China Monetary Policy Report, Quarter Four, 2010

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Monetary Policy Analysis Group of the People's Bank of China

Executive Summary

In 2010, the Chinese economy developed in the direction intended by the macroeconomic management policies. Performance was generally sound. Consumption grew fairly rapidly and steadily, the structure of fixed-asset investments continued to improve, and external trade recovered quickly. The output of the agricultural sector increased steadily and the output of the industrial sector grew rapidly. Income gains in the household sector continued, but upward pressures on prices grew. In 2010, the Gross Domestic Product (GDP) registered 39.9 trillion yuan, up 10.3 percent year on year. The Consumer Price Index (CPI) rose by 3.3 year on year.

In 2010, the PBC continued its moderately loose monetary policy in line with the arrangements of the State Council. As the momentum of stable and rapid economic development gradually became entrenched, the PBC worked to make policies better targeted and more flexible, achieved a balance between supporting sound and relatively rapid growth, as well as restructuring the economy and managing inflationary expectations, and promoted a gradual normalization of monetary conditions. The PBC strengthened liquidity management by using multiple monetary policy instruments, guided financial institutions to properly manage the aggregates, pace, and structure of credit provisions by adjusting the interest rates, promoted the RMB exchange rate regime reform, advanced the financial reform, and improved foreign exchange administration so as to safeguard financial stability and safety.

Money and credit growth declined from the high levels registered in the previous year, and the flexibility of the RMB exchange rate was strengthened. At end-2010, outstanding M2 registered 72.6 trillion yuan, up 19.7 percent year on year, a deceleration of 8 percentage points over the end of 2009. Outstanding M1 stood at 26.7 trillion yuan, an increase of 21.2 percent year on year and a deceleration of 11.2 percentage points. Outstanding RMB loans grew 19.9 percent year on year, a deceleration of 11.8 percentage points and 7.95 trillion yuan more than that at the beginning of 2010, a deceleration of 1.65 trillion yuan year on year. Lending interest rates of financial institutions continued to inch up. At end-December, the weighted average lending rate reached 6.19 percent, up 0.94 percentage points over that at the beginning of the year. At end-2010, the central parity of the RMB against the US dollar was 6.6227 yuan per US dollar, up 3 percent over end-2009.

In 2011, the first year of the 12th Five-Year Plan period, the PBC will implement the decisions adopted at the 5th Plenum of the 17th CPC Central Committee and the Central Economic Work Conference, follow the theme of scientific development and transformation of the economic growth pattern, implement a prudent monetary policy, make policy measures well-targeted, more flexible, and effective in line with the general principle of a prudent stance featuring proper measures of macroeconomic management and supporting structural optimization, strike a balance between maintaining stable and relatively fast economic growth, adjusting the economic structure and managing inflation expectations, give greater priority to maintaining the stability of the overall price level, preserve the sound and safe performance of the financial system, and contribute to stable and healthy economic development.

As the weight of direct financing continuously increases, the share of bank lending in all-system financing aggregate will gradually decline. In the package of macroeconomic management policies, it is necessary to attach more importance to the role of aggregate money supply in guiding expectations and to give more consideration to measuring the support of the financial sector to the real economy from the perspective of all-system financing aggregate. It is also necessary to keep all-system financing aggregate at a proper volume, strengthen the role of the market in resource allocation, and further build endogenous drivers of economic growth. The PBC will continue to use price and quantity instruments, such as interest rates, the reserve requirement ratio and open market operations, improve the monetary policy instruments, combine control over the aggregates of money, credit, and liquidity with improvements in the macro-prudential regulatory framework in accordance with the decision of the State Council, to create a counter-cyclical financial macro-prudential regulatory framework and to adjust liquidity by using differentiated deposit reserve requirement ratios as a supplement to conventional monetary policy instruments, so as to effectively manage liquidity. Efforts will be made to improve the credit structure by guiding financial institutions to divert more lending to the real economy, in particular to small- and medium-sized enterprises, agriculture, rural areas, farmers, and so forth, and to increase financial support for the shift in the economic development pattern and economic restructuring. The PBC will also steadily push forward the market-based interest rate reform and the reform of the RMB exchange rate regime, promote financial market innovation, and deepen the reform of financial institutions.

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Part 1 Monetary and Credit Performance

In 2010, China's economy continued its relatively rapid growth. From its high in 2009 the trend in the growth of money and credit supply was normal. The year 2010 witnessed abundant liquidity in the banking system, enhanced flexibility of the RMB exchange rate, and sound financial performance.

I. The trend in the growth of money supply was stable

At end-2010, outstanding M2 registered 72.6 trillion yuan, up 19.7 percent year on year, a deceleration of 8 percentage points over the end of 2009. Outstanding M1 stood at 26.7 trillion yuan, an increase of 21.2 percent year on year and a deceleration of 11.2 percentage points. Outstanding M0 totaled 4.5 trillion yuan, up 16.7 percent year on year, an acceleration of 4.9 percentage points over the end of the previous year. Net cash injections reached 638.1 billion yuan, an increase of 235.4 billion yuan year on year.

Aggregate money growth generally slowed down from its high in 2009. The growth of M1 and M2 registered a year-on-year decline in the first 7 and 9 months respectively of 2010, whereas aggregate money rebounded due to the rapid credit growth and the larger foreign exchange inflows. At the end of 2010, the growth of M2 and M1 recovered by 2.1 and 0.3 percentage points respectively over the lows during the year.

II. Deposit growth of financial institutions slowed down

At end-2010, outstanding loans in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, the same applies throughout this report) totaled 73.3 trillion yuan, up 19.8 percent year on year, a deceleration of 8.1 percentage points and 12.1 trillion yuan more than that at the beginning of 2010, a deceleration of 1.1 trillion yuan. Outstanding RMB deposits registered 71.8 trillion yuan, up 20.2 percent year on year, 8.0 percentage points lower than that at end-2009 and 12.0 trillion yuan more than that at the beginning of 2010, a deceleration of 1.1 trillion yuan. Outstanding foreign currency deposits registered US$228.7 billion, up 9.5 percent year on year and an increase of US$20 billion over the beginning of 2010, an acceleration of US$3.9 billion.

Household deposits were stable, with demand deposits accounting for a larger share. The growth of deposits of non-financial institutions declined in the first half of the year, but the trend in the second half of the year was stable and the share of demand deposits rose. At end-2010, outstanding household deposits registered 30.8 trillion yuan, up 16.5 percent year on year, a deceleration of 2.8 percentage points and 4.4

trillion yuan more than that at the beginning of 2010, an acceleration of 97.2 billion yuan year on year. Outstanding RMB deposits of non-financial institutions reached 30.5 trillion yuan, up 21.5 percent year on year, a deceleration of 16.0 percentage points over the beginning of 2010 and 5.3 trillion yuan more than that at the beginning of 2010, a deceleration of 2.0 trillion yuan year on year. The growth of RMB deposits of non-financial institutions dropped, with the growth at end-June decelerating by 18 percentage points compared to that at end-2009, partly due to the high base level in 2009. At present, the growth of RMB deposits of non-financial institutions remains relatively rapid and enterprises enjoy a strong payment capability. The share of demand deposits generally increased due to inflationary expectations and other factors. Among new household deposits, the share of demand deposits rose quarter by quarter, standing at 42 percent, 51 percent, 55 percent, and 135 percent in Q1, Q2, Q3, and Q4 respectively and reaching 56 percent for the entire year. The share of demand deposits of non-financial institutions accounted for 55 percent of new household deposits in 2010. At end-2010, outstanding fiscal deposits registered 2.5 trillion yuan, up 13.6 percent year on year and up 304.5 billion yuan over the beginning of the year, a deceleration of 132.2 billion yuan year on year.

III. Loan growth of financial institutions declined from their previous high level

At end-2010, outstanding loans in domestic and foreign currencies of all financial institutions reached 50.9 trillion yuan, up 19.7 percent year on year, a deceleration of 13.3 percentage points and 8.4 trillion yuan more than that at the beginning of 2010, a deceleration of 2.2 trillion yuan.

The growth of RMB loans stabilized after a decline from their previous high level. At end-2010, outstanding RMB loans stood at 47.9 trillion yuan, up 19.9 percent year on year, a deceleration of 11.8 percentage points and 7.95 trillion yuan more than that at the beginning of 2010, a deceleration of 1.65 trillion yuan. The pace of loan extensions became more balanced quarter by quarter, with new loans registering 2.60 trillion yuan, 2.03 trillion yuan, 1.67 trillion yuan, and 1.64 trillion yuan respectively in Q1 through Q4. Broken down by sectors, the growth of household loans gradually slowed down, and that of non-financial institutions and other sectors remained relatively stable. At end-2010, outstanding household loans increased 37.6 percent year on year, decelerating by 4.6 percentage points and 11.7 percentage points over end-September and end-June respectively. Although slower than the last year, the growth of outstanding household loans remained relatively rapid at end-2010, up 2.9 trillion yuan over the beginning of the year, an acceleration of 412.5 billion yuan. Outstanding loans of non-financial institutions and other sectors rose 15.3 percent year on year, 5.1 trillion yuan more than that at the beginning of 2010 and a deceleration of 2.1 trillion yuan. Among this total, medium- and long-term loans grew 4.2 trillion yuan over the beginning of the year, a deceleration of 793.8 billion yuan.

Bill financing was 905.1 billion yuan less than that at the beginning of 2010, 1.4 trillion yuan more than the reduction of 2009. In general, in 2010 financial institutions reduced bill financing and enhanced loan financing.

Table 1: RMB loans of financial institutions in 2010

Unit: 100 million yuan

	2010	
	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	40822	-12899
Chinese-funded Small and Medium Banks Operating Nationwide②	23456	-1704
Chinese-funded Small and Medium Local Banks③	5289	-2018
Rural Cooperative Financial Institutions④	9656	-71
Foreign-funded Financial Institutions	1628	1610

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

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

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

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

Source: The People's Bank of China

Demand in the corporate sector for foreign currency loans declined in 2010 due to generally stable expectations for the RMB exchange rate, the progress made in RMB settlement of cross-border trade transactions, and the increase in trade credit of domestic and overseas enterprises as a result of the improved liquidity of overseas enterprises. At end-2010, outstanding foreign-currency loans of financial institutions reached US$453.4 billion, up 19.5 percent year on year and US$74 billion more than that at the beginning of 2010, a deceleration of US$61.8 billion year on year. Import and export financing increased US$17.7 billion, a deceleration of US$41 billion, with the newly added amount accounting for 24 percent of the total. Overseas loans and medium- and long-term loans were enhanced by US$45.7 billion, a deceleration of US$13.3 billion, with the share of the newly added amount constituting 61.8 percent of the total.

IV. Liquidity in the banking sector was generally adequate

At end-2010, outstanding base money registered 18.5 trillion yuan, up 28.7 percent year on year and an increase of 4.1 trillion yuan over that at the beginning of the year. At end-2010, the money multiplier was 3.92, 0.19 lower than that at end-2009. At end-2010, the ratio of excess reserves of financial institutions stood at 2.0 percent, 1.13 percentage points lower than that at the end of the last year. The excess reserves ratios of Chinese-funded large banks, Chinese-funded medium banks, Chinese-funded small banks, and rural credit cooperatives registered 0.9 percent, 1.8 percent, 4.4 percent, and 7.7 percent respectively.

V. The lending rate of financial institutions registered a stable increase

The lending rates offered to non-financial institutions and other sectors increased slightly in 2010. The interest rate rose more rapidly in Q4 as a result of the upward adjustment of the reserve requirement ratio on two occasions during the quarter. At end-December, the weighted average lending rate reached 6.19 percent, up 0.94 percentage points over the beginning of the year. The weighted average interest rate for general lending registered 6.34 percent, up 0.46 percentage points over the beginning of 2010, and the weighted average bill financing rate posted 5.49 percent, up 2.75 percentage points over the beginning of the year. The weighted average residential mortgage rate rose by 0.92 percentage points over the beginning of 2010 to 5.34 percent in December.

Loans with interest rates lower than or flat with the benchmark rate accounted for a smaller share of the total, whereas loans with interest rates higher than the benchmark rate increased as a percentage of the total. In December, the share of loans with interest rates lower than or at the benchmark rate stood at 27.80 percent and 29.16 percent respectively, down 5.39 percentage points and 1.1 percentage points respectively over the beginning of 2010. Loans with interest rates higher than the benchmark rate accounted for 43.04 percent of the total, up 6.49 percentage points over that at the beginning of the year.

Table 2: Shares of loans with rates at various ranges of the benchmark rate in the first half of 2010

Unit：%

	Lower than the benchmark	At the benchmark	Higher than the benchmark					
	[0.9，1]	1	Sum	(1，1.1]	(1.1，1.3)	(1.3，1.5]	(1.5，2]	Above 2
January	35.38	31.18	33.44	11.92	8.74	4.42	5.71	2.65
February	32.64	31.95	35.41	12.77	9.21	4.31	6.09	3.03
March	30.05	28.91	41.04	13.12	10.91	5.45	7.11	4.45
April	26.22	31.18	42.60	13.83	11.66	5.89	7.47	3.75
May	26.56	29.55	43.89	14.92	11.88	5.77	7.62	3.70
June	27.72	30.89	41.39	14.44	11.63	5.34	6.80	3.18
July	27.03	29.72	43.25	15.38	11.76	5.42	7.05	3.64
August	25.75	29.31	44.94	14.79	12.57	5.42	7.93	4.23
September	25.54	30.19	44.27	14.61	12.57	5.36	7.76	3.97
October	26.69	29.80	43.51	14.80	12.14	5.27	7.44	3.86
November	27.49	30.60	41.91	13.96	12.31	5.00	7.34	3.30
December	27.80	29.16	43.04	13.80	11.89	5.66	8.18	3.51

Source: The People's Bank of China

Foreign currency deposits and lending rates moved up due to the change in the supply and demand of funds in China and the movement of interest rates on the international financial market. In December, the weighted average interest rates of US dollar demand deposits and large-value US dollar deposits with a maturity of less than 3 months stood at 0.33 percent and 1.84 percent respectively, up 0.16 percentage points and 1.38 percentage points over the beginning of 2010. The weighted average 3-month and 3-6 month US dollar lending rate posted 2.57 percent and 2.85 percent respectively, up 0.98 percentage points and 1.19 percentage points over that at the beginning of 2010.

Table 3: The average interest rate for large-value deposits and loans denominated in US dollars, January through December 2010

Unit：%

	Large-value deposits						Loans				
	Demand Deposits	Within 3 months	3-6 months	6-12 months	1 year	More than 1 year	Within 3 months	3-6 months	6-12 months	1 year	More than 1 year
January	0.12	0.62	0.88	1.07	1.88	2.96	1.55	1.91	2.07	2.09	3.04
February	0.15	0.70	0.85	1.50	1.65	1.75	1.68	1.88	1.90	2.16	2.79
March	0.15	0.76	0.81	1.34	2.32	0.82	1.69	1.82	2.03	2.32	2.87
April	0.15	0.92	0.87	1.69	1.99	3.83	1.94	2.12	2.14	2.53	2.50
May	0.16	1.41	1.65	1.72	3.09	2.82	2.39	2.88	2.63	2.96	3.02
June	0.21	1.76	1.44	2.32	1.60	3.94	2.39	2.81	2.88	3.10	3.33

July	0.22	1.99	2.20	2.66	3.02	2.89	2.48	2.99	3.18	3.22	3.07
August	0.31	2.04	2.18	2.65	3.42	2.19	2.37	2.72	3.03	2.78	2.12
September	0.26	1.93	1.85	2.12	3.48	2.16	2.30	2.46	2.94	2.83	3.82
October	0.20	1.85	2.47	1.96	1.18	1.80	2.35	2.58	2.85	2.81	3.02
November	0.21	1.86	1.81	2.49	3.37	3.95	2.38	2.68	3.06	2.98	3.15
December	0.33	1.84	2.19	2.27	1.91	1.80	2.57	2.85	3.13	3.16	2.74

Source: The People's Bank of China

VI. The flexibility of the RMB exchange rate rose significantly

After the furthering of the RMB exchange rate reform on June 19, 2010, the RMB exchange rate moved in both directions and appreciated slightly with much stronger flexibility, and expectations of RMB exchange rate movements remained generally stable. At end-2010, the central parity of the RMB against the US dollar was 6.6227 yuan per US dollar, up 2055 basis points or 3 percent over end-2009. The central parity of the RMB against the euro registered 8.8065 yuan per euro, an appreciation of 11.25 percent from end-2009, and the central parity of the RMB against the Japanese yen stood at 8.1260 yuan per 100 Japanese yen, a depreciation of 9.20 percent from end-2009. Beginning from the reform of the RMB exchange rate in July 2005 to end-2010, the RMB appreciated 24.97 percent against the US dollar, 13.71 percent against the euro, and depreciated 10.09 percent against the Japanese yen. The BIS estimates that in 2010 the nominal effective RMB exchange rate appreciated 1.8 percent and the real effective exchange rate appreciated 4.7 percent, and from the exchange rate reform in 2005 to end-2010 the nominal effective RMB exchange rate appreciated 14.7 percent and the real effective exchange rate appreciated 23.2 percent.

In 2010, the central parity of the RMB against the US dollar peaked at 6.6227 yuan per dollar and reached a trough of 6.8284 yuan per dollar. Among the 242 trading days, the inter-bank foreign exchange market saw an appreciation on 133 days, flat movement on 6 days, and a depreciation on 103 days. The largest appreciation in a single day was 0.43 percent (or 295 points), whereas the largest depreciation in a single day was 0.36 percent (or 247 points).

Part 2 Monetary Policy Conduct

In 2010, the PBC continued its moderately loose monetary policy in line with the arrangements of the State Council. It worked to make policies better-targeted and more flexible, achieved a balance between supporting sound and relatively rapid growth, restructuring the economy and managing inflationary expectations, and promoted a gradual normalization of monetary conditions.

Ⅰ. Flexible open market operations

Based on close analysis and monitoring of domestic and global economic and financial developments and liquidity in the banking system, in 2010 the PBC conducted flexible open market operations and improved the mix of tools to keep liquidity in the banking system at an appropriate level. First, the PBC flexibly handled the intensity and pace of open market operations, which, in combination with the effect of the reserve requirement policy, helped withdraw more liquidity. In 2010, the PBC issued 4.2 trillion yuan of central bank bills and conducted 2.1 trillion yuan of repurchase operations. Outstanding central bank bills as of end-2010 stood at about 4 trillion yuan. Second, building on an analysis of the market environment and liquidity supply and demand, the PBC improved the mix of tools for open market operations. In early April, the PBC resumed the issuance of 3-year central bank bills to freeze more liquidity. It flexibly arranged the maturities for short-term repurchase operations and used both short- and long-term tools to effectively adjust the liquidity in the banking system. Third, to support monetary policy and taking into consideration the market environment and interest rate movements, the PBC increased the flexibility of the interest rates of open market operations to guide market expectations. In the first six months, interest rates for operations with a maturity of less than one year went up in line with the upward movement of interest rates in the money market. In the second half of the year, interest rates for all operations rose as there was a hike in benchmark lending and deposit rates. As of end-2010, interest rates for 3-month and 1-year central bank bills recorded 2.0156 percent and 2.5115 percent respectively, up 64.72 and 75.10 basis points from the beginning of 2010. Fourth, to accommodate fiscal policy, the PBC increased the frequency and scale of state treasury cash management operations. The PBC deposited 400 billion yuan of state treasury funds in commercial banks in 12 separate operations throughout 2010, with an outstanding amount of 160 billion yuan at the end of the year.

II. Increased reserve requirement ratios

As there was an excess of liquidity in the banking system in 2010 due to the loose liquidity conditions at the global level and the large BOP surplus, and because the effects of the open market operations were partly constrained by weaker purchasing willingness on the part of commercial banks, the PBC increased the use of the reserve requirement ratio as a policy instrument, taking advantage of its capability to freeze an enormous amount of liquidity. Complemented by flexible open market operations, the use of this instrument is designed to give the central bank greater initiative in managing liquidity, to facilitate efforts to normalize money and credit growth, and to handle inflationary expectations. In 2010, the PBC raised the reserve requirement ratio for RMB deposits in depository financial institutions by 3 percentage points on a cumulative basis, including 6 increases of an increment of 0.5 percentage points on January 18, February 25, May 10, November 16 and 29, and December 20. The combination of the reserve requirement ratio, open market operations, and other instruments, which was needed to partly sterilize the excessive liquidity, demonstrated the PBC's commitment to a more calibrated and flexible policy.

Ⅲ. The interest rate as policy leverage

The PBC pursued a stable interest rate policy in the first three quarters of 2010. In the fourth quarter, as inflationary expectations intensified and money and credit supply grew rapidly, the PBC raised the benchmark deposit and lending rates on October 20 and December 26, bringing the 1-year benchmark deposit rate from 2.25 to 2.75 percent, and the 1-year benchmark lending rate from 5.31 to 5.81 percent, both up by 0.5 percentage points cumulatively. Interest rates for central bank lending were also raised on December 26. The PBC lifted the interest rate for 1-year central bank lending from 3.33 to 3.85 percent and for 1-year central bank lending to rural credit cooperatives (RCCs) from 3.33 to 3.85 percent, and increased the rediscount rate from 1.80 to 2.25 percent.

In 2010, the PBC focused on product innovation in its effort to build the benchmark interest rate in the money market. More products based on the Shibor were developed, and the role of the Shibor in lending, repurchasing, bond issuance, inter-bank financing as well as in pricing derivative transactions and other market-based products grew. With the improving performance as a benchmark, the Shibor provided a sound reflection of capital costs, market supply and demand, and monetary policy expectations, and gradually became an important benchmark interest rate in the market as well as an internal and external pricing benchmark for financial institutions.

Ⅳ. Improved credit structure

The PBC enhanced window guidance on financial institutions. It improved credit policy guidance and encouraged financial institutions to properly adjust the credit structure and manage the pace of credit provisions so as to provide greater support to economic restructuring and the shift in the development pattern. Following the requirement for differentiated credit policies, the PBC guided financial institutions to enhance financial support to key industries, areas, and regions, including key industrial rejuvenation programs, energy conservation and environmental protection, emerging strategic industries, the services sector, weak links in the economy, employment, consumption, balanced regional economic development, and disaster response and reconstruction. Banks were also encouraged to improve agro-linked financial services as well as financial services to small- and medium-sized enterprises (SMEs). While ensuring credit to key projects under construction, the PBC cut back lending to high energy-consuming and polluting industries and industries with excessive capacity, and restricted unauthorized lending to local government financing platforms. It implemented a differentiated mortgage policy, promoting healthy and stable development of the property market. The PBC encouraged financial institutions to improve their schemes for performance evaluation and to properly pace the credit supply to avoid lending fluctuations between months and quarters. The PBC used rediscount operations to optimize the credit structure and expand financing for agriculture, rural areas, farmers, and SMEs. Rediscount operations totaled 171.2 billion yuan in 2010, up 146.32 billion year on year, and outstanding rediscounts at end-2010 registered 79.1 billion, a year-on-year hike of 60.98 billion yuan. About 32 percent of the rediscounted bills was linked to agriculture, and 87 percent of the total was issued or held by SMEs.

The credit structure continued to be improved as agro-linked lending and lending to SMEs increased while mortgage loans fell. At end-2010, outstanding RMB and foreign currency loans to rural areas by the main financial institutions, rural cooperative financial institutions, urban credit agencies, and township banks and finance companies reached 9.8 trillion yuan, up 31.5 percent year on year and 11.9 percentage points higher than the growth of total RMB and foreign currency loans during the same period of 2009. RMB bank lending to SMEs increased 3.3 trillion yuan from early 2010, and the outstanding amount at end-2010 expanded 22.4 percent compared with that during the same period of the last year. In particular, lending to small enterprises increased 1.7 trillion yuan from early 2010, and outstanding loans at end of the year rose 29.3 percent, outpacing outstanding lending to medium-sized enterprises and large enterprises by 11.5 and 16.0 percentage points respectively. The supply of mortgage loans increased sharply at the beginning of the year, with an average of 180 billion yuan being granted each month in the first five months. Nevertheless, it dropped noticeably since July as policies began to have an impact on the property market. Mortgage loans went up by 1.3 trillion yuan from January to December 2010, accounting for 45 percent of household loans. As property transactions have recently begun to recover in some regions, continued attention is needed to monitor the development of mortgage lending in the coming months.

Ⅴ. Breakthroughs in RMB settlement of cross-border trade

In general, the pilot program for RMB settlement of cross-border trade was extended to more cities and regions, and the volume grew rapidly. Supportive measures were improved and cross-border RMB investment and financing was launched on a pilot basis. In June 2010, with the approval of the State Council, the PBC, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the China Banking Regulatory Commission (CBRC) jointly issued the *Notice on Issues Regarding Expanding the Pilot Program for RMB Settlement of Cross-border Trade Transactions* (PBC Document 2010 [No. 186]). According to the Notice, the pilot program was expanded from Shanghai and four cities in Guangdong to 20 provinces (autonomous regions and municipalities), and became applicable to all countries and regions instead of just Hong Kong, Macao, and the ASEAN countries. Eligible trade for the program was expanded to include cross-border trade of goods, services, and other items under the current account. The number of exporters that joined the program increased to 67,724 in December 2010, compared with 365 when the program was first launched. The settlement volume grew steadily after the program was expanded, totaling 506.34 billion yuan in 2010. To support this program and to help Chinese enterprises finance their large overseas projects, the PBC initiated a pilot cross-border RMB investment and financing program on a case-by-case basis. As of end-2010, a total of 386 transactions with 70.17 billion yuan had been conducted under the new program. In October 2010, the PBC launched pilot RMB settlement of cross-border direct investment, which was first applied in Xinjiang.

Figure 1. Monthly RMB settlement of cross-border trade transactions

Source: The People's Bank of China

Ⅵ. Improving the exchange rate regime

In line with economic and financial conditions both at home and abroad as well as China's BOP position, in June 2010 the PBC decided to further reform the RMB exchange rate regime. Focusing on the role of market supply and demand, the reform was designed to make the RMB exchange rate more flexible with reference to a basket of currencies and to keep it basically stable at an adaptive and equilibrium level.

Box 1: The Further Reform of the RMB Exchange Rate Regime had a Positive Effect on the Real Economy

In view of the domestic and global economic and financial situations and China's BOP position, on June 19, 2010 the PBC decided to further reform the RMB exchange rate regime, focusing on the role of market supply and demand with reference to a basket of currencies. Over the past six months, the RMB has moved in both directions with markedly greater flexibility. By the end of 2010, the central parity of the RMB against the US dollar had increased 3 percent since the reform began. The reform has had a positive effect on the real economy.

Foreign trade continues to grow at a fast pace, and the overly rapid expansion in the momentum of the trade surplus has moderated. As a stronger yuan made imports of consumer goods and commodities cheaper, imports expanded, averaging US$120 billion each month since June 2010. Export growth remains strong and has returned to its pre-crisis level, despite various uncertainties. Monthly exports reached new highs in 2010, exceeding US$130 billion for 8 months. For 2010 as a whole, the trade surplus registered US$183.1 billion, down 6.4 percent year on year.

The structure of imports and exports has further improved, and the export destination structure has become more balanced. Imports of commodities have risen rapidly. In 2010, China imported 240 million tons of crude oil, up 17.5 percent from 2009 and 33.8 percent from 2008. Driven by a more flexible currency, exporters stepped up R&D and innovation, improved product quality, and accelerated product upgrading to strengthen their competitiveness in the global market. Exports of electro-mechanical products and high-tech products increased 30.9 and 30.7 percent respectively, representing a significant acceleration from 2009. With a growing interest in settling in other currencies, exporters have enhanced their presence in emerging markets, thus helping reduce the export concentration and leading to an improved regional structure. As a result, China's exports to the US and Europe as percentage of total exports dropped from 18.6 and 19.8 percent in June 2010 to 17.0 and 18.8 percent in December respectively.

Exporters are in a better position to respond to volatility in the exchange rate. Companies developed a deeper understanding of exchange rate fluctuations after the exchange rate reform in 2005 and adopted a wide range of measures in response to the fluctuations, including raising the added value and using financial instruments to manage risks. In a November survey of 2,181 export-oriented SMEs and 2,038 export-oriented manufacturers, the PBC found that exporters generally were in a sound state and that average profits had risen by 0.6 percent since June. As the survey suggests, the overall competitiveness of exporters has been strengthened and employment in the export sector has remained stable. Furthermore, although it had an impact on the profitability of exporters, the modest appreciation of the RMB did not cause massive closures or suspensions of production. In a survey of exporters' operations jointly conducted by the Ministry of Commerce, the PBC, and the State Administration of Foreign Exchange (SAFE)，78.4 percent of the surveyed factories reported a similar or higher capacity utilization rate. Labor-intensive industries are more sensitive to the RMB appreciation and provide more job opportunities. From June to December 2010, exports of labor-intensive products exceeded the pre-crisis level.

Chinese enterprises are going global at a faster pace. The exchange rate reform allows enterprises to use both domestic and global resources and markets more efficiently, supporting their efforts to enter the global market. The reform plays a positive role in encouraging capital outflows and facilitates implementation of China's energy and resources strategy. In 2010, outbound direct investments by non-financial corporations grew 36.3 percent year on year to US$59 billion.

The foreign exchange market has developed rapidly. The RMB exchange rate flexibility has increased, transactions in the inter-bank foreign exchange market have remained buoyant, and the volume of transactions has expanded. This has enhanced the role of the foreign exchange market in resource allocation. The market for forward, swap, and other derivatives has grown quickly and they are widely used by enterprises to hedge exchange risks. Spot transactions in the inter-bank foreign exchange market in 2010 recorded US$3.05 trillion, up 3.5 percent; forward transactions posted US$32.7 billion, up 234 percent; and swap transactions reached US$1.28 trillion, up 60 percent. Total transactions in the foreign exchange market expanded by 16 percent to US$4.36 trillion.

In general, the further reform of the exchange rate regime has had a positive effect on the real economy. Combined with other structural policies, it will continue to play a role in supporting trade-structure adjustments, economic-structure optimization, industrial upgrading, and sustainable economic development. In the meantime, it should also be noted that as the RMB exchange rate becomes more flexible, corporations, households, and financial institutions will need to better manage exchange risks. Going forward, the PBC will press ahead with the RMB exchange rate regime reform in line with the principle of making it a self-initiated, controllable, and gradual process. The PBC will accelerate development of the foreign exchange market, promote innovation in exchange-rate risk management tools, and improve foreign exchange administration. It will guide enterprises to enhance structural adjustments and encourage financial institutions to provide better services to corporations to help them manage exchange risks.

Ⅶ. Progress in financial institution reform

The joint stock reform in large commercial banks was completed and the reform of policy financial institutions was advanced. The PBC supported the refinancing and capital enhancing programs of the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB), and the Bank of Communications, which raised a total amount of 263.6 billion yuan through convertible bonds and rights offerings on both the A- and H-share markets. The Agricultural Bank of China (ABC) was listed in both Shanghai and Hong Kong on July 15 and 16, and raised US$22.1 billion. As of end-September, the capital adequacy ratio of these five banks stood at 11.6 percent, 11.4 percent, 11.7 percent, 11.6 percent, and 12.5 percent respectively; their non-performing loan (NPL) ratio posted 1.15 percent, 2.08 percent, 1.10 percent, 1.14 percent, and 1.22 percent, whereas their before-tax profits registered 166.3 billion yuan, 89.2 billion yuan, 107.4 billion yuan, 143.8 billion yuan, and 13.5 billion yuan. The PBC released policies to support the ABC's pilot reform program for building a multi-divisional structure to provide financial services to the rural areas and to encourage the bank to enhance its rural financial services. With the efforts of the PBC, the China Everbright Bank improved its structure and went public in Shanghai on August 18, 2010, and the China Development Bank proceeded with its transition to commercial operations. The PBC studied the overall reform plan for the Export and Import Bank of China and the China Export and Credit Insurance Corporation. Moreover, it promoted the deepening of internal reform at the China Agricultural Development Bank in preparation for an overall overhaul.

Significant achievements were made in the reform of the RCCs. With an improved asset quality and a stronger capital position, the RCCs greatly strengthened their financial support to rural development. Property rights reform in the RCCs also made headway. Based on the four-category loan classification, outstanding NPLs at the RCCs at end-2010 totaled 318.3 billion yuan, down 30 billion yuan. Their share of total RCC lending dropped 1.8 percentage points from end-2009 to 5.6 percent. Total RCC deposits posted 8.6 trillion yuan, accounting for 11.8 percent of the total deposits in financial institutions, up 0.1 percentage points from end-2009. RCC lending stood at 5.5 trillion yuan, or 11.9 percent of the total lending by financial institutions, an increase of 0.3 percentage points from end-2009. This included 3.9 trillion yuan of agro-linked loans and 2.0 trillion yuan of lending to rural households, up 782.5 billion yuan and 393.7 billion yuan respectively from end-2009. As of end-2010, a total of 1,976 RCCs, 84 rural commercial banks, and 216 rural cooperative banks had been established, all with legal person status at the county (city) level.

Ⅷ. Reform of foreign exchange administration

Efforts were stepped up to monitor and manage cross-border capital flows and to curb irregular capital inflows. In February 2010, a special campaign was launched to deter hot money inflows in 13 provinces (municipalities) with large amounts of foreign exchange transactions. As a result, 197 cases were identified, involving US$7.34 billion. The campaign also led to the punishment of 97 banks and corporations and 10 individuals, and the seizure of 29.713 million yuan. In addition, foreign exchange operations in 12 bank branches were suspended and 2 senior executives were penalized. The annual quota for outstanding short-term foreign debt of domestic financial institutions was cut by 1.5 percent from 2009. Assessment of the banks' implementation of foreign exchange-related policies was improved to encourage closer examination of the authenticity of cross-border capital flows. Online selling and purchasing of foreign exchange by individuals were included as part of the annual quota. Management of foreign exchange used for home purchases by overseas institutions and non-resident individuals was improved. In November, a contingency plan was initiated in an effort to discourage hot money inflows, and seven policies regarding the bank position for foreign exchange selling and purchasing and FDI were released.

Reform in key areas of foreign exchange management was advanced, which further facilitated the sale and purchase of foreign exchange. In May 2010, the reform of the verification and writing-off system for import payments in foreign exchange was launched in 7 provinces (municipalities) on a pilot basis, and it was expanded to the rest of the country in December, allowing 95 percent of importers to drop the writing-off procedure for normal foreign exchange payments. In the meantime, a new pilot program was launched to allow exporters to deposit at overseas banks part of their proceeds based on authentic and legal trade deals. Moreover, Chinese-funded corporations were allowed, under certain conditions, to borrow foreign currency on a short-term basis, and policies for providing guarantees to overseas entities were reformed to satisfy the demands of overseas Chinese enterprises that have made outward investments for credit support from institutions within the Chinese mainland. Efforts were also made to improve the Qualified Foreign Institutional Investor (QFII) and the Qualified Domestic Institutional Investor (QDII) schemes. In 2010, a total number of 22 QFIIs with an investment quota of US$3.05 billion and 21 QDIIs with an investment quota of US$8.32 billion were approved.

Ⅸ. Currency cooperation with other monetary authorities

To promote cross-border trade and investment, the PBC signed 153.5 billion yuan worth of domestic currency swap agreements with monetary authorities in Iceland and Singapore in 2010. As of end-2010, the overall scale of currency swap agreements reached 803.5 billion yuan. The PBC also conducted 30 billion yuan worth of local currency swap operations at the request of a number of monetary authorities. These agreements and operations have played a role in promoting the use of local currencies in cross-border trade settlement and investment. They signal a new level of currency cooperation between the PBC and other monetary authorities and lay a foundation for future currency cooperation.

Part 3 Financial Market Analysis

In 2010, the financial market continued to perform in a sound and stable manner and played an active role in implementing macroeconomic policies, optimizing resource allocation, promoting financial system reform, and stepping up financial support for economic growth. Throughout the year, the money market traded briskly and market interest rates moved up; the bond market indices climbed up slightly and bond issuances grew steadily; stock indices declined slightly and financing on the stock markets reached a historic high. Financing by domestic non-financial sectors (including the household, corporate, and public sectors) continued to rise and displayed a diversified financing structure. In 2010, total financing by domestic non-financial sectors amounted to 11.1 trillion yuan, representing a deceleration of 1.9 trillion yuan from the last year, while total financing excluding bank loans accelerated by 311.1 billion yuan year on year. In terms of the financing structure, the dominant role of loan financing declined noticeably and the shares of government securities and equities increased.

Table 4：Financing by domestic non-financial sectors in 2010

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	2010	2009	2010	2009
Financing by domestic non-financial sectors	111136	129678	100.0	100.0
Bank loans①	83572	105225	75.2	81.2
Equities②	6116	3904	5.5	3.0
Government securities③	9735	8182	8.8	6.3
Enterprise bonds④	11713	12367	10.5	9.5

Notes: ①Bank loans in this table include domestic and foreign currency loans.

②Equity financing in this table does not include additional share offerings to designated investors and financing by financial institutions on the stock market.

③The financing volume of government securities includes municipal bonds issued by the Ministry of Finance on behalf of local governments.

④Enterprise bonds include enterprise bonds, corporate bonds, convertible bonds, bonds with detachable warrants, collective bills, short-term financing bills, and medium-term notes, and exclude bonds issued by financial institutions.

Source: The People's Bank of China

I. Financial market analysis

1. The money market traded briskly and there was an upward trend in interest rates

Interest rates on the money market moved up noticeably. Due to a number of factors, such as greater financing demand on the market, heightened inflation expectations, and macroeconomic management policies, interest rates on the money market moved up amid fluctuations. In December 2010, the weighted average interest rates of bond-pledged repo and inter-bank borrowing posted 3.12 percent and 2.92 percent respectively, up 0.73 and 0.61 basis points from June 2010 and up 1.85 and 1.67 basis points from December 2009.

In 2010, the turnover of bond repos and inter-bank borrowing grew at a rapid pace. In particular, the turnover of bond repos on the inter-bank market totaled 87.6 trillion yuan, with a daily turnover of 350.4 billion yuan and year-on-year growth of 24.6 percent; the turnover of inter-bank borrowing reached 27.9 trillion yuan, with an average daily turnover of 111.5 billion yuan and year-on-year growth of 44.0 percent. In terms of the maturity structure, transactions mainly focused on overnight products and the maturity of transactions showed an obvious shortening tendency. In 2010, transactions of repos and overnight inter-bank borrowings accounted for 79.9 percent and 87.9 percent of total turnovers respectively, up 2.1 and 4.3 percentage points from the last year. The total turnover of government securities repos on the stock exchanges soared 85.7 percent to 6.59 trillion yuan.

In terms of financial institutions, the financing structure on the money market showed the following characteristics: first, due to the impact of rapid asset expansion, other commercial banks became net borrowers instead of net lenders; second, due to the remaining uncertainties about macroeconomic and financial conditions both at home and abroad, non-bank financial institutions traded cautiously. Funding demand of securities companies and fund management companies remained stable, while funding demand of insurance companies declined notably due to the rapid increase in premium income. Third, with the impact of the global financial crisis gradually easing, to some extent funding demand of foreign financial institutions increased.

Table 5：Fund flows among financial institutions in 2010

Unit：100 million yuan

	Repo		Inter-bank borrowing	
	2010	2009	2010	2009
State-owned commercial banks	-237497	-254127	-23502	-17539
Other commercial banks	84212	-8636	7286	4367
Other financial institutions (1)	121228	232790	13599	7030
Of which：Securities and fund management	74675	94468	2149	1739

companies				
Insurance companies	21869	40331	——	——
Foreign-funded financial institutions	32057	29973	2617	6142

Notes: (1) “Other financial institutions” in this table refer to policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies. (2) A negative sign indicates net lending; a positive sign indicates net borrowing.

Source: China Foreign Exchange Trade System

Trading of RMB interest rate swaps grew rapidly, while trading of forward interest rate products was somewhat sluggish. In 2010, 11,643 transactions in RMB interest rate swaps were conducted, with an aggregate notional principal of 1500.34 billion yuan, up 225 percent year on year. In particular, the notional principal of interest rate swaps in Q4 2010 accounted for 46.8 percent of the interest swaps during the year. In terms of the maturity structure, trading of RMB interest rate swaps with a maturity of less than 1 year was the most buoyant, with an aggregate notional principal of 857.96 billion yuan, accounting for 57.2 percent of the total. In terms of base interest rates, the base interest rate of RMB interest rate swaps or the floating end in 2010 included the 7-day fixing repo rate, the Shibor, and the 1-year time deposit rate, and their related notional principal accounted for 54.5 percent, 40.3 percent, and 5.2 percent of the total. In 2010, 967 bond forward transactions were conducted, with a total turnover of 318.34 billion yuan, down 51.4 percent year on year. Interest rate forward products traded sluggishly and in 2010 only 20 transactions were conducted, with an aggregate notional principal of 3.35 billion yuan. All interest rate forward agreements were based on the Shibor.

Table 6: Transactions of interest rate derivatives

	Bond forwards		Interest rate swaps		Forward rate agreements	
	Transactions	Volume(1) (100 million yuan)	Transactions	Volume of nominal principal (100 million yuan)	Transactions	Volume of nominal principal（100 million yuan）
2006	398	664.5	103	355.7	—	—
2007	1238	2518.1	1978	2186.9	14	10.5
2008	1327	5005.5	4040	4121.5	137	113.6
2009	1599	6556.4	4044	4616.4	27	60.0
2010	967	3183.4	11643	15003.4	20	33.5

Note: ① Since 2009 statistics on transactions of bond forwards have been changed to the settlement amounts of the transactions.

Source: China Foreign Exchange Trade System

2. Indices on the bond market went up slightly and bond issuances grew steadily

Indices on the bond market went up slightly. In 2010, bond indices on both the inter-bank bond market and the stock exchanges rose slightly. The index of total returns on the inter-bank bond market rose 1.9 percent, from 130.2 points at the beginning of 2010 to 132.7 points at end-2010. The index of government securities on the stock exchanges rose 3.3 percent, from 122.3 points at the beginning of 2010 to 126.3 points at end-2010. The yield curve of bonds flattened. Taking the yield curve of government securities as an example, its movements in 2010 can basically be divided into three stages. In the first stage (from January to August), the yield curve saw an overall rise on the short-term end and a steadily declining trend on the medium and long end. In the second stage (from September to mid-November), the yield curve steepened and moved up, with the yield curve of medium-term products moving up the most. In the third stage (from late November to end-2010), the yields of short-term products increased rapidly and the yield curve steadily shifted upward, with yields of all maturities reaching their highest levels in 2010.

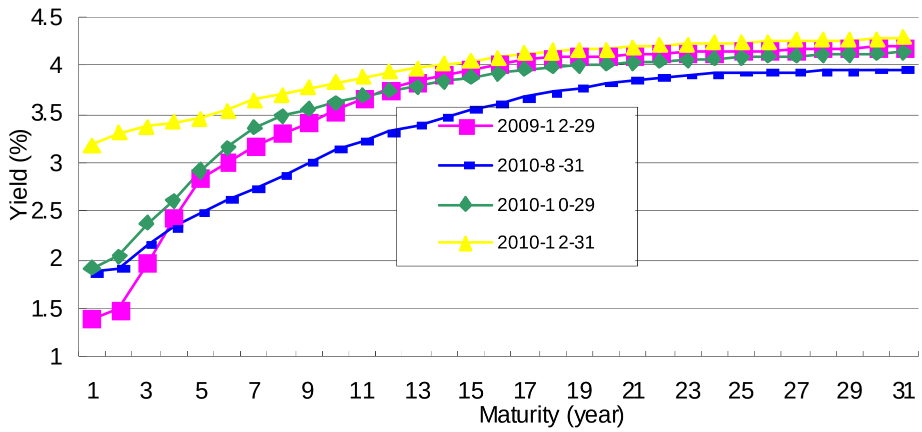

Figure 2: Yield curves of government securities on the inter-bank bond market in 2010

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

There was an upward trend in bond issuance rates. Affected by the two hikes in the benchmark interest rate and the heightened inflation expectations, the upward trend affected bond issuance rates of all maturities. The fixed interest rate of 5-year book-entry interest-bearing government securities issued in December 2010 was 3.64 percent, 0.74 basis points higher than that of the same products issued in late 2009. The interest rate of 30-year fixed-rate bonds issued by the China Development Bank was 4.7 percent, 0.28 basis points higher than that of the same products issued in March 2010. The Shibor played a greater role in bond pricing. In 2010, 24 floating-rate bonds based on the Shibor were issued on the primary bond market, with a total issuance volume of 55.2 billion yuan, accounting for 13 percent of the total volume of floating-rate bond issuances. Other floating-rate bonds were mainly based on the one-year benchmark deposit rate. In addition, 180 enterprise bonds were issued based on the Shibor, with a total volume of 362.1 billion yuan. A total of 241.4 billion yuan of short-term fixed-rate financing bills was issued based on the Shibor, accounting for 37 percent of the issuance of all short-term fixed-rate financing bills.

Spot bond trading on the inter-bank bond market increased notably. The aggregate turnover in 2010 posted 64.0 trillion yuan, while the average daily turnover reached 256.2 billion yuan, representing year-on-year growth of 35.5 percent. State-owned commercial banks were mainly net buyers on the inter-bank spot bond market, with net purchases of 995.6 billion yuan; other commercial banks were mainly net sellers on the inter-bank spot bond market, with net sales of 1.0 trillion yuan; insurance companies became net purchasers after being net sellers in the first half of 2010, with net purchases of 44.6 billion yuan. A total of 166.2 billion yuan of government securities was traded on the stock exchanges, representing a year-on-year decline of 20.3 percent.

Bond issuances grew steadily. In 2010, a total of 5.2 trillion yuan (excluding central bank bills) of RMB bonds was issued on the primary bond market, up 5.4 percent year on year. In particular, short-term financing bills, bonds issued by the China Development Bank and other policy banks, and government securities grew significantly by 46.2 percent, 13.0 percent, and 9.5 percent respectively. In order to further support the development of small and medium-sized enterprises, broaden the financing channels for enterprises, and meet the diversified investment demands of investors, super & short-term commercial paper (SCP) was launched in December 2010, and the volume of the total issuance of such paper reached 15 billion yuan. At end-2010, a total of 20.4 trillion yuan of bonds, including central bank bills and corporate bonds, was deposited in the bond market.

Table 7：Issuances of bonds in 2010

Type of bonds	Issuances (100 million yuan)	Year-on-year growth(%)
Government securities①	19778	10.3
Of which：municipal bonds	2000	0
Financial bonds issued by the China Development Bank and other policy banks	13193	13.0
Bank subordinated bonds and hybrid capital bonds	920	-66.5
Bank ordinary bonds	10	-90.0

Enterprise bonds②	16812	0.8
Of which：short-term financing bills	6742	46.2
Medium-term notes	4924	-29.5
Corporate bonds	603	-18.0

Notes: ①Including 200 billion yuan of municipal bonds issued by the Ministry of Finance on behalf of local governments;

②Including enterprise bonds, short-term financing bills, medium-term notes, collective bills of SMEs, convertible bonds, bonds with detachable warrants, and corporate bonds.

Source: The People's Bank of China

3. Outstanding bill financing continued to decline and bill market interest rates moved up amid fluctuations

Bill market interest rates moved up amid fluctuations and remained at an elevated level. In early 2010, as financial institutions significantly increased bill market interest rates in order to cut down on their bill holdings, bill market interest rates were higher than money-market interest rates. Since the second quarter of 2010, with the growth of credit aggregates moderating, the willingness of financial institutions to hold bills increased and bill market interest rates declined somewhat. In the second half of 2010, with the interest rates on the money market gradually rising, bill market interest rates continued to move up, with the greatest increase in the fourth quarter of 2010.

Although outstanding bills continued to decline, transactions on the bill market were generally buoyant. In 2010, commercial drafts issued by enterprises totaled 12.2 trillion yuan, representing an increase of 18.5 percent year on year; cumulative discounted bills amounted to 26.0 trillion yuan, representing an increase of 12.4 percent year on year. At end-2010, the total value of outstanding commercial drafts increased 35.9 percent year on year to 5.6 trillion yuan; outstanding discounted bills registered 1.5 trillion yuan, down 37.9 percent year on year. Since 2010, due to the impact of the structural adjustment of credit assets by financial institutions, outstanding discounted bills declined quarter by quarter. At end-2010, the share of outstanding bill financing to outstanding loans was 3.1 percent, down nearly 3 percentage points year on year.

4. Stock indices declined somewhat while the volume of equity financing reached a historic high

The stock indices fell. At end-2010, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index dropped 14.3 percent and 9.1 percent respectively to close at 2808 points and 12459 points. The average P/E ratio on the A-share markets in Shanghai and Shenzhen declined from 29 times and 47 times at end-2009 respectively to 22 times and 45 times at end-2010.

Trading on the stock market remained buoyant. In 2010, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 54.6 trillion yuan, 964.7 billion yuan more than that in the previous year; and the daily turnover increased 2.6 percent year on year to 225.5 billion yuan, a deceleration of 98 percentage points from the previous year. At end-2010, market capitalization increased 27.7 percent year on year to 19.3 trillion yuan. The GEM board developed steadily. At end-2010, there were 153 enterprises listed on the GEM board, with market capitalization of 736.5 billion yuan, 575.5 billion yuan more than that at end-2009.

Financing on the stock market increased notably. According to preliminary statistics, a total of 1.13 trillion yuan was raised in 2010 by non-financial enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, additional offerings, right issuances, and warrant exercises, a surge of 635.1 billion yuan or up 1.3 times from the previous year, thus hitting a historical high. In particular, a total of 895.5 billion yuan was raised on the A-share markets, an acceleration of 506 billion yuan from the previous year.

5. The insurance market developed steadily and total premium income maintained a momentum of rapid growth

During the first eleven months of 2010, the total premium income of the insurance industry amounted to 1344 billion yuan, up 31.6 percent year on year. Among this total, premium income of the property insurance sector increased 33.6 percent and premium income of the life insurance sector increased 30.8 percent. Total claim and benefit payments increased 0.3 percent year on year to 281.3 billion yuan. In particular, total claim and benefit payments in the property insurance sector increased 10.9 percent, while those in the life insurance sector declined 9.6 percent.

Total assets of the insurance industry continued their fairly rapid growth. At end-November 2010, the total assets of the insurance industry were 4.9 trillion yuan, an increase of 25.3 percent year on year, up 3.7 percentage points from the previous year. Among this total, bank deposits increased 32.7 percent, up 2.7 percentage points from the previous year; and investment-type assets increased 25.6 percent, up 5.8 percentage points from the previous year.

Table 8：Use of insurance funds at end-November 2010

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-November, 2010	End-November, 2009	End-November, 2010	End-November, 2009
Total assets	48962	39063	100.0	100.0
Of which：Bank deposits	12854	9686	26.3	24.8
Investments	32492	25879	66.4	66.2

Source: China Insurance Regulatory Commission

6. The foreign exchange swap market developed rapidly

The RMB foreign exchange spot market developed soundly and the volume of swap and "currency pairs" increased by a large margin. In 2010, the turnover of spot RMB foreign exchange transactions increased 3.5 percent year on year; the turnover on the RMB foreign exchange swap market totaled US$1.3 trillion, an increase of 60.1 percent year on year. Among this total, overnight swap transactions amounted to US$741.2 billion, accounting for 57.8 percent; the turnover on the RMB foreign exchange forward market totaled US$32.7 billion, an increase of 234.5 percent year on year. The turnover of foreign currency pairs amounted to US$66.6 billion, an increase of 63.9 percent year on year. In particular, the US$/HKD pair accounted for the lion's share, or 60.4 percent, up 9.5 percentage points from the previous year. The number of participants on the foreign exchange market increase further. In 2010, 32 new members were accepted on the spot market, 3 new members on the forward market, 3 new members on the foreign exchange swap market, and 4 new members on the currency swap market. In addition, 11 enterprise-group finance companies were admitted to trade on the inter-bank foreign exchange market.

7. Both the price and volume of the gold market increased

The price of gold showed an upward trend. In 2010, the price of gold on the international market continued to reach record highs, exceeding US$1300 per ounce and then US$1400 per ounce and hitting a record high of US$1421 per ounce in November. Similarly, the price of gold on the Shanghai Gold Exchange witnessed an upward trend, hitting a record high of 306 yuan per gram. At end-2010, the price of gold closed at 301.2 yuan per gram, up 24.9 percent from the beginning of the year; the weighted average of the price of gold was 265.8 yuan per gram, 50.8 yuan more than the price in the previous year.

The turnover on the Shanghai Gold Exchange also reached historic highs. In 2010, a total of 6051.5 tons of gold was traded on the Shanghai Gold Exchange, an increase of 28.5 percent year on year; the total turnover posted 1615.78 billion yuan, an increase of 57.0 percent; the average daily turnover was 25.0 tons, an increase of 29.5 percent year on year. The trading volume of silver was 73,615 tons, an increase of 353.1 percent year on year; total turnover amounted to 386.33 billion yuan, an increase of 558.6 percent. The trading volume of platinum declined 3.5 percent to 54.7 tons and total turnover rose 27.8 percent to 19.84 billion yuan.

II. Institutional building in the financial market

1. **In parallel with the pilot program for RMB cross-border trade settlement, three types of overseas institutions were allowed to invest in the inter-bank bond market on a pilot basis**

The *Notice on a Pilot Scheme for Three Types of Eligible Institutions Outside of Mainland China, Including the RMB Clearing Bank, to Invest Their RMB Funds in* *the Mainland's Inter-bank Bond Market*, was released (PBC Document No.217 [2010]). The entry of overseas institutions to the inter-bank bond market opens a channel for these institutions to preserve the value of their RMB holdings, and as a necessary arrangement to support the cross-border trade RMB settlement scheme, it facilitates the use of RMB in the settlement of cross-border trade transactions.

2. Facilitating bond transactions on stock exchanges by listed commercial banks

In order to implement the *Several Opinions of the General Office of the State Council on Providing Financial Support for Economic Development* (General Office of the State Council Document No.126 [2008]), in October 2010 the China Securities Regulatory Commission, the People's Bank of China, and the China Banking Regulatory Commission jointly released the *Notice on the Pilot Participation of Listed Commercial Banks in Bond Trading on the Stock Exchanges*, to promote the interconnection, efficiency, and healthy and coordinated development of the bond market.

3. Promoting financial product innovation

To enrich the credit-risk management tools for investors and to improve the credit-risk sharing mechanism on the bond market, the People's Bank of China promoted the National Association of Financial Market Institutional Investors (NAFMII) to launch credit-risk mitigation tools. In addition, super & short-term commercial paper (SCP) was launched on a pilot basis. The SCP is a short-term commercial paper with a maturity of up to 270 days issued on the inter-bank bond market by non-financial enterprises that have legal person status and a high credit rating. As a debt-financing instrument for non-financial enterprises, the commercial paper is a money-market instrument, featuring straightforward information disclosure, high registration efficiency, and easy issuance procedures. As a market-based instrument, it can be widely used by a large variety of institutions and can help broaden the direct debt-financing channels for large enterprises, enrich product varieties on the money market, increase the sensitivity of the real economy to interest-rate policy, and lay a solid foundation for macroeconomic management. On December 21, 2010, the NAFMII published the *Guidelines for Super and Short-term Commercial Paper (SCP) Issued by Non-financial Enterprises on the Inter-bank Bond Market (Provisional)*, and formally began to accept registrations for the issuance of SCP on the inter-bank bond market. By end-2010, two super and short-term commercial papers had been issued, with a total value of 15 billion yuan.

4. Strengthening the institutional building of the gold market

On July 26, 2010, the PBC, jointly with the National Development and Reform Commission, the Ministry of Industry and Information Technology, the Ministry of Finance, the State Administration of Taxation, and the China Securities Regulatory Commission, released *Several Opinions on Promoting Gold Market Development* (PBC Document No.211 [2010]), highlighting the roadmap and main tasks for the development of the gold market. The document has played a significant role in promoting stable and healthy development of the gold market, strengthening supervision over the gold market, and earnestly protecting the legitimate rights and interests of investors.

5. Strengthening the institutional building of the securities market

Continued efforts were made to advance the reform of the IPO system and to promote financial product innovation. On October 11, 2010, the China Securities Regulatory Commission promulgated the *Guidelines on Deepening the Reform of the IPO Mechanism* and the *Decision on Amending the Administrative Measures on Securities Offerings and Underwriting*. The two documents aim to improve the pricing, subscription, and placement management system, expand the price enquiry audiences and offline institutional investors, and enhance the transparency of pricing information and the clawback mechanism and suspension of the offering mechanism. On March 31, a trading system for margin trading and short selling was launched on the Shanghai and Shenzhen Stock Exchanges. The launch of margin trading and short selling is an important step to improve institutional arrangements for China's capital market and will help improve the pricing mechanism and enhance market liquidity. As approved by the State Council, stock index futures were formally launched on April 8. The gradual improvement in stock index futures is conducive to enriching the risk-management tools on the stock market.

Continued efforts were made to standardize the behavior of intermediary institutions. Centralized administration was applied to securities brokerage businesses. Efforts were made to standardize securities companies and securities investment advisory companies when conducting securities investment consulting, to specify the basic rules that lawyers should follow in engaging in various securities law practices, and to highlight the major areas of focus for the financial advisors in acquisitions, major asset reorganizations, purchase of assets through share offerings, and re-purchasing of public shares of listed companies. In addition, efforts were intensified to prevent insider trading and to strengthen supervision over securities offerings.

6. Strengthening basic institutional arrangements in the insurance market

Efforts were made to strengthen solvency supervision, supervision over investments of insurance funds, and corporate governance. Efforts were made to further strengthen solvency regulation and specified the admitted asset standard for investment assets, such as unsecured enterprises bonds, real estate, and equities of unlisted companies. In order to strengthen comprehensive risk management, the *Guidelines on Comprehensive Risk Management of Life Insurance Companies* were released. In order to strengthen regulation over the investment of insurance funds, the *Interim Measures for the Administration of Utilization of Insurance Funds* were released, specifying the condition, scope, and upper limits for insurance funds to be invested in real estate, equities of unlisted companies, and so forth. Efforts were made to improve the corporate governance of insurance companies, raise the access criteria for shareholders, intensify supervision over major shareholders, strengthen the responsibilities of shareholders, and standardize supervision over insurance-group companies. Furthermore, management of the insurance salesperson system was improved.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In 2010, the global recovery proceeded at an uneven speed across the various economies. In the advanced economies, growth was subdued by mounting worries about fiscal sustainability and high unemployment. The U.S. economy witnessed a brisk recovery in Q4 but growth in the euro area and Japan continued to be sluggish. In many emerging economies, activities remained buoyant, but inflation and capital inflow pressures also picked up, leading to a gradual tightening of monetary policy in some countries. The major financial markets fluctuated, world trade growth rebounded to the pre-crisis level, and commodity prices stabilized and began to rise. In the *World Economic Outlook* released by the IMF in January, the IMF reported that the global growth rate was 5 percent in 2010, and activity in the United States, the euro area, Japan, and the emerging and developing economies had expanded at 2.8 percent, 1.8 percent, 4.3 percent, and 7.1 percent respectively in 2010, an acceleration of 5.4, 5.9, 10.6, and 4.5 percentage points compared with 2009.

1. Economic developments in the major economies

The U.S. recovery showed positive signs but uncertainties persisted regarding future developments. The growth rate of GDP in 2010 was 2.9 percent, with the growth rate in the four quarters registering 3.7 percent, 1.7 percent, 2.6 percent, and 3.2 percent respectively. The unemployment rate in December stood at 9.4 percent, down 0.4 percentage points from the last month but still at a high level. Inflation remained subdued, with the CPI rising by only 1.5 percent year on year, a historical low in the past two years. The core CPI increased by 0.8 percent year on year, the lowest level since record-keeping began. The trade deficit and debt continued to pose serious risks. From January to November, the cumulative trade deficit reached US$457.8 billion, an increase of 35.8 percent year on year. The United States federal deficit for fiscal year 2010 was close to US$1.3 trillion, down slightly from the US$1.42 trillion recorded in the last year, which was the highest level since World War II. The total debt incurred by local governments soared to US$2 trillion.

Recovery in the euro area was hampered by the sovereign debt crisis and was remarkably different among the various member states. In Q3, GDP growth in the euro area registered 1.9 percent year on year, or 0.3 percent month on month, notably lower than the 1 percent month-on-month growth seen in Q2. In November, the unemployment rate remained high at 10.1 percent. In December, the euro area HICP increased by 2.2 percent year on year, exceeding the 2 percent target rate set by the ECB for the first time. On January 23, Jean-Claude Trichet, president of the ECB, pointed out that inflation pressures in the euro area needed to be monitored closely. The performance of Germany was much better than that of the other member states, with GDP growth in 2010 reaching 3.6 percent, its fastest pace since 1991, and unemployment dropped to 7.5 percent, becoming the main engine behind the recovery in the euro area. Activities in other member states were sluggish. In both France and Italy, the month-on-month GDP growth in Q3 stood at only 0.3 percent, notably lower than that in Q2. Following the sovereign debt crisis, Greece, Ireland, and Spain slid into zero or negative growth. In 2010, the sovereign debt crisis caused Greece and Ireland to turn to the EU and IMF for help, burdened Portugal, Spain, and other member states with heavy debt, and pushed up treasury yields and CDS spreads in France, Italy, Belgium, and Germany. During the recent bailout, the EU and the ECB strengthened the fiscal constraints on member states and facilitated the establishment of the EFSF, EFSM, and the permanent ESM, but the effects of these measures remain to be seen.

In Japan, deflation continued, unemployment was still high, and growth momentum remained weak. In Q3, annualized month-on-month GDP growth registered 4.5 percent, which was better than expected. Deflation lingered on with the core CPI declining by 1 percent year on year in 2010, a negative reading for two years in succession and the monthly core CPI declining continuously for 22 consecutive months. The unemployment rate remained at the same high level of the last year, averaging 5.1 percent for the year. Under the influence of the tepid global demand and the appreciation of the Japanese yen, exports and growth of the trade surplus continued to fall, with month-on-month exports standing at 43.3 percent, 33.2 percent, 17.8 percent, and 10 percent respectively in the four quarters. The contribution of external demand to economic growth dropped.

The emerging market economies experienced a generally strong recovery but they were also facing pressures from capital inflows and inflation, which were caused by the quantitative easing policies in the advanced economies. Starting from 2010 and boosted by the strong domestic demand and the rebound of commodity prices, the emerging and developing economies in Asia and Latin America saw buoyant activity, making them the leading engines behind global economic growth. According to the IMF, during the year economic growth in India, Brazil, and Russia reached 9.7 percent, 7.5 percent, and 3.7 percent respectively However, due to continuously excessive global liquidity and slow-paced recovery in the advanced economies, hot money swarmed into those emerging market economies with relatively robust growth and large spreads, putting upward pressures on their stock markets and housing prices and forcing their currencies to appreciate. Capital inflows also became a source of imported inflation. According to the central banks of India, Brazil, and Russia, in 2010 the CPI for the three countries would reach 8 percent, 4.7 percent, and 7.0 percent respectively.

2. Global financial market development

The exchange rates of the major currencies fluctuated with large swings. In 2010, influenced by factors such as the European sovereign debt crisis, the US dollar first rallied, then turned downward but eventually rebounded. On December 31, the exchange rate of the US dollar against the euro and the Japanese yen closed at 1.3377 dollar per euro and 81.15 yen per dollar, a depreciation of the euro against the dollar by 6.6 percent and an appreciation of the yen against the dollar by 14.5 percent from the beginning of the year. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, cumulatively depreciated by 2.4 percent for the year.

International money-market interest rates fluctuated. The US dollar Libor slid back after an initial rise. In the first half of 2010, the US dollar Libor squeezed up and the 1-year Libor reached a year high of 1.22 percent on May 25, 2010. Later, due to slow U.S. growth and strong expectations that the U.S. would roll out further quantitative easing measures, the Libor fluctuated downward and on December 31, the 1-year Libor touched 0.78 percent, down 0.20 percentage point from the beginning of the year. The Euribor edged up amid fluctuations due to the influence of the European sovereign debt crisis. On December 31, 2010, the 1-year Euribor was 1.51 percent, up 0.26 percentage point from the beginning of the year.

The yield of government securities in the major countries fluctuated dramatically. In the first half of 2010, yields were driven up due to risk aversion as worries about the Greek debt crisis and the world economic outlook intensified. Starting from August, as the sovereign debt crisis gradually subsided and as market expectations about further quantitative easing measures by the U.S. Fed rose, there were increasing worries about excessive liquidity, the weak US dollar, and heightened mid- and long-term inflationary pressures. Therefore, a large amount of capital flowed into the bond and commodity markets where yields were higher and the investors' adjustments of asset allocations pushed up the yields of government bonds. Since the launch of the second round of quantitative easing measures (QE2) by the U.S. Fed, the yields of 10-year Treasury bonds soared by about 100 basis points from the 2.57 percent on

November 3, and yields of 30-year Treasury bonds also rocketed. On December 31, the yields of 10-year Treasury bonds in the U.S., euro area, and Japan closed at 3.36 percent, 2.97 percent, and 1.12 percent respectively, down 0.43, 0.41, and 0.17 percent from the last year, but up by 0.85, 0.71, and 0.18 percent from the end of the last quarter.

The major stock indices fluctuated upward. In the first half of 2010, the major stock indices tumbled amid the uncertainties caused by the European sovereign debt crisis. At the beginning of May and end-June, there were several consecutive slumps. In Q3, against the backdrop of the eased sovereign debt crisis, the establishment of the U.S. Financial Reform Act, and the announcement of the results of the bank stress tests in the EU, the major stock markets picked up. In Q4, boosted by the launch of the QE2 by the U.S. Fed, better economic data, and the improved profitability of public companies, stock markets in the United States and Japan rebounded amid a handful of corrections. On December 31, the Dow Jones Industrial Average, the NASDAQ, and the Nikkei 225 closed at 11578, 2653, and 10229 respectively, up 7.3, 12.0, and 9.2 percent from the end of the last quarter and up 11.0, 16.9, and down 3.0 percent from the end of the last year. It is noteworthy that the Dow Jones Industrial Average reached a new high in the year, back to its level before the September 2008 crash of Lehman Brothers. Influenced by the QE2 and the Irish debt crisis, stock indices in the euro area were quite volatile, with the STOXX50 closing the year at 2601, up 0.85 percent compared with the last year and up 4.79 percent from the end of the last quarter.

3. Housing market development in the major economies

The performance of the U.S. housing market was lackluster. The first-time homebuyer tax credit played an important role in facilitating sales of existing homes in the first half of the year, and sales of homes picked up a bit. But with the expiration of the tax credit and still serious unemployment conditions, sales of homes dropped sharply in the latter half of the year. According to the U.S. Department of Commerce, by November 2010 sales of new homes registered 3.52 million, down 14.9 percent year on year. According to the National Association of Realtors, in 2010 sales of existing homes stood at 4.908 million, down 4.8 percent year on year. The foreclosure rate rose rapidly. The U.S. banking industry foreclosed 69,800 homes in December and the cumulative number of foreclosed homes for the year registered 1.05 million, more than the last year’s 918,000.

The European housing market remained tepid. Constrained by the government fiscal austerity measures, the British housing market continued to be sluggish. The Halifax

Index declined by 1.3 percent month on month in December and dropped by 1.6 percent year on year in Q4. Housing demand and prices remained stable in Germany. But prices tumbled in some countries including Spain, Italy, and Ireland due to the lingering debt crisis.

Japanese housing prices declined. Stimulated by the government's subsidy and tax concessions for energy-saving houses, the start of new housing climbed 6.8 percent year on year in November, representing six months of consecutive growth. But dragged down by weak economic activities, housing prices slid continuously. According to statistics of Japan's Ministry of Land, Infrastructure, Transport, and Tourism, land prices fell by an average of more than 3 percent in 2010.

4. The monetary policies of the major economies

In 2010, diversified economic recoveries led to different monetary policies among the various countries. The central banks of the major economies continued to rely on measures such as low interest rates and quantitative easing to stimulate growth, but countries with robust activities and elevated inflationary pressures began to tighten their monetary policies.

In order to facilitate economic growth and improve employment conditions, the U.S. Fed, the ECB, and the Bank of England kept their target rates unchanged at 0~0.25 percent, 1 percent, and 0.5 percent respectively in 2010. On November 3, the U.S. Fed released the QE2 so as to promote a stronger pace of economic recovery and to push inflation up to its target level. On October 5, the Bank of Japan returned to its zero interest rate policy after a lapse of more than four years, stated that it would encourage the uncollateralized overnight call rate to remain at around 0 to 0.1 percent, and announced a 5 trillion yen asset purchase program. On December 7, the Bank of Japan stated that it would disburse a total of 998.3 billion yen in loans to 106 institutions so as to enhance the banking industry's support to the real economy. The ECB was comparatively prudent in using quantitative easing measures. To fight the sovereign debt crisis, the ECB agreed to a 110 billion euro bailout package for Greece and an 85 billion euro package for Ireland, and provided the market with liquidity through refinancing operations and the Securities Market Program. The Bank of England also kept the Bank Rate unchanged at 0.5 percent and the stock of purchased assets at £200 billion.

Some economies rebounded strongly and those with elevated inflationary pressures accelerated the pace of normalizing their monetary policies. To contain inflation, India, South Korea, Vietnam, Chile, Australia, and Sweden raised their interest rates. To prevent speculative capital inflows and a rapid appreciation in exchange rates, some emerging economies strengthened controls on capital flows and interventions in the foreign exchange markets. Brazil raised the financial transaction tax on foreign investments in local equities as well as the reserve requirements on foreign exchange positions of its domestic banks. Bank Indonesia announced further restrictions on short-term external borrowing by banks and gradually increased the bank reserve ratio on foreign assets. The Central Bank of Turkey tried to curb speculative capital inflows by implementing differentiated reserve rates and cutting interest rates.

5. World economic outlook

Looking forward, the global recovery will continue with the emerging economies in the lead, despite remaining elevated uncertainties. Problems such as high unemployment and low income in the advanced economies cannot be resolved in the near future and factors such as the European sovereign debt crisis and the fiscal austerity measures in the advanced economies will weigh on external demand. In the January 2011 *World Economic Outlook*, the IMF pointed out that the two-speed recovery was continuing and it projected that global output would expand by 4.5 percent in 2011, an upward revision of about 0.25 percentage point compared to its October forecast. Growth in the emerging and developing economies is expected to remain buoyant at 6.5 percent, a modest slowdown from the 7 percent growth registered in 2010. Activity in the advanced economies is projected to expand by 2.5 percent, which is still sluggish considering the depth of the 2009 recession.

Box 2: Quantitative Easing Monetary Policy

Originally used by the Bank of Japan in 2001, quantitative easing refers to unconventional monetary policy measures used by central banks to expand the supply of base money and to pump a large amount of liquidity into markets so as to stimulate private lending and expenditures. It is used when conventional tools such as interest rates are no longer effective and it is mainly done through the purchase of government and corporate bonds by the central banks.

Hard hit by the 2008 financial crisis, the major advanced economies experienced a slow recovery and high unemployment. As a countermeasure, the central banks of the advanced economies lowered their target rates to historic lows. But the low policy rates proved insufficient to stimulate the economy and both the United States and Japan faced deflation risks. At the same time, because the advanced economies were also burdened by a large public debt and a fiscal deficit after the crisis, an expansionary monetary policy was conducive to reducing the cost of public financing. Under these circumstances, policymakers in the advanced economies all turned to or expanded the use of quantitative easing measures.

Starting from the outbreak of the subprime crisis in 2008 to end-March 2010, the U.S. Fed implemented its first round of quantitative easing by purchasing a total of US$1.7 trillion of asset-backed securities and government bonds, which helped prevent a financial market meltdown. On November 3, 2010, the U.S. Fed launched its second round of quantitative easing by announcing that it would buy another US$600 billion of Treasury bonds by the end of the second quarter of 2011, a pace of about US$75 billion per month, and would reinvest principal payments from its securities holdings to keep the size of the balance sheet unchanged. At the same time, the U.S. Fed also decided to keep the target range for the federal funds rate at the historic low level of zero to 0.25 percent.

On October 5, to fight deflation and contain the appreciation of the Japanese yen, the Bank of Japan returned to its zero interest rate policy after a lapse of more than four years, encouraged the uncollateralized overnight call rate to remain at around 0 to 0.1 percent, and announced a 5 trillion yen asset purchase program. These measures enhanced the quantitative easing policy.

After its meetings on November 4 and December 2, the ECB announced that the interest rate on its main refinancing operations would remain unchanged at 1 percent. In addition, the ECB would also provide liquidity to the market through refinancing operations and the Securities Market Program. Jean-Claude Trichet, president of the ECB, expressed an open attitude regarding further purchases of government bonds but denied that the Securities Market Program was quantitative easing. By December 21, the ECB bought a total of 72 billion euro of government bonds. On December 9, the Bank of England decided to keep the Bank Rate unchanged at 0.5 percent and the stock of purchased assets at £200 billion.

In effect, the purchase of government bonds by central banks spurred a rush into assets with higher risks, such as corporate bonds and stock markets, increasing the yields of those assets and resulting in wealth effects and reducing the costs of financing by enterprises. Therefore, such purchases play an active role in boosting an economic recovery and containing deflation. For example, since implementation of the QE2 by the U.S. Fed, the credit spread has narrowed, consumer expenditures have increased, and employment conditions have improved, indicating more active economic activities. However, quantitative easing cannot remove the root causes of the economic problems, and instead it might exacerbate problems such as the excessive global liquidity and the competitive depreciation of currencies, leading to a negative spillover effect on the emerging market economies through exchange rates and cross-border capital flows.

There are concerns about the rising long-term inflation expectations caused by the quantitative easing. For example, since the launch of the QE2 in the U.S., yields of long-term treasury bonds have been edging up. In addition, the exit strategies of the quantitative easing policy and their impact on financial markets have caused market worries. Meanwhile quantitative easing also has spillover effects, mainly through portfolio, information, and liquidity channels, especially because it releases a large amount of liquidity into the commodity markets and the emerging market economies with relatively robust growth, which might lead to imported inflation and short-term capital inflows in those countries and add to their pressures. When the U.S. Fed signaled the QE2 in August 2010, a large amount of capital swarmed into the emerging market countries, leading to currency appreciations and asset bubbles and increasing the risks in their financial systems. Many emerging market economies established capital-control and macro-prudential measures to protect their financial stability. The aggressive quantitative easing policy by the advanced economies has caused obvious negative spillover effects. Issuers of the major reserve currencies should adopt responsible policies and countries throughout the world should make concerted efforts to improve the international monetary system and to facilitate the creation of an international reserve monetary system, featuring stable currency values, orderly supplies, and adjustable aggregate amounts. Also, the capability of the emerging market economies to deal with financial risks should be strengthened.

The strong growth in China and the large market capacity have also attracted some capital inflows. As countermeasures, on the one hand, the People’s Bank of China and the State Administration of Foreign Exchange have tightened foreign exchange administration; on the other hand, they have taken sterilization measures against the RMB liquidity resulting from the foreign exchange inflows so as to mitigate the negative effects on China’s macroeconomy due to the foreign capital inflows. In addition, studies are being conducted regarding how to bring the management of the capital inflows into the macro-prudential regulatory framework.

II. Analysis of China's macroeconomic performance

In the fourth quarter of 2010, the Chinese economy developed in the direction intended by the macroeconomic management policies and it generally performed well. Consumption continued to grow rapidly, the structure of fixed-asset investments improved, and external trade recovered further. Performance of the agricultural sector was good, industrial production grew steadily, household income continued to grow, and the growth of prices accelerated. In 2010, the Gross Domestic Product (GDP) registered RMB 39.8 trillion, up 10.3 percent year on year based on comparable prices, an acceleration of 1.1 percentage points from the previous year. The Consumer Price Index (CPI) was up 3.3 percent year on year, an acceleration of 4.0 percentage points from the previous year The trade surplus posted US$183.1 billion, representing a decline of US$12.6 billion from the last year.

1. Consumption grew steadily, the investment structure improved, and external trade recovered rapidly

Supported by the income gains of urban and rural residents, domestic consumption remained stable. In 2010, the per capita disposable income of urban households posted 19,109 yuan, representing year-on-year growth of 11.3 percent and real growth of 7.8 percent. The per capita cash income of rural households registered 5,919 yuan, up 14.9 percent, or 10.9 percent in real terms. The PBC survey on urban depositors in the fourth quarter shows that the income index of residents in the period under review posted 51.1 percent, up 0.5 percentage points from the previous quarter and down 0.6 percentage points from the same period of the last year. This indicates that the residents' willingness to invest has been strengthened, their willingness to consume has remained stable, and their willingness to save has declined. In 2010, retail sales of consumer goods totaled 15.5 trillion yuan, representing a year-on-year increase of 18.4 percent and an acceleration of 2.9 percentage points from the last year. Price-adjusted real consumption growth was 14.8 percent, a deceleration of 2.1 percentage points from 2009. The deceleration was mainly due to the movement of the retail price index, which was up 3.1 percent in 2010 but dropped 1.2 percent the previous year. Broken down by urban and rural areas, consumption in the urban areas outpaced that in the rural areas, and the growth gap remained basically stable. In 2010, retail sales in the urban areas registered 13.4 trillion yuan, up 18.8 percent, or 15.6 percent in real terms, whereas retail sales in the rural areas posted 2.1 trillion yuan, up 16.1 percent, or 12.1 percent in real terms.

Growth of fixed-asset investments declined, but growth of investments in the tertiary sector remained rapid. In 2010, fixed-asset investments totaled 27.8 trillion yuan, up

23.8 percent year on year, a deceleration of 6.2 percentage points from the last year, or up 19.5 percent in real terms, representing a deceleration of 14.3 percentage points from the previous year. Completed fixed-asset investments in the urban areas totaled 24.1 trillion yuan, up 24.5 percent year on year and a deceleration of 5.9 percentage points; completed fixed-asset investments in the rural areas registered 3.7 trillion yuan, up 19.7 percent year on year and a deceleration of 7.6 percentage points from the previous year. Broken down by regions, urban fixed-asset investment growth in the eastern, central, and western regions registered 22.8 percent, 26.9 percent, and 26.2 percent respectively, with the central and western regions obviously outpacing the eastern region. Broken down by industries, urban fixed-asset investments in the primary, secondary, and tertiary industries grew 18.2 percent, 23.2 percent, and 25.6 percent respectively, and growth in tertiary industry was much higher than that in the other two industries. The total planned investment in projects under construction in the urban areas grew by 23.1 percent year on year to 52.2 trillion yuan. The willingness of enterprises to invest remained strong, as evidenced by the index for fixed-asset investment, equipment investment, and civil engineering investment that, despite a decline from the previous quarter, was at its second highest since 2008.

The volume of imports and exports grew rapidly, the trade structure further improved, and the trade surplus declined modestly. In 2010, imports and exports totaled US$2972.8 billion, up 34.7 percent year on year, representing an acceleration of 48.6 percentage points from the previous year. Specifically, exports posted US$1577.9 billion, up 31.3 percent year on year, an acceleration of 47.3 percentage points from the previous year; imports registered US$1394.8 billion, up 38.7 percent year on year and an acceleration of 49.9 percentage points from the last year; the trade surplus dropped by US$12.6 billion from the level registered in 2009 to US$183.1 billion. Improvement in the export mix bolstered the continued trade recovery. In 2010, exports of machinery and electronic products, and high- and new-technology products grew 30.9 percent and 30.7 percent respectively, representing an acceleration of 44.2 and 40.0 percentage points from the last year. In the long run, we expect that the U.S. and Japan will remain the major destinations for Chinese exports, but their share of the total exports will decline, which shows that China's trade is becoming increasingly diversified. Actually utilized foreign investment in 2010 reached US$105.74 billion, up 17.4 percent and an acceleration of 20 percentage points from the last year.

2. Agricultural production remained stable, industrial production grew rapidly

In 2010, the added value of the primary, secondary, and tertiary industries reached 4.0 trillion yuan, 18.6 trillion yuan, and 17.1 trillion yuan respectively, up 4.3 percent, 12.2 percent, and 9.5 percent respectively. The share of the three industries in GDP was 10.2 percent, 46.8 percent, and 43.0 percent respectively. The share of secondary industry in GDP expanded, indicating a greater contribution to GDP growth.

Agricultural production was satisfactory and 2010 was another year of a bumper grain harvest. In 2010, the total output of meat (including port, beef, mutton, and poultry) posted 77.8 million tons, up 3.6 percent year on year. In particular, the output of pork totaled 50.7 million tons, about 3.7 percent higher than that in the previous year.

Industrial production grew rapidly and corporate profitability remained stable. In 2010, the added value of statistically large enterprises grew 15.7 percent year on year, representing an acceleration of 4.7 percentage points from the last year. Production and sales of industrial products were well connected, and 97.9 percent of manufactured goods were sold, up 0.2 percentage points from 2009. In the first eleven months, the pre-tax return on sales of industrial enterprises reached 6.22 percent, representing an acceleration of 0.76 percentage points from the previous year. The survey of 5,000 industrial enterprises conducted by the PBC in the fourth quarter reveals that the corporate business index registered growth for seven consecutive quarters and reached 71.3 percent, a new high since the first quarter of 2008. Inventories of finished products increased, and the inventory index posted 50.3 percent, an acceleration of 1.8 and 2.3 percentage points higher from the previous quarter and the last year respectively. Corporate profitability remained stable, with the profitability index edging up by 0.8 percentage points from the previous quarter to 61.1 percent, an acceleration of 3.4 percentage points from the last year.

3. Pressure on price hike was high

In general, price increases in 2010 continued their upward trend since the latter half of 2009. In the latter half of 2010, in the fourth quarter in particular, price-hike pressures mounted notably. With respect to the major price indices, driven by continuously rising food and housing prices, CPI growth accelerated quarter by quarter. Since the fourth quarter, the increase of non-food prices also climbed. Affected by the base period effect that tails up at the end-period and international commodity prices that went up at the beginning of the year, dipped in mid-year, and climbed later, the PPI continued to rise in the first half of the year, dropped notably in the third quarter, and rebounded in the fourth quarter.

The CPI continued to rise. In 2010, the CPI gained 3.3 percent year on year, an acceleration of 4 percentage points from 2009. The quarterly CPI was up 2.2 percent, 2.9 percent, 3.5 percent, and 4.7 percent respectively. Broken down by food and non-food items, food prices increased by 7.2 percent, an acceleration of 6.4 percentage points from the previous year, and non-food prices edged up by 1.4 percent, an acceleration of 2.8 percentage points from 2009. Broken down by consumer goods and services, the prices of consumer goods grew by 3.7 percent, up 4.3 percentage points from the last year, and the prices of services were up 2.0 percent, an acceleration of 3.1 percentage points from 2009.

Producer prices grew rapidly. In 2010, ex-factory producer prices of industrial products gained 5.5 percent year on year, an acceleration of 10.9 percentage points from the previous year. The quarterly price hike was 5.2 percent, 6.8 percent, 4.5 percent, and 5.7 percent respectively year on year. The purchase prices of raw materials, fuel, and power increased by 9.6 percent year on year, representing an acceleration of 17.5 percentage points from 2009, and the increase in the four quarters posted 9.9 percent, 11.7 percent, 7.7 percent, and 9.1 percent year on year. In 2010, the Corporate Goods Price Index (CGPI) monitored by the PBC grew 6.5 percent, an acceleration of 11.5 percentage points from the last year. Broken down by the application of goods in the CGPI basket, prices of investment goods and consumer goods rose 6.7 percent and 6.1 percent respectively. Broken down by categories within the basket of the CGPI, prices of agricultural products, mineral products, coal, oil, and electricity, and processed products were up 12.4 percent, 13.8 percent, 12.0 percent, and 3.8 percent respectively. In 2010, the producer prices of agricultural products (the prices at which farmers sell their products) climbed by 10.9 percent, an acceleration of 13.3 percentage points from the previous year, whereas the prices of agricultural capital goods gained 2.9 percent, an acceleration of 5.4 percent from the previous year.

The import price hike was higher than that of the export price hike. In 2010, import prices went up by 13.7 percent year on year, representing an acceleration of 27.0 percentage points from the previous year, or up by 15.6 percent, 18.7 percent, 10.9 percent, and 9.8 percent respectively in the four quarters. Export prices grew by 2.4 percent, an acceleration of 8.4 percentage points from the previous year, or up by -3.1 percent, 1.6 percent, 5.1 percent, and 5.8 percent respectively in the four quarters. In the four quarters of 2010, the average price of crude oil futures traded on the New York Mercantile Exchange posted quarter-on-quarter growth of 3.6 percent, -1.1 percent, -2.4 percent, and 11.8 percent respectively, or up 12.0 percent in cumulative terms. The average spot prices of copper on the London Metal Exchange were up by 8.9 percent, -2.9 percent, 3.0 percent, and 19.6 percent quarter on quarter in the four quarters respectively, or 30.3 percent in cumulative terms, whereas the average price of aluminum traded on the London Metal Exchange posted quarter-by-quarter growth of 8.1 percent, -3.4 percent, -0.2 percent, and 12.4 percent respectively, or 17.1 percent cumulatively.

Labor compensation continued to grow rapidly. In the first three quarters, the monthly average salary of urban employees grew 14 percent year on year, faster than the growth in the first half of the year. In particular, the salaries of urban employees in collective enterprises grew faster than the salaries of employees in state-owned enterprises and other types of profit-making entities (excluding private enterprises).

The GDP deflator rebounded rapidly. The GDP in 2010 registered 39.8 trillion yuan, or up 10.3 percent year on year. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 5.8 percent, up 6.4 and 0.7 percentage points from the previous year and the third quarter respectively.

The price reform of resource goods advanced steadily, and a pilot program for resource tax reform was launched. In June, the long-discussed reform of the resource tax began in Xinjiang Autonomous Region as a pilot program, which changed the specific tax regime for crude oil and natural gas to an ad valorem regime at a tax rate of 5 percent. Furthering the reform of the resource tax will help improve the resource goods pricing mechanism, fully reflecting the production costs and the scarcity of resource goods, enhancing the fundamental role of the market in resource allocations, and promoting energy conservation, pollution reduction, economic restructuring, and the shift in the economic growth pattern.

Box 3: Inflation and Money

In a modern economy, money serves as a means of payment, and its amount and the velocity of its circulation reflect aggregate demand of economic agents with paying capacity at a certain time-point. Under the preconditions of relatively stable supply, the amount of money supply at a particular point in time by and large reflects aggregate social demand that influences the level of inflation.

In reality, the relationship between inflation and money is complicated. In China, M2 growth has long exceeded GDP growth. Therefore, when analyzing the effect of cumulative money supply on inflation, we need to take into account various factors. First, in the medium- and long-term, due to different savings ratios, financing structures, monetarization processes, and supply-side factors from country to country, money supply influences inflation to varying degrees in each country. In China, factors such as the high household savings ratio and savings predominantly in the form of bank deposits, the dominance of bank loans in financing, and the monetarization process related to the transition all have an impact on actual monetary demand and the correlation between money and inflation. Second, in the short run, consumption and the propensity for investment vary in different phases of the macroeconomic cycle, and these differences affect the pace at which money is translated into actual demand, hence in turn influencing the general price level. Third, apart from the demand-pulling effects including those resulting from money supply, inflation is also driven by supply-side factors such as supply shocks, cost drivers, and productivity. In the context of speeding up the shift in the economic growth pattern and continuing the resource pricing mechanism, the impact of the supply factors on inflation in China is worth noting. In addition, in an open economy, monetary conditions and inflation are subject to external shocks. In general, an oversupply of money might be inflationary; however, inflation is not always triggered by money supply, and sometimes it is influenced by changes in expectations, the velocity of money, whether resource prices are streamlined, and other structural factors. One cannot simply compare broad money with the GDP. For example, China's M2/GDP ratio continued to rise from 0.36 in 1980 to 1.64 in 2003, but inflation did not become worse. In fact, China was on the verge of deflation for several years after the Asian financial crisis. Between 2003 and 2008, China's M2/GDP ratio dropped from 1.64 to 1.51, but during this period liquidity was above normal and inflationary pressures were building up. Therefore, we need to adopt a scientific view when diagnosing the factors influencing inflation and how inflation comes into being.

The international financial crisis that erupted in September 2008 dealt a heavy blow to China's economy. Facing the grave situation, the State Council changed its policy stance in a timely manner by adopting a proactive fiscal policy and a moderately easing monetary policy. Supported by massive infrastructure construction and credit support from local governments, money and credit registered continued and rapid growth. In general, the swift increase in money and credit played a pivotal role in boosting confidence and expanding domestic demand, as evidenced by the rapid economic recovery, from 6.5 percent year-on-year growth in the first quarter of 2009 to above 10 percent in the first three quarters of 2010. At the same time, price levels went up in tandem with the gradual recovery in demand in the real economy.

Specifically, the current round of price hikes is closely related to the following two factors. The first is loose external monetary conditions. Since the outbreak of the international financial crisis, the major economies have loosened their monetary policies, resulting in massive inflows of funds to the fast-growing emerging market economies. Moreover, devaluation of the major currencies such as the US dollar has pushed up commodity prices in the international market. In 2010, China's import prices denominated in the US dollar posted an average growth of 13.7 percent, and export prices rose by an average of 2.4 percent, building up pressures of imported inflation. The second is the gradual strengthening of cost-driving factors as a result of rising labor costs and the reform of resource prices in recent years that shores up prices and leads to rapid price hikes of labor-intensive agricultural products and services.

Judging from the monetary environment at the current juncture and going forward, the super accommodative monetary policy of the major economies will not be changed within a short period of time, and the stock of domestic money has been growing rather rapidly. In terms of economic fundamentals, endogenous drivers of economic growth remain strong, which, in combination with the plentiful price-pushing factors, will probably shore up inflationary expectations. So the underlying inflationary risks cannot be neglected. Based on these judgments, monetary policy in the next stage will be made according to the principles adopted at the Central Economic Work Conference, including an appropriate aggregate volume, flexible adjustments, and an optimized structure, and we will place a higher priority on the task of curbing rapid price increases in the macroeconomic management agenda, take into full consideration the potential risks from the previous rapid increase of money stock and the need for counter-cyclical adjustments, appropriately control the liquidity, and keep interest rates at a rational level, so as to create a favorable monetary environment for stabilizing the general price level, managing inflationary pressures, and regulating the real estate market.

4. Fiscal revenue grew rapidly and growth of fiscal expenditures decelerated

In 2010, fiscal revenue (excluding debt income) surged by 21.3 percent year on year to 8,308 billion yuan, representing an acceleration of 9.6 percentage points, whereas fiscal expenditures registered 8,957.5 billion yuan, up 17.4 percent year on year and a deceleration of 4.5 percentage points from 2009. As a result, revenue was 649.5 billion yuan short of expenditures, representing a reduction of 128.7 billion yuan compared with the deficit of 2009.

As for the structure of fiscal revenue, tax revenue posted 7,320.2 billion yuan, a year-on-year increase of 23.0 percent and an acceleration of 13.2 percentage points. In particular, the domestic VAT, business tax, and consumption tax revenue were up 14.1 percent, 23.8 percent, and 27.5 percent respectively year on year Within the expenditure basket, the three largest items were education (1,245 billion yuan, or 13.9 percent of the total spending), general public services (935.3 billion yuan, or 10.4 percent of the total spending), and social security and employment (908.1 billion yuan, or 10.1 percent of the total spending). Among all the items in the basket, expenditures on subsidized housing, environmental protection, and interest payments for public debt registered relatively rapid growth at 30.7 percent, 25.4 percent, and 23.7 percent respectively year on year.

5. The balance of payments continued to post a "dual surplus"

In the first three quarters of 2010, China's balance of payments (BOP) continued to post a surplus in both the current account and the capital and financial account, and international reserve assets continued to rise. In the first three quarters, the current account grew by 30 percent year on year to US$203.9 billion, the capital and financial account surplus was up 2 percent to US$130.1 billion, and international reserve assets grew by US$286 billion, or 7 percent year on year.

In the third quarter, China's current account surplus posted US$102.3 billion, a onefold increase on a year-on-year basis (the same applies below). In a breakdown, based on the BOP statistics trade in goods registered a surplus of US$81.4 billion, trade in services a deficit of US$3.9 billion, returns a surplus of US$14 billion, and current transfers a surplus of US$10.8 billion. The capital and financial account surplus was down 65 percent year on year to US$15.2 billion, including US$24.6 billion of net inflows of direct investment, US$14.1 billion of net inflows of portfolio investments, and US$24.5 billion of net outflows of other investments.

As of end-September 2010, the stock of China's external debt stood at US$546.45 billion (excluding the external debt of Hong Kong, Macao, and Taiwan, the same applies below), up 31.7 percent from the end of 2009. Among this total, short-term external debt (remaining maturities) posted US$369.44 billion, accounting for 67.6 percent of the stock of external debt. With respect to the structure of the short-term external debt, as of end-September (remaining maturities) trade credit and trade financing (such as credit support provided by banks for exporters and importers) accounted for 59.5 percent and 18.7 percent respectively, totaling 78.2 percent. This can be attributed to the rapid development of external trade in recent years.

6. Sectoral analysis

Industrial profits grew rapidly but at a decelerated pace. In the first eleven months, statistically large industrial enterprises registered total profits of 3,882.8 billion yuan, up 49.4 percent year on year, representing an acceleration of 41.6 percentage points from the corresponding period of the last year but a deceleration of 5.7 percentage points from the first eight months of the year. Among all 39 industrial sectors, 38 sectors reported year-on-year growth in profits, but the petroleum processing industry and the coking and nuclear fuel processing industry experienced a profit reduction. In 2010, 38 out of the 39 industrial sectors realized a year-on-year increase in added value, and the supply and demand of coal, power, and oil was generally balanced. In the first eleven months of the year, coal output increased 15.5 percent year on year to 3.04 billion tons, and 28.91 billion tons of freight volume was handled, up 14.8 percent year on year. In 2010, power generation increased 13.3 percent to 4141.3 million megawatts per hour, and the output of crude oil grew 6.9 percent to 203.01 million tons.

(1) The real estate sector

In 2010, after the release of the *State Council Notice on Resolutely Containing the Excessive Real Estate Price Hikes in Certain Cities* (State Council Document No. 10 [2010], hereinafter referred to as State Council Document No. 10) and implementation of a series of macroeconomic management policies targeting the real estate sector, the real estate sector started to pull back and stabilize, growth of sales of commercial housing declined, the increase in housing prices moderated, and the growth of housing loans issued by the major financial institutions slowed down.

Sales of commercial real estate decelerated. Growth of the sold floor area and sales value pulled back rapidly since end-2009, but since September 2010 has gone up. In 2010, the sold floor area of commercial real estate was up 10.1 percent year on year to 1.04 billion square meters, representing an acceleration of 1.9 percentage points from that in the first three quarters, but a deceleration of 32 percentage points from 2009. In 2010, sales of commercial real estate was up 18.3 percent year on year to RMB5.3 trillion, representing an acceleration of 2.4 percentage points from the first three quarters but a deceleration of 57.2 percentage points from 2009. In particular, the sold floor area and the sales value of commercial residential housing accounted for 89.2 percent and 83.8 percent of the sold floor area and the sales value of commercial housing respectively, and the sold floor area and the sales value of offices and real estate for commercial use both grew faster than that of commercial housing.

The surge in real estate prices moderated. Housing prices grew rapidly in early 2010, but growth slowed down after the release of State Council Document No. 10. In December, housing prices in 70 large and medium-sized cities were up 6.4 percent year on year, representing a deceleration of 6.4 percentage points from April when the price hike was its highest, or up 0.3 percent month on month, representing a deceleration of 1.1 percentage points from April. In particular, the price of newly built homes was up 7.6 percent year on year, and 0.3 percent month on month, whereas the price of pre-owned homes was up 5.0 percent year on year and 0.5 percent month on month.

Investment in real estate development continued to grow rapidly. In 2010, investment in real estate development totaled 4.8 trillion yuan, up 33.2 percent year on year, representing a deceleration of 3.2 percentage points from the first three quarters but an acceleration of 17.1 percentage points from 2009. In 2010, the floor area of newly built housing increased by 40.7 percent year on year to 1.638 billion square meters, representing a deceleration of 22.4 percentage points from the first three quarters but an acceleration of 28.2 percentage points from 2009. Land purchases by real estate development companies were up 28.4 percent year on year to 410 million square meters, compared to -18.9 percent in 2009.

The expansion of real estate loans decelerated. With the changes in the real estate market, beginning in May the growth of outstanding real estate loans moderated. As of end-2010, the outstanding real estate loans of the major financial institutions reached 9.35 trillion yuan, up 27.5 percent year on year and a deceleration of 5.3 and 10.6 percentage points from end-September 2010 and end-2009 respectively. In particular, outstanding land development loans were up 24.7 percent year on year to 832.58 billion yuan, representing a deceleration of 11.3 and 79.5 percentage points from end-September and end-2009 respectively; outstanding housing development loans were up 23.0 percent year on year to 2.3 trillion yuan, representing an acceleration of 1.5 and 7.2 percentage points from end-September and end-2009 respectively; outstanding mortgage loans posted year-on-year growth of 29.7 percent to 6.2 trillion yuan, representing a deceleration of 7.6 and 12.8 percentage points from end-September and end-2009 respectively. At end-2010, outstanding real estate loans accounted for 20.5 percent of total outstanding loans. New real estate loans posted 2.0 trillion yuan in 2010, a year-on-year increase of 17 billion yuan. On a monthly basis, year-on-year growth of new real estate loans accelerated in the first five months, but decelerated in the remaining seven months. In December, new real estate loans registered 74.6 billion yuan, a reduction of 114.8 billion yuan from the corresponding month in 2009.

In order to contain the excessive housing price hike in some cities, in accordance with the *Notice on Promoting the Stable and Healthy Development of the Real Estate Market* and State Council Document No. 10 issued by the General Office of the State Council in January and April respectively, in September the Ministry of Land Resources, the Ministry of Housing and Urban-Rural Development, the Ministry of Finance, and the PBC adopted relevant measures to regulate the real estate market. In particular, on September 29, the PBC and the China Banking Regulatory Commission released the *Notice on Matters Related to Improving the Differentiated Mortgage Credit Policy* (PBC Document No. 275 [2010]), specifying the requirements for the downpayment ratios for the purchase of housing, lending interest rates, and so forth. The tightening measures have had an impact on the performance of the real estate market. The Central Economic Work Conference, which convened from December 10 to December 12, pointed out that “[efforts will be made] to promote the creation of a subsidized housing system, to make the government more accountable for this issue, to mobilize the resources of society, so as to construct more government-subsidized housing, speed up the renovation of shanty houses and dilapidated rural housing, develop public rental housing, ease people’s housing difficulties, and create a government-subsidized housing system and a commercial housing system in line with China’s situation," for the purpose of improving the welfare of the people.

(2) The transportation sector

The transportation sector, as an important service sector closely related to the economy and people's life, is a sector that plays a fundamental and leading role in the national economy. During the financial crisis, in efforts to carry out the package of measures announced by the central government to deal with the international financial crisis and to stimulate economic growth, the transportation and communication sector made rapid progress in infrastructure building. To some extent, the fastt development of the transportation sector has helped ease the transportation bottlenecks.

Investments in the transportation sector grew rapidly and a comprehensive transportation network began to take shape. In 2010, fixed-asset investments in transportation, warehousing, and postal services registered year-on-year growth of 19.5 percent to 2,782 billion yuan; fixed-asset investments in railways, roads, urban public transportation, waterways, and civil aviation grew by 12.5 percent, 20.9 percent, 16.1 percent, 24.4 percent, and 46.3 percent respectively year on year. As of end-2010, the total mileage of roads nationwide reached 3.984 million kilometers, including 74,000 kilometers of highways, which represents an increase of 33,000 kilometers. The total mileage of operational railways was 90,000 kilometers, and the speed of passenger trains reached an advanced international level. Specialized transportation systems for coal, oil, minerals, containers, and grain were basically established at seaports. The infrastructure for civil aviation gradually improved and a modestly sized and multi-functional airport system took initial shape.

Transportation capacity has been strengthened, but structural problems still exist. As of end-November 2010, passenger traffic by major means of transportation, passenger turnover, freight volume, and freight turnover posted 2.71 billion passengers, 217.65 billion passenger-km, 2.78 billion tons, and 1195.45 billion ton-km respectively, representing average annual growth of 12.7 percent, 9.2 percent, 11.0 percent, and 11.1 percent respectively between 2005 and 2009, topping the world in terms of passenger traffic, freight volume, converted turnover, and transportation intensity. However, the transportation sector still faces the structural problems of a large gap among regions and between urban and rural areas, insufficient inter-city capacity, traffic congestion in some areas, and unsatisfactory services and low intra-city capacity. Effective connections and integrated coordination among railways, roads, waterways, and air transport need to be improved further.

To address the problems existing in the development of the transportation industry, at the current stage and going forward, building on the efforts of maintaining an appropriate size and pace of infrastructure construction, we should ensure the completion of key projects under construction and follow-up projects designated by the government to expand domestic demand and efficient use of such projects, expedite structural adjustments, and advance equal access by all to basic public services.

Part 5 Monetary Policy Stance for the Next Period

Ⅰ. Outlook for the Chinese economy

The Chinese economy is developing in the direction intended by the macroeconomic management policies. The momentum of steady and fairly rapid economic growth has been further strengthened. In terms of the international environment, with the turmoil of the international financial crisis gradually easing, the recovery and growth of the world economy is likely to continue. In 2010, the contribution of external demand to China's GDP growth again became positive, in contrast to the negative contribution of net exports by four percentage points in 2009. The Chinese economy is expected to have a relatively stable environment for external demand in 2011. Many favorable domestic factors are available to support relatively stable and rapid growth. In the first year of the 12th Five-Year Plan period, local governments have strong investment incentives; the effects of various policies and measures adopted for the rejuvenation of the strategic and emerging industries, welfare housing development, shanty area redevelopment, and boosting private investment are unfolding; the vast domestic market, ongoing consumption upgrading and urbanization, stronger measures to reform income distribution, transformation of the growth pattern and the economic restructuring are all expected to play a role in sustaining economic growth. In 2010, planned investment for new urban projects totaled 19.1 trillion yuan, up by a fairly large margin of 25.6 percent. According to the business survey, banker survey, and urban depositors' survey conducted by the PBC in Q4, the major indices have remained stable and fairly high. The household income sentiment index .was flat with the level in the previous quarter; the employment sentiment index went down modestly; the market demand index and the domestic order index were up 0.4 percentage points and 0.1 percentage points from the previous quarter; and the export orders index slid a bit.

However, it is worth noting that uncertain and unstable factors remain plentiful in the world economy. Due to a lack of apparent new growth points, the need to constrain fiscal borrowing and the deleveraging of the corporate and household sectors, the global recovery is likely to be difficult and protracted. At home, given the growing pressures of economic restructuring, stronger resource and environment constraints, and the arduous task of improving people's livelihood, it is necessary to make greater efforts to achieve balanced and sustainable growth driven by endogenous factors.

The upward price pressures should not be neglected. Since the outbreak of the international financial crisis, global monetary conditions have been fairly loose. The expectation of the major economies to maintain a monetary easing to stimulate the economy remains strong. The emerging economies with strong growth performance are experiencing massive capital inflows. Against the backdrop of abundant liquidity supply and with growth stabilizing and pointing upward, sustained inflationary expectations are likely to emerge and the excess funds will inevitably look for various kinds of investment opportunities. Meanwhile, due to the Balassa-Samuelson effect and the moderated growth of the working-age population in China, labor costs are expected to rise. The prices of agricultural products and services, with a large labor cost content, face upward pressures. The reform of resource products is imminent. Structural factors combined with inflation expectations will heighten inflationary pressures. According to the PBC's Q4 urban depositor survey, the household price sentiment index hit an unprecedented low since Q4 1999, and the future price expectation index went up by 8.5 percentage points to 81.7 percent. The share of respondents expecting higher prices in the next quarter was up 15.2 percentage points quarter on quarter, and the share of respondents expecting higher housing prices in the next quarter was up again from the previous quarter by 6.8 percentage points.

Ⅱ. Monetary policy during the next stage

Going forward, the PBC will implement the decisions adopted at the 5th Plenum of the 17th CPC Central Committee and the Central Economic Work Conference, follow the theme of sustainable development and transforming the economic growth pattern, implement the prudent monetary policy, make policy measures well-targeted, more flexible, and effective in line with the general principle of a prudent stance featuring proper measures for macroeconomic management and supporting structural optimization, striking a balance between maintaining stable and relatively fast economic growth, adjusting the economic structure and managing inflation expectations, giving greater priority to maintaining the stability of the overall price level, preserving the sound and safe performance of the financial system, and contributing to stable and healthy economic development. As the weight of direct financing increases continuously, the share of bank lending in all-system financing aggregate will gradually decline. In the package of policies for macroeconomic management, it is necessary to attach more importance to the role of aggregate money supply in guiding expectations and to give more consideration to measuring the support of the financial sector to the real economy from the perspective of all-system financing aggregate. Furthermore, it is necessary to keep all-system financing aggregate at a proper volume, strengthen the role of the market in resource allocations, and further build endogenous drivers for economic growth. In 2011, the preliminary projection for the growth of broad money M2 is about 16 percent.

Box 4: A Proper Understanding of the Prudent Monetary Policy

The Central Economic Work Conference decided to adopt a prudent monetary policy in 2011, signaling a significant change in the stance of macroeconomic policy. The previous round of prudent monetary policy was adopted in 1998 in response to the Asian financial crisis and the deflationary trend at home, an easing from the previous relatively tight monetary policy. The prudent stance continued until 2007 and included a period of preventing deflation and a period of preventing inflation. In other words, it aimed to keep a proper growth rate of money supply under the precondition of preventing financial risks to support the stable and healthy development of the economy. The two periods during this decade of prudent monetary policy include the period of preventing deflation from 1998 to 2002 and the period of preventing inflation from 2003 to 2007. The flexibility of the prudent monetary policy helps to properly handle the relationship among stable growth, economic restructuring, and preventing inflation.

In 2011, the monetary policy moved from a relatively easy stance to a prudent stance, and this is the right choice given the domestic and international environment. The serious turmoil caused by the international financial crisis has eased. Though recovery in the advanced economies is slow and not stable, the external demand situation on the whole has improved. The momentum for economic growth in China has become more solid. It is feasible to support the stable and fairly rapid growth with a prudent monetary policy. Returning monetary policy to a normal stance will help manage inflation expectations and prevent asset bubbles. With the rich supply of liquidity both at home and abroad, inflation expectations and pressures are both strong. It is necessary to move to a prudent monetary policy so as to control the monetary conditions for a potential excessive price hike, and to place a higher priority on stabilizing the general price level and on the determination to fight inflation. A timely return of monetary policy to a prudent stance will facilitate the transformation of the economic growth pattern and economic restructuring, help the banking sector adjust the credit structure, implement the differentiated credit policy, guide investment and consumption behavior, and provide a stable and proper monetary environment for economic restructuring and for increasing the efficiency of resource allocation. Furthermore, a prudent monetary policy will help prevent systemic financial risks, guide financial institutions to strengthen efforts in adjusting their asset size and structure, properly manage the pace, destinations, and intensity of credit extensions, and control risky assets, for the purpose of preventing a further build-up of risks in the banking system, promoting sound operations of financial institutions and improving their resilience to shocks and their ability to support economic growth in a sustainable way.

It is necessary to properly understand the content of the prudent monetary policy. First of all, it means good management of aggregate money supply. With the switch from a relatively easy to a prudent stance, growth of aggregate money supply measured by M2 will be lowered to the average as seen in the previous rounds of prudent monetary policy. Only after the aggregate money supply returns to normal can the government's objective of good management of the liquidity-supply valve be achieved. Second, the growth of all-system financing aggregate and aggregate lending should be properly managed. In recent years, the financial structure in China has diversified, financial markets have deepened and broadened, the share of direct financing has grown remarkably, and the off-balance-sheet business of commercial banks has become an alternative to the lending business. More attention should be given to all-system financing aggregate in measuring the support of the financial system to the real economy. Apart from local currency loans, all-system financing aggregate includes financing through bond issuances, share offerings, trust loans, and entrusted loans. In managing the size of all-system financing aggregate, the ultimate goal is to satisfy normal demand from stable and healthy economic growth. Bank loans, as an important component of all-system financing aggregate, should be consistent with the major objectives of social and economic development. In particular, it is necessary to give consideration to the objectives of economic growth and inflation management and to change from an extraordinary anti-crisis state to reasonable growth. Third, measures of credit structure optimization will continue to guide commercial banks to give more credit support to key strategic areas and weak links in the economy, strictly control lending to highly energy-consuming and heavily polluting sectors and those with excess capacity, so as to serve the overall drive for economic restructuring and to support sustainable economic growth. Fourth, effective measures will be taken to prevent systemic financial risks. Potential pro-cyclical risks that might build up from the abundant liquidity and credit supply when the growth rate is high should be monitored and prevented.

To implement the prudent monetary policy, the PBC will use price and quantity instruments such as interest rates, the reserve requirement ratio, and open market operations, further improve the monetary policy instruments, combine the aggregate adjustment in the management of money, credit, and liquidity with improving the macro-prudential regulatory policy as a response to the government’s requirement for building a counter-cyclical financial macro-prudential regulatory framework, and use the adjustment of the differentiated deposit reserve requirement ratio to support the role of conventional monetary policy instruments.

First, measures will be adopted to continue to strengthen liquidity management and to keep growth of money and credit at appropriate levels. In light of the changes in economic and financial conditions and in the flow of foreign exchange funds, a number of monetary policy instruments will be adopted and the mix and maturity structure of these instruments as well as the strength of operations will be properly arranged to strengthen liquidity management, to keep liquidity in the banking system at appropriate levels, to properly manage aggregate liquidity, and to maintain a reasonable growth of money and credit. Monitoring and adjustment of all-system financing aggregate will be strengthened to keep the size and pace of financing at appropriate levels. While making sure that the demand for capital is met to support economic growth, it is necessary to maintain favorable monetary conditions that help keep general price levels stable.

Second, the establishment of a macro-prudential policy framework will be promoted to supplement conventional monetary policy instruments. In accordance with the decision of the State Council to create a counter-cyclical financial macro-prudential regulatory framework, management and adjustment of aggregate money, credit, and liquidity will be combined with stronger measures of macro-prudential regulation, including changes in the differentiated deposit reserve requirement ratio. The adoption of this measure will be based on the extent to which the growth of bank lending has diverged from what is needed for the development of the economy and considerations of the systemic importance and soundness of different financial institutions, and will aim to guide and encourage financial institutions to perform soundly and to manage their lending. As a flexible mechanism providing positive incentives, this measure is expected to make macroeconomic management more targeted and effective, help improve liquidity management, promote the reasonable growth of money and credit, and strengthen the resilience of financial institutions against shocks.

Third, efforts will be made to guide financial institutions to manage the pace of lending and improve the credit structure in accordance with the differentiated-treatment credit policy. Also, it is necessary to guide financial institutions to increase support to strategic and emerging industries, energy-conserving and environmental protection industries, modern service sectors, and projects for independent innovation in science and technology, to strictly control lending to industries that consume excessive energy and heavily pollute, and industries with excess capacity, and to support the development of a low-carbon economy. More funds will be channeled to the rural areas, agricultural sector, farming households, and the SMEs, and financial services will be provided to support job creation, students in need, and poverty reduction. Consumer credit services will be developed to boost domestic demand. Financial support will be continued to support balanced development among the various regions of the country. The stock and growth of borrowing by local government financing platforms will be closely monitored to strengthen credit risk signaling. The differentiated mortgage credit policy will be implemented to promote the healthy development of real estate finance.

Fourth, the market-based interest rate reform and the RMB exchange rate regime will be advanced. The role of interest rate leveraging will be strengthened in the management of aggregate demand and inflation expectations. Efforts will continue to develop benchmark interest rates on the money market, improve the pricing capability of financial institutions, advance market-based interest rate reform in a well-sequenced manner through various measures such as selecting financial institutions with strong discipline, and gradually liberalize prices of alternative financial products according to the overall arrangements of the 12th Five-Year Plan. The PBC will, in accordance with the principle for reforming the RMB exchange rate regime in a self-initiated, controllable, and gradual manner, further improve the RMB exchange rate regime based on market supply and demand with reference to a basket of currencies, allow market demand and supply to play a fundamental role in the exchange rate regime, increase the flexibility of the RMB exchange rate, keep the exchange rate basically stable at an adaptive and equilibrium level, and promote the balance of the BOP account. The PBC will promote the development of the foreign exchange market and encourage innovation in tools for managing exchange-rate risks. It will steadily promote the use of RMB in cross-border trade and investment and expand channels for RMB to exit and return to China. Measures will be taken to stop the inflow of hot money through illegal channels, closely monitor cross-border flows of capital, and prevent risks. The reform of import and export verification practices in the management of foreign exchange will be accelerated to facilitate trade. The reform of the capital account will be advanced. Management of foreign exchange reserves will be improved to preserve and increase the value of foreign exchange reserve assets. The methods of foreign exchange administration will be reformed to make them more effective, including through the supervision of foreign exchange entities, the consolidation of data and systems, and off-site supervision.

Fifth, the PBC will continue to promote product innovation in financial markets and support the sound development of the market. The financial market will play a fundamental role in resource allocations. Direct financing will be expanded through product innovation so that the financial market will support the growth of the real economy. The institutional framework and infrastructure of the financial market will be improved. A large variety of foreign institutions will be allowed to issue bonds in the Chinese market, and the opening-up of the inter-bank bond market will be advanced actively and prudently.

Sixth, the reform of financial institutions will be deepened to establish a modern financial enterprise system and to improve the system of organization for financial services. The reform of large commercial banks will be deepened to improve the delivery and quality of financial services so that they will shoulder their social responsibilities. The reform of the Agricultural and Rural Business Division of the Agricultural Bank of China will be advanced to improve services for the agricultural sector, farmers, and the rural areas. Transformation of the China Development Bank into a commercial bank will be advanced by improving its corporate governance structure. Reform of the Import and Export Bank of China and the China Export and Credit Insurance Corporation will be accelerated.

In addition, it will be necessary to strengthen coordination among fiscal, industrial, and monetary policies, with a focus on promoting reform and economic restructuring, so as to enhance the endogenous growth dynamics in the economy. Continued efforts will be made to reform the fiscal and tax systems, to further relax restrictions on investments and financing, to improve the income distribution structure, to build a more dynamic private sector, and to increase the disposable income of households. The market mechanism will be improved as well so that the market fully plays a fundamental role in the allocation of resources.