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Monetary Policy Analysis Group of

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Executive Summary

Since the beginning of 2006, the national economy has maintained steady and rapid growth. Demand has been strong in terms of investment, consumption, and net exports. There was a bumper harvest of summer grain. Industrial structural adjustments have been promoted. The supporting roles of coal, electricity, and transportation have improved. Household and enterprise income and fiscal revenues have increased further, and the standard of living has improved. Prices have remained basically stable. In the first half of 2006, GDP grew by 10.9 percent and the consumer price index (CPI) increased by 1.3 percent on a year-on-year basis.

Under the guidance of the State Council and in line with the State Council's overall plan to improve and enhance macroeconomic management, the People's Bank of China (PBC) continued to follow a scientific development approach and implement a sound monetary policy by strengthening liquidity management of the banking system and coordinating policies for domestic and foreign currencies. It also made use of a variety of monetary policy instruments to curb the excessive growth of money and credit and to improve the credit structure. First, open market operations were conducted flexibly to intensify sterilization and reasonably arrange the combination of instruments and their maturity structures. Second, the role of the interest rate was strengthened in macroeconomic management and the benchmark interest rate on loans of financial institutions was raised. Third, the required reserve ratio was increased two times and commercial banks were prompted to make an orderly adjustment of their lending activities and to curb the excessive credit growth through a strengthening of liquidity management. Fourth, the exchange rate regime reform was steadily advanced. The PBC formally introduced swap transactions between the RMB and foreign currencies and established a RMB forward market pricing mechanism. Fifth, window guidance and credit policy guidance were further intensified to convey macroeconomic management intentions in a timely manner to financial institutions, to guide financial institutions to strengthen capital constraints, and to improve the credit structure; the mortgage policy of commercial banks was adjusted and the minimum downpayment ratio of mortgage loans was raised on a differentiated basis. Meanwhile, efforts were made to vigorously promote financial market development, steadily promote financial enterprise reform, and accelerate the reform of the foreign exchange management system.

In the first half of 2006, money supply increased fairly rapidly and credit aggregates rose by a large margin. However, the financial industry performed soundly. At end-June, broad money M2 stood at 32.3 trillion yuan, an increase of 18.4 percent over the same period of the previous year. Base money amounted to 6.3 trillion yuan, a year-on-year growth of 10.0 percent. Outstanding RMB loans grew by 15.2 percent year on year to 21.5 trillion yuan. Money market interest rates gradually picked up. At end-June, foreign exchange reserves reached US$941.1 billion, US$122.2 billion more than that recorded at the end of 2005.

In general, the national economy is expected to continue to grow at a steady and relatively rapid pace. However, serious attention should be paid to monitoring the risks associated with the excessive growth of fixed-asset investment, the oversupply of money and credit, imbalances in international payments, excessive energy consumption, increasing pressures on the environment, and the potential rise of inflationary pressures.

In the second half of 2006, the PBC will continue to apply a mix of monetary policy instruments to appropriately control money and credit growth and to prevent overheating from the rapid economic growth, according to the State Council's overall plan. Meanwhile, the PBC will take comprehensive measures aimed at the medium and long term, will speed up implementation of various policies such as boosting domestic demand, and will accelerate economic restructuring and promote a BOP equilibrium.

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Part 1 Monetary and Credit Performance

In the first half of 2006, the national economy continued to grow steadily and rapidly, with the financial industry performing in a sound manner. Money supply increased fairly rapidly and credit aggregates rose by a large margin.

I. Monetary aggregates grew at a relatively rapid pace

At end-June 2006, broad money M2 stood at 32.3 trillion yuan, an increase of 18.4 percent y-o-y, up 2.8 and 0.9 percentage points over the same period of the previous year and end-2005 respectively. Narrow money M1 reached 11.2 trillion yuan, an increase of 13.9 percent y-o-y, up 2.7 and 2.2 percentage points over growth in the same period of the previous year and end-2005 respectively. Cash in circulation M0 grew by 12.6 percent y-o-y to 2.3 trillion yuan. Net cash withdrawals in the first half of 2006 totaled 56.3 billion yuan, 5.7 billion yuan less than during the same period of the previous year. Since the beginning of 2006, broad money has remained at a high level, while narrow money growth has escalated, narrowing the growth discrepancy between M2 and M1. The acceleration of narrow money was caused by increased demands of enterprises for current deposits due to expansion of both industrial production and fixed-assets investment.

