such risk exposures indicate there will be positive signals of market clearing and structural adjustments; on the other hand, risk mitigation systems should be established or improved to prevent large fluctuations and pro-cyclical developments in the financial system and to ward off systemic or regional financial risks. Fourth, as structural adjustments and reforms become increasingly imperative and difficult, more efforts will be made to boost production efficiency and the dynamics of the economy. Moreover, the reforms will be deepened to solve the deep-rooted problems in the economy. As a result, there will be demanding requirements to continuously deepen financial reform and to develop the financial market. Measures will be taken to effectively accelerate economic structural adjustments and the pace of reform, to keep policies in line with the changes in the economic structure and demand, and to make breakthroughs in key areas. The key is to cultivate new economic growth points, stimulate the dynamics of the economy, and improve the quality and efficiency of development. These measures will also contribute to the effective allocation of financial resources to the proper sectors.

II. Monetary policy during the next stage

The PBC will earnestly implement the decisions of the 18th Party Congress, the 3rd and 4th Plenary Session of the 18th Central Committee of the Chinese Communist Party and the Central Economic Work Conference and follow the strategic arrangements of the Party Central Committee and the State Council. The PBC will adhere to the guideline of seeking progress while maintaining stability and the overall principle of maintaining stable macro-economic policies while adopting flexible micro policies, take initiatives to adapt to the new normal in the economy, prioritize the change in the development pattern and structural adjustments, maintain the consistency and stability of policies, continue to implement a sound monetary policy that is neither too tight nor too loose, conduct timely and appropriate fine-tunings and preemptive adjustments, create a neutral and proper monetary and financial environment for structural adjustments, transformation, and the upgrading of the economic structure, and promote sustainable economic development. Innovation in reform will be emphasized and the reform measures will be integrated with the macro-economic management policies so that monetary policy will work closely with the reform measures to further tap into the decisive role of the market in resource allocations. In view of the financial deepening and the innovations in the financial markets, the conduct of policies, including that of the transmission mechanism, will be further improved. Efforts will be concentrated on solving the thorniest problems. The quality of financial services, the efficiency of the financial sector, and the capacity of the financial sector to provide services to the real sector will be improved.

First, a combination of various monetary policy instruments will be employed, the macro-prudential policy framework will be improved, and the combination of policy measures will be further diversified and optimized to keep liquidity at an appropriate volume and to realize the opportune growth of money, credit, and all-system financing aggregates. In view of the changes in domestic and international economic and financial conditions, we will flexibly utilize various monetary policy tools, improve the central bank collateral management framework, maintain liquidity at an appropriate level, and safeguard the stability of the money market. At the same time, we will guide commercial banks to strengthen liquidity and balance-sheet management by properly handling the liquidity level at various time points and sensibly planning the total volume and term structure of assets and liability so as to enhance liquidity risk management. The dynamic adjustment mechanism of the differentiated reserve requirement will continue to play a role in counter-cyclical management and structural adjustments. The parameters for the mechanism will be adjusted properly and in a timely manner according to five factors, including lending to small enterprises and the agricultural sector, the capital adequacy ratio, internal risk controls, the opening of new branches, and regional development, so that the mechanism will be more differentiated and targeted to guide financial institutions to keep pace of credit extensions in line with real and seasonal demands, to provide more credit to the agricultural sector, rural areas, and farmers and other key areas and to the weak links in the economy, and to support the development of the real economy. Continued efforts will be made to explore and improve the mechanism and approach of macro-prudential regulation.

Second, the stock of credit assets will be revitalized and the use of new loans will be optimized to support the structural adjustments, transformation, and upgrading of the economy. Measures will be taken to optimize the direction and structure of the provision of liquidity, properly implement the targeted reduction in the deposit reserve requirement ratio, and tap into the role of credit policy supporting central bank lending and the central bank discount policy to guide financial institutions to optimize the credit structure. Efforts will be made to encourage innovations in financial products and services, support economies of scale in agricultural activities, give more support to the construction of water conservancy projects and provide better financial services to the new type of urbanization. Policies supporting small and micro enterprises will continue to be implemented and funding sources for these enterprises will be expanded and diversified so as to facilitate the healthy growth of small and micro enterprises. Assessments of the effects of credit policy guidance will be further improved and the results of such assessments will be closely linked with the utilization of monetary policy and financial market tools to guide financial institutions to increase credit to the agricultural sector, rural areas, farmers, and small and micro enterprises. Better financial services will be provided to support the strategy of innovation-driven development, financing products tailored to the needs of enterprises in technology innovation will be designed, and financial institutions will be encouraged to enhance support to science and technology, culture, the strategic emerging industries, and other key areas. Efforts will be made to promote the removal of excess capacity, provide better financial services for development-oriented poverty reduction, facilitate the development of micro-credit for poverty alleviation, and strengthen the coordination of financial services for large and extremely poverty-stricken areas. Financial inclusion will be actively promoted and financial support and services related to the people’s livelihood will be enhanced, such as those for employment, education, ethnic minorities, migrant workers, and college-graduate-turned-village officials. A differentiated housing mortgage policy will be implemented to support the building of welfare housing and common commercial housing with small and medium floor area plans and reasonable home purchases by households, while regular and market-based financing channels will be broadened. Development financing will continue to play a role in the reconstruction of shantytowns. A number of measures will be taken to reduce the costs of financing in the entire economy, such as maintaining the reasonable growth of money and credit, improving the corporate governance of banks, cleaning up the unreasonable financial service charges, improving a multi-tiered capital market, increasing the supply of financial services, deepening the reforms and structural adjustments, and so forth.

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

Fourth, there will be continued efforts to improve the system of financial markets, to support the role of financial markets in preserving stable economic growth, supporting economic structural adjustments and transformation, deepening reform and opening up, and preventing financial risks. The financial infrastructure and the institutional arrangements will be strengthened to provide a more efficient investment and financing market for economic structural adjustments and upgrading. Market innovations will be encouraged to diversify the products and layers in the bond market and to better meet investor demands. The market-making mechanism will be improved to enhance liquidity in the bond market and to lay a solid foundation for an effective yield curve. The investor base will be expanded and market participants will be diversified. The diversity of financial markets, financial products, investors, and financing intermediaries will be further promoted. Qualified overseas and domestic institutional investors will be welcomed to invest in the inter-bank bond market. The risk-sharing and market-discipline mechanisms will be strengthened. We will implement measures to promote direct financing and develop a multi-tiered capital market. Market supervision and the role of the corporate debenture bond joint ministerial coordination mechanism will be enhanced. We will further strengthen regulatory coordination and facilitate the development of market discipline mechanisms, such as information disclosure and credit ratings, to regulate the trading behavior of market participants, to prevent financial risks, and to promote the efficient operation and sound development of financial markets.

Fifth, the reform of financial institutions will be deepened to improve financial services by increasing supply and enhancing competition. The reform of large commercial banks and other large financial institutions will furthered so as to continue to improve corporate governance, build effective mechanisms for decision making, execution, and checks and balances, and to translate the principle of corporate governance into daily operations and risk-control behaviors. Further studies will be carried out on expanding the pilot reform program of the Rural Finance Business Division of the Agricultural Bank of China so that it can be expanded and deepened. Research will be advanced to explore a sustainable model for market-based financial services to the agricultural sector, rural areas, and farmers, and to improve financial services to the agricultural sector, rural areas, and farmers, and customers in the counties. A reform program for the policy financial institutions will be implemented to establish capital constraint mechanisms, improve the governance structure, and support fiscal and financial policy in order to create a favorable policy environment and foster policy financial institutions with Chinese characteristics that operate on a sustainable basis and provide good services to support economic development. The shift to market-based operations of asset management companies will be further promoted. Under the precondition of stronger supervision, the development of various kinds of financial institutions, financial service organizations, and intermediary agencies will be encouraged to build a financial eco-environment for fair competition with participation by all kinds of market participants. The standards and rules for Internet financing will be further improved to promote fair play, to enhance industry self-regulation, to build stronger capacity for risk management, to safeguard the rights and interests of investors, and to promote sound development of Internet financing.

Sixth, effective measures will be adopted to mitigate systemic financial risks and to preserve stability in the financial system. Macro-prudential regulation will be enhanced to guide financial institutions to operate on a sound basis and to encourage them to strengthen liquidity, internal controls, and risk management. While supporting financial innovations, monitoring and prevention of potential risks in the wealth management and inter-bank business will be enhanced. We will cooperate with the relevant government agencies to dispose of local government debts and to prevent the risks from those debts. The systemic financial risk early-warning and assessment mechanism will be improved, and monitoring and analysis of overcapacity industries, borrowing by local government financing vehicles, the real-estate sector, shadow banking businesses, and mutual guarantees and joint peer guarantees of enterprises will be enhanced to identify potential risks on a continual basis and to urge financial institutions to draft response plans for various scenarios. The Joint Ministerial Financial Regulatory Coordination Conference will play a role in enhancing risk monitoring and in regulatory coordination of cross-sector and cross-market products, in coordinating development of various financial markets and instruments, and in establishing a system of comprehensive financial statistics and an information-sharing mechanism. Efforts will be adopted to prepare for the implementation of a deposit insurance regime. A comprehensive set of measures will be taken to preserve financial stability and to safeguard the bottom line of preventing systemic and regional financial risks.