II. Deposits of financial institutions increased steadily

At end-June, outstanding deposits of all financial institutions (including foreign-funded financial institutions) denominated in both RMB and foreign currencies increased by 17.2 percent y-o-y to 33.1 trillion yuan, 3.3 trillion yuan more than at the beginning of the year, and an acceleration of 604.1 billion yuan compared with the same period of the previous year. In particular, RMB deposits rose by 18.4 percent y-o-y to 31.8 trillion yuan, a growth of 3.2 trillion yuan from the beginning of the year and an acceleration of 632.4 billion yuan from the previous year. Foreign currency deposits totaled US$161 billion, decreasing by 2.6 percent y-o-y but US$8.8 billion more than at the beginning of the year, a deceleration of US$1.7 billion.

Since 2006, the maturity structure of deposits has been marked by a rapid increase in the volume of current deposits and their share in total deposits, which, to a certain extent, reversed the trend in 2005 when time deposits became increasingly dominant. At end-June, the outstanding corporate RMB deposits increased by 15 percent y-o-y to 10.4 trillion yuan, representing growth of 805.2 billion yuan from the beginning of the year and an acceleration of 256.4 billion yuan over the previous year. In particular, corporate current deposits accelerated by 282 billion yuan from the previous year, while time deposits decelerated by 25.6 billion yuan over the same period of 2005. RMB savings deposits increased by 17.1 percent y-o-y to 15.5 trillion yuan, increasing by 1.4 trillion yuan over the beginning of the year, 116.9 billion yuan more than the growth recorded during the same period of the previous year. In particular, current deposits increased by 150.2 billion yuan more than the growth during the same period of the previous year, while time deposits decelerated by 33.3 billion yuan. At end-June, fiscal deposits increased by 23.1 percent y-o-y to 1.24 trillion yuan, representing an increase of 437.5 billion yuan over the beginning of the year and an acceleration of 55.8 billion yuan compared with the previous year.

III. Loans of financial institutions expanded rapidly

Outstanding loans of financial institutions (including foreign-funded financial institutions) in both RMB and foreign currencies amounted to 22.8 trillion yuan at end-June, representing a growth of 14.3 percent y-o-y, or an increase of 2.2 trillion yuan over the beginning of the year, an acceleration 606.81 billion yuan compared with one year earlier. Outstanding RMB loans grew by 15.2 percent y-o-y to 21.5 trillion yuan, an increase of 2.2 trillion yuan over the beginning of the year, an acceleration of 723.3 billion yuan. Outstanding foreign currency loans rose by 5.0 percent y-o-y to US$157.7 billion, representing an increase of US$7.5 billion over the beginning of the year and a deceleration of US$8.7 billion on a year-on-year basis.

The relatively fast growth of loans in the first half of 2006 was due to the following factors. First, demand for credit was buoyant owing to the rapid economic expansion and increasing investment projects. Second, imbalances in international payments continued to accumulate and the large amount of foreign exchange inflow increased liquidity, which provided capital conditions for commercial banks to expand their credit. Third, after recapitalization, commercial banks focused more on return of assets and shareholders’ dividends and had stronger incentives to seek larger profits through credit expansion.

In terms of loan destinations, short-term RMB loans and commercial paper financing for corporate working capital increased by 1.14 trillion yuan in the first half of 2006, an acceleration of 340.3 billion yuan compared with the previous year. Commercial paper financing increased by 342.1 billion yuan, an acceleration of 91.32 billion yuan. In particular, in the second quarter of 2006 commercial paper financing grew by 31.61

billion yuan. Long- and medium-term RMB loans grew by 1.02 trillion yuan compared with the previous year, an acceleration of 383.5 billion yuan, among which, capital construction loans accelerated by 155.37 billion yuan. In the first half of 2006, long- and medium-term RMB loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) increased by 937.21 billion yuan from the beginning of the year, accounting for 93.1 percent of the new long- and medium-term loans of all financial institutions. The real estate, transportation and communication, storage, and postal services, water conservancy, environmental and public facility management, manufacturing, electric power, gas, and water production, and supply industries were the main recipients of new long- and medium-term loans, with an increase of 656.2 billion yuan over the beginning of the year.

Broken down by institutions, the growth of RMB loans of all financial institutions (excluding policy banks) escalated compared with the same period of the previous year. RMB loans of the four state-owned commercial banks increased by 918.53 billion yuan, an acceleration of 408.25 billion yuan. RMB loans of joint-stock commercial banks, city commercial banks, and rural financial institutions (including rural cooperative banks, rural commercial banks, and rural credit cooperatives) increased by 491.8 billion yuan, 164.1 billion yuan, and 350.4 billion yuan respectively, representing an acceleration of 172.4 billion yuan, 74.5 billion yuan, and 58.7 billion yuan respectively. RMB loans of policy banks increased by 144.4 billion yuan, representing a deceleration of 27.4 billion yuan.

IV. Base money grew at a stable pace

At end-June, the outstanding balance of base money stood at 6.3 trillion yuan, representing an increase of 10.0 percent y-o-y but 124.7 billion yuan less than that at the beginning of the year and 24.63 billion yuan less than the decrease in the previous year. The excess reserve ratio of financial institutions averaged 3.1 percent at end-June, down 0.62 percentage points from the same period of 2005. In particular, the excess reserve ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 2.5 percent, 4.2 percent, and 5.7 percent respectively.

V. Lending rates of financial institutions rose slightly

The statistical report of the PBC on the floating interest rates of financial institutions in the second quarter showed that, among the lending of all financial institutions in the second quarter, the proportion of loans with interest rates floating below the benchmark rate increased by 1.71 percentage points from the first quarter, while the proportion of loans with interest rates at or above the benchmark rate declined by 1.66 and 0.04 percentage points respectively over the first quarter.

Table 1: Share of Loans with Rates Floating against the Benchmark in Various Ranges during the Second Quarter of 2006

Unit: %

	Sum	Floating Downward	Benchmark	Floating Upward				
		[0.9，1.0]	1	Sum	（1.0，1.3]	（1.3，1.5]	（1.5,2]	above 2
Sum	100	24.67	26.53	48.8	30.11	6.45	9.88	2.36
State-owned commercial banks	100	29.56	31.03	39.41	36.32	2.56	0.52	0.01
Joint-stock commercial banks	100	34.83	30.47	34.7	33.86	0.77	0.03	0.04
Regional commercial banks	100	23.04	18.64	58.32	42.15	10.29	5.16	0.73
Urban and rural credit cooperatives	100	1.98	5.25	92.77	17.4	20.73	43.81	10.83
Policy banks	100	32.32	66.69	0.99	0.99	0	0	0

Note: The floating interest range for urban and rural credit cooperatives is (2，2.3].

Source: Reports of lending rates of commercial banks.

Affected by the rise in the benchmark lending rate, the lending rates of commercial banks increased slightly. In the second quarter, the weighted average interest rate of one-year RMB loans of commercial banks was 6.05 percent, which was 1.03 times the benchmark rate, up 0.2 percentage points from the previous quarter. In particular, the weighted average interest rate of fixed-interest-rate loans, which accounted for 85.16 percent of the total loans, stood at 6.05 percent, up 0.2 percentage points from the previous quarter, and the weighted average interest rate of floating-interest-rate loans, accounting for 14.84 percent of the total loans, was 6.01 percent, up 0.2 percentage points from the previous quarter.

In the first half of 2006, the interest rate of negotiable RMB deposits (above 30 million yuan in one deposit) increased slightly. In particular, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 3.64 percent in the second quarter, down 0.07 percentage points from the previous quarter but up 0.39 percentage points from the beginning of the year; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 3.73 percent, up 0.27 and 0.66 percentage points from the previous quarter and the beginning of 2006 respectively.

Affected by the continuous interest-rate hikes by the Federal Reserve and higher rates in the international financial market, the domestic interest rates on foreign currency loans and large-value foreign currency deposits moved up further. In June 2006, the weighted average interest rate of large-value US dollar deposits with a maturity of up to 3 months (accounting for 73 percent of all large-value US dollar deposits of financial institutions) was 4.39 percent, an increase of 1.11 percentage points from the beginning of the year. The weighted average rate of one-year US dollar fixed-rate loans was 6.35 percent and the weighted average rate of US dollar floating rate loans was 6.23 percent, up 0.9 and 0.71 percentage points respectively from the beginning of the year.

Table 2: Average Interest Rates of Large-value US$ Deposits and US$ Loans in the First Half of 2006

Unit: %

	Jan.	Feb.	Mar.	Apr.	May	Jun.
I. Large-value Deposits:						
Within 3 months	2.9947	3.6879	3.4049	4.0769	4.2816	4.391
3-6 months	4.6609	4.5713	4.7528	4.8992	4.9897	4.9406
6-12 months	4.5001	4.7217	3.6802	4.9552	4.9579	5.3003
1 year	4.2042	4.587	4.6506	4.7946	4.7055	5.3986
II. Loans:						
1 year (fixed)	5.1379	5.6163	5.5822	6.0507	5.8239	6.345
1 year(monthly floating)	5.5766	5.5904	5.6562	5.9982	6.0307	6.2311

Source: Reports of foreign currency interest rates of commercial banks.

VI. The elasticity of the RMB exchange rate was further strengthened

In the first half of 2006, the elasticity of the RMB exchange rate was further strengthened. The linkage of the RMB exchange rate with other major currencies was clear, and the fundamental role of market supply and demand was further enhanced. Due to China's trade surplus and the trends of the major currencies in the international market, the central parity of the RMB against the US dollar fluctuated around 8 yuan per US dollar in May and June. On June 30, the central parity of the RMB against the US dollar was 7.9956 yuan per US dollar, accumulatively appreciating by 0.94 percent in the first half of 2006. Due to the large appreciation of the euro and the Japanese yen against the dollar in the international market, the RMB exchange rate depreciated by 1.16 percent against the euro and the appreciation of the RMB exchange rate against the Japanese yen was narrowed to 5.17 percent. In the first half of 2006, the peak and bottom central parity of the RMB against the US dollar were 7.9956 yuan per US dollar and 8.0705 yuan per US dollar respectively. In a total of 118 trading days, the RMB saw an appreciation in 66 days and a depreciation in 52 days. The largest fluctuation in a single business day was 0.21 percent. The average daily volatility of the RMB exchange rate was 35 basis points, larger than the average daily volatility of 17 basis points in the post-reform period in 2005, indicating the increased flexibility of the RMB exchange rate. At end-June, the quotation of one-year forward contracts in the inter-bank RMB forward market was around 7.74 yuan, the discount being 2500 basis points and basically stable around the interest rate parity level.

Part 2 Monetary Policy Conduct

The PBC continued to follow a scientific development approach and implement a sound monetary policy by strengthening liquidity management of the banking system and coordinating policies for domestic and foreign currencies in line with the State Council's overall plan to improve and enhance macroeconomic management. It also extensively promoted financial reform and made use of a variety of monetary policy instruments to curb excessive growth of money and credit and to improve the credit structure.

I. Flexible Open Market Operations

In the first six months of 2006, the PBC closely monitored developments in the international financial market and the domestic monetary and credit situation. Given the generally loose liquidity in the banking system, the PBC further strengthened liquidity management and forecasting, intensified sterilization through open market operations, and reasonably arranged a combination of instruments and their maturity structures. In the run-up to the Spring Festival, the PBC mainly used 1-year central bank bills and short-term reverse repo to conduct open market operations. As a result, operations not only maintained the intensity of central bank bill issuances, but also played a role in meeting the liquidity needs of commercial banks in the run-up to the Spring Festival. After the Spring Festival, the PBC strengthened the issuance of 1-year central bank bills, resumed the issuance of 3-month central bank bills, and conducted short-term repo operations on a discrete basis, leading to appropriate control of base money growth. Since May 2006, given the relatively rapid growth of credit, the PBC, in addition to market-based issuances of central bank bills, issued central bank bills targeting those institutions that experienced an excessively rapid growth of credit and lax liquidity. The targeted issuances played a good signaling role.

In the first six months of 2006, the PBC withdrew base money in the amount of 574.8 billion yuan on a net basis. Forty-five central bank bill issuances were made, totaling 2.223 trillion yuan, among which the issuance of 3-month bills totaled 748 billion yuan, that of 6-month bills totaled 85 billion yuan, and that of 1-year bills totaled 1.39 trillion yuan (including bills of 200 billion yuan of the targeted issuances). At the end of June, the outstanding amount of central bank bills stood at 2.91 trillion yuan.

II. The role of interest rates in macroeconomic management

The PBC decided to raise the benchmark interest rate on loans of financial institutions as of April 28, 2006.The benchmark rate on one-year loans was adjusted upward by 0.27 percentage points from 5.58 percent to 5.85 percent, with rates on loans of other maturities raised accordingly.

Higher benchmark lending rates are conducive to curbing excessive investment, better aligning investment and consumption, and facilitating the appropriate pricing of assets. They also help optimize the economic structure and promote adjustments in economic growth patterns. Moreover, a rise in lending rates can strengthen the capacity of the financial system to prevent risks and ensure sustainable, rapid, balanced, and sound development of the economy.

III. Two increases in the required reserve ratio

With the approval of the State Council, the PBC announced two increases in the required reserve ratio by 0.5 percentage points on June 16 and July 21, which took effect on July 5 and August 15 respectively. The two required reserve ratio hikes totaling 1 percentage point froze about 300 billion yuan of the banking system liquidity. To ensure credit input and to improve financial services for the rural areas and farmers, the required reserve ratio for rural credit cooperatives tentatively remained unchanged at 6 percent. Given the sufficient liquidity, the increase in the required reserve ratio by a small margin is a fine-tuning measure that helps prompt commercial banks to make an orderly adjustment of their lending activities and to curb the excessive credit growth.

Box 1: Required Reserve Ratio: One of the Three Major Monetary Policy Instruments

As one of three traditional monetary policy instruments, the required reserve ratio refers to the ratio set by the central bank at which commercial banks are required to hold, on a mandatory basis, the deposits they receive. The initial function of the required reserve ratio was to make sure that commercial banks had sufficient liquidity to deal with unexpected payment requirements. However, the required reserve ratio has become an institutional arrangement or instrument for the central bank to manage banking system liquidity.

Today, major central banks implement monetary policy through adjusting liquidity in the banking system by means of monetary policy instruments. As economic aggregates continue to rise, commercial banks need more liquidity to meet the needs of business expansion and payment and settlement requirements. In general, if liquidity is not revamped, there will be a gap in the commercial banks' liquidity. The reserve requirement will thus create a systemic shortage of liquidity. Since the central bank monopolizes the issuance of currency, it serves as the ultimate supplier of liquidity for the entire banking system. Hence, the central bank is capable of influencing the price of capital (i.e., interest rates) and consequently overall economic and financial performance by controlling the aggregate liquidity supply. According to its forecast of liquidity changes, the central bank can marginally fine-tune the issuance of base money through open market operations so that the level of banking liquidity is kept in line with the short-term interest-rate target. The reserve requirement can help the central bank better forecast liquidity.

When liquidity is tight, it is correct to say that raising the required reserve ratio is a "heavy dose of medicine." Under such circumstances, commercial banks always keep their excess reserve at a minimum level. Once the required reserve ratio is raised, commercial banks will have to meet the requirement within a short period of time by cutting off lending and reducing bond-holding, which will push up market interest rates. Thereafter, market expectations will experience significant changes. Given the strong effect of raising the required reserve ratio, major central banks throughout the world usually do not refer to raising the required reserve ratio as a conventional monetary policy instrument.

However, the liquidity environment in China in recent years has been very different from that elsewhere. There is no liquidity gap. On the contrary, excess liquidity has been persistent and building up. The main reason for this is the serious imbalance in the BOP. The central bank had to issue a large amount of base money to the banking system to purchase foreign exchange. In order to control the excessive growth of money and credit, a major challenge in implementing monetary policy is to effectively sterilize the excess liquidity in the banking system.

Currently, the domestic financial market has undergone significant development and commercial banks hold a large amount of bonds and policy financial bonds which are highly liquid. As a result, liquidity withdrawals through open market operations work only at a "shallow" level. Moreover, the volume and progress of the open market operations also depend on the willingness of the commercial banks to purchase central bank bills. Hence, the capacity of the central bank to actively and effectively conduct open market operations may be constrained. In contrast, the reserve requirement has the capacity to "deeply" freeze liquidity. When the central bank passively issues base money, the reserve requirement can be used as a sterilization instrument. Raising the required reserve ratio can "deeply" freeze part of the liquidity, thus easing pressures on the central bank to issue bills and enhancing the capacity of the central bank to guide the interest rate and credit through open market operations.

Therefore, increasing the required reserve ratio by a small margin is not a "heavy dose of medicine" when there is abundant liquidity. The two recent adjustments in the required reserve ratio were characterized by: 1) sufficient liquidity in the banking system; 2) a small margin of adjustment in the required reserve ratio; 3) a period after the announcement, thus leaving the financial institutions with a sufficient amount of time to adjust positions; 4) coordination with the issuance of central bank bills aimed at maintaining the orientation of a sound monetary policy. Since the authorities announced an increase in the required reserve ratio, the financial market has been performing smoothly, with a slight increase in inter-bank market interest rates and a small decline in bond prices. Stock market transactions have remained active, with the Shanghai Stock Market Composite Index rising for 11 consecutive trading days after June 14.

The PBC has used central bank bills and the reserve requirement ratio as two sterilization instruments to manage banking liquidity. These operations are necessary so as to positively and effectively implement monetary policy. The use of these two instruments helps maintain the basic stability of money market interest rates and market expectations. It is also useful for the central bank to actively and promptly adjust its policy stance so that an appropriate monetary policy environment is maintained for the rapid and sound development of the national economy.

IV. Adjustment of the mortgage policy of commercial banks

According to the *Guidelines on Adjusting the Housing Supply Structure and Stabilizing Housing Prices* issued jointly by nine ministries including the Ministry of Construction on May 24, on May 31 the PBC released the *Notice on Adjusting the Mortgage Policy*, stipulating that as of June 1, 2006, the downpayment ratio for mortgage loans (except provident fund loans) by commercial banks (including rural cooperative banks and rural and urban credit cooperatives) shall be no less than 30 percent. Nevertheless, those who purchase apartments of less that 90 square meters in construction area for their own use remain subject to a minimum downpayment ratio of 20 percent. The policy of raising the minimum downpayment ratio for mortgage loans on a differentiated basis will help contain excessive demand in the housing market and relieve pressures of price hikes. Meanwhile, it will serve to adjust the supply structure in the housing market so that demand by middle- and low-income households will be better met.

V. Intensified window guidance and credit policy guidance

Since April, the PBC further strengthened window guidance and credit policy guidance in light of the macroeconomic development and the objective of harmonious economic and social development. First, the PBC convened three window guidance meetings, requiring commercial banks to be on the alert to the risks associated with an excessive growth of loans, to enhance risk control capacity, to avoid blind credit expansion driven by excessive profit seeking, and to control credit aggregates. Second, the PBC guided financial institutions to strengthen capital constraints, establish a philosophy of sustained and sound operations, implement the requirements of the macro adjustment policy and the industrial policy of the state, enhance adjustments of the credit structure, strictly control lending to industries with excessive investment in line with the government's macro management and industrial policies, tighten control on mortgage loans, and stop issuing package loans and credit lines to local governments. Third, the PBC played a further role in credit policy guidance by encouraging financial institutions to improve financial services and strengthen credit supply in support of rural areas, farmers, job creation, education, rural workers, and the non-public economy.

VI. Steady progress in financial enterprise reform

The joint-stock reform of state-owned commercial banks continued to advance smoothly. The IPO of the Bank of China was a success, with its H-share listed on the Hong Kong Stock Exchange on June 1, 2006 and its A-share on the Shanghai Stock Exchange on July 5, 2006. The Bank of China issued 29.4 billion H-shares at HK$2.95 per share, raising HK$86.7 billion (equivalent to about US$11.2 billion). It also issued 6.494 billion A-shares at 3.08 yuan per share, raising around 20 billion yuan. The initial prices of the A-shares and H-shares were basically equal, providing good investment opportunities for domestic investors and significantly increasing the stability and investment value of the A-share market. The Industrial and Commercial Bank of China continued to deepen joint-stock reform and actively prepared for a public listing. In addition, relevant government agencies are working actively on the joint-stock reform plan of the Agricultural Bank of China, taking into account the overall program of establishing a socialist new countryside and rural financial system reform.

Important progress has been made in the pilot reform of the rural credit cooperatives. First, their historical burdens have been primarily dissolved, leading to significant improvement in their asset quality. By the end of June 2006, the PBC, together with the China Banking Regulatory Commission (CBRC), had made ten issuances of special central bank bills aimed at supporting a pilot reform of the rural credit cooperatives (one issuance in each quarter). These bills totaled 165.2 billion yuan, which were issued to 2,388 counties (and cities). The PBC also provided lending of 260 million yuan to support the reform in Jilin and Shaanxi provinces. The combined amount of special central bank bills and lending accounted for 99 percent of the planned financial support. In the second quarter, the PBC, together with the CBRC, started the redemption of the special central bank bills, amounting to 980 million yuan, to rural credit cooperatives in 18 counties (and cities) in 6 provinces (and municipalities), including in Jiangsu where the reform was pioneered. According to data of the supervisory authorities, allowing for the factor of special bills, the NPL ratio of rural credit cooperatives nationwide stood at 12.6 percent at end-June, 24.3 percentage points lower than the figure at end-2002. The capital adequacy ratio rose to 7.7 percent, 12.3 percent, and 8.6 percent for rural credit cooperatives, rural cooperative banks, and rural commercial banks respectively. Second, the size of their assets continued to grow. The goal of supporting rural areas and farmers has been strengthened and credit input has been rising significantly. At the end of June, the outstanding amount of agricultural loans of rural credit cooperatives nationwide stood at 1224.1 billion yuan, with their share in the total loans of rural credit cooperatives rising from 40 percent in 2002 to 48 percent. The share of rural credit cooperatives in the agricultural loans of all financial institutions has risen from 81 percent in 2002 to 92 percent. Third, the reform of the property rights system has been advanced. Progress has been made in the transformation of the management mechanism. In light of the principle of differentiating treatment and different guidance on the basis of actual conditions, rural credit cooperatives experimented with establishing stock companies or stock cooperation companies, and established rural commercial banks, rural cooperative banks, and rural credit cooperatives with legal persons at the county level on a pilot basis. At end-May, a total of 80 rural commercial banks and rural cooperative banks had been set up, and 584 rural credit cooperatives with legal persons at the county level had been established. Some rural credit cooperatives actively probed ways of strengthening internal control, enhancing information disclosure, and improving corporate governance, leading to some good experiences and practices.

Box 2: Financial Support to the Pilot Reform of the Rural Credit Cooperatives

The reform of the rural credit cooperatives is an important part of the rural financial system reform that has a bearing on agricultural development, rural area stability, and farmers' production. In August 2003, the State Council convened a working conference on deepening the pilot reform of the rural credit cooperatives, indicating the beginning of a deeper reform of the rural credit cooperatives in 8 provinces (municipalities and autonomous regions) including Jilin. In August 2004, the State Council convened another meeting to expand the coverage of the reform of the rural credit cooperatives. So far, 29 provinces (municipalities and autonomous regions) have begun a pilot reform of rural credit cooperatives.

Since the commencement of the pilot reform of the rural credit cooperatives, the PBC, together with the CBRC, formulated and implemented a financial support policy for the pilot reform of the rural credit cooperatives under the leadership of the State Council. Two financial support programs were designed for selection by the rural credit cooperatives in the pilot reform areas. First, central bank bills can be issued to exchange non-performing loans and accumulated losses. Second, the PBC can entrust the China Development Bank to lend earmarked loans to the rural credit cooperatives to dissolve historical burdens whereby the provincial government is responsible for repayment. The issuance of central bank bills is conditioned on a rise in the capital adequacy ratio of the rural credit cooperatives and conversion of the bills conditioned on the improvements in internal control, corporate governance and services, with a view to rendering financial support by "buying good mechanisms" and providing positive incentives for the reform.

First, the conditions for financial support were clarified. In its document entitled *Plan for Deepening the Pilot Reform of the Rural Credit Cooperatives* (No. [2003]15), the State Council clearly indicated that the issuance of special central bank bills must be linked with progress in the rural credit cooperative reform, which is subject to assessment at the county level. The criteria are clear property rights, sufficient paid-in capital, and complete corporate governance. To encourage rural credit cooperatives to promote the pilot reform step by step, starting with the easier part, toward the criteria set by the State Council, the PBC formulated a "three-step strategy," requiring the rural credit cooperatives to make sequenced progress in such areas as internal control, information disclosure, and corporate governance before meeting the criteria set by the State Council. Meanwhile, a series of operational procedures were formulated to streamline and regulate practices in the issuance, redemption terms, and assessment procedures of the special central bank bills.

Second, the assessment mechanism was improved. The PBC established assessment committees at different levels, from the headquarters to the branches, operation offices, and sub-branches in provincial capitals and municipalities, to cast secret votes to assess the applications for special central bank bill redemption submitted by the rural credit cooperatives. This mechanism is helpful to increase the credibility and transparency of the assessment. The PBC and its branches, together with the CBRC and its branches, also aim to enhance the efficiency and quality of the assessment by conducting on-site assessments on the progress of the rural credit cooperatives reform at the county level. Redemption assessment evaluations and appeal mechanisms were also established to strengthen accountability associated with the assessment of special bill redemption. Meanwhile, efforts were made to support prompt redemption by qualified rural credit cooperatives.

Third, the quota for financial support was fine-tuned. To appropriately strengthen financial support for the rural credit cooperatives in old revolutionary bases, areas inhabited by minority ethnic groups, as well as remote and underdeveloped areas, the PBC, together with the CBRC, fine-tuned the financial support policy for the rural credit cooperatives undergoing the pilot reform. The three principles for fine-tuning are as follows: strengthening positive incentives; preferential treatment in terms of financial support for old revolutionary bases, regions inhabited by minority ethnic groups, and remote and underdeveloped areas; adopting a uniform nationwide calculation method. The fine-tuning targeted rural credit cooperatives with a small size of assets, few losses, and relatively sound management. The financial support quota was increased by 3.3 billion yuan for 616 counties (and cities) as a result of the fine-tuning. Geographically, 12 provinces (municipalities and autonomous regions) in western China accounted for 85 percent of the fine-tuned financial support and 82 percent in terms of the number of counties that benefited from the fine-tuning policy. The figures for poor counties (and cities) that receive poverty reduction relief from the central government budget were 44 percent and 43 percent respectively. The fine-tuning policy reflected the policy intentions to improve positive incentives and to benefit western China.

Fourth, the financial support policy was implemented consistently. At the national working conference on cooperative financial institution supervision and reform convened at the beginning of this year, the CBRC indicated that supervision of the rural credit cooperatives shall be subject to the same standards as that of commercial banks. In essence, a five-category loan classification standard shall be adopted across the board and the capital adequacy ratio shall be calculated using the method adopted by the commercial banks. The PBC actively supported the CBRC in assessing the authenticity of the rural credit cooperatives' loan classification and their capital adequacy ratio. Meanwhile, in order to ensure the consistency, continuity, and stability of the financial support, when the redemption of special bills was assessed, the PBC examined their capital adequacy ratios calculated on the basis of the existing financial support policy and their NPL ratios on the basis of a four-category loan classification.

In general, the financial support policy has been implemented smoothly. At the end of June 2006, the PBC provided financial support in the amount of 165.5 billion yuan to the rural credit cooperatives in the pilot reform program by means of issuing special bills and earmarked lending, accounting for 99 percent of the planned financial support. As the financial support policy is gradually implemented, it will contribute to relieving the historical burdens of the rural credit cooperatives, enhancing their asset quality, and improving their services and the sustainability of the economic development.

Thus far, the pilot reform of the rural credit cooperatives has made important progress, reaching a key stage of consolidating and reinforcing the progress by further enhancing corporate governance and comprehensively improving internal control and operational mechanisms. Together with the CBRC, the PBC will continue to implement the pilot financial support policy, provide continuous positive incentives for the rural credit cooperatives, promptly correct the practices of the declining rural credit cooperatives, encourage rural credit cooperatives to grasp opportunities, clarify property rights, improve corporate governance, transform operational mechanisms, and realize healthy and sustainable development.

VII. Continued and steady advance of the exchange rate regime reform

In the second quarter, the PBC launched a series of supporting measures according to the principle of a self-initiated, controllable, and gradual approach to further improve the exchange rate regime reform. First, the PBC formally introduced swap transactions between the RMB and foreign currencies. It not only increased the variety of foreign exchange market instruments, beefed up trading in the market, and allowed enterprises, residents, and financial institutions to better manage exchange risks, but it has also helped return forward prices to appropriate levels. Second, all foreign exchange designated banks adopted accrual accounting for the position of foreign exchange sales and purchase, which, together with the formal launch of swap transactions between the RMB and foreign currencies in April, formed a forward market pricing mechanism and enabled the domestic RMB forward market to play a dominant role in RMB forward exchange rate pricing. Third, the PBC deepened the reform of exchange management by substantially adjusting exchange management policies to facilitate trade and investment and to promote a general balance in the BOP.

Box 3: Improve the RMB Forward Market Pricing Mechanism

On the basis of the possibility of arbitrage,[1] the forward exchange rate pricing mechanism can be divided into two types: one based on expectations and the other based on interest rate parity. If arbitrage is possible, the forward exchange rate will converge to interest rate parity. If not, the forward rate can only be determined by expectations. As expectations are influenced more by non-market factors, the forward price thus formed is usually not as stable as that based on interest rate parity. Hence, the pricing mechanism based on interest rate parity is conducive to forming a stable forward exchange rate and thus conducive to enterprises, residents, and financial institutions hedging exchange rate risks with foreign exchange forward products, boosting active foreign exchange forward transactions, and promoting sound development of the foreign exchange spot market.

In April 1997, the Bank of China began conducting forward purchase and sale of foreign currencies on a pilot basis. In April 2004, the business of forward foreign exchange transactions was launched by the four state-owned commercial banks, and in late February 2005 by three joint-stock commercial banks, i.e., the Bank of Communications, the CITIC Bank, and the China Merchants Bank. At that time, the banks managed their positions in these transactions on a cash basis. That is, the forward transactions of clients conducted through the banks could not be squared on the spot market. Hence, arbitrage on interest rate parity was not possible. The pricing of the forward exchange rate was still based on expectations of the future RMB exchange rate. After the Asian financial crisis, the non-deliverable forward (NDF) on the RMB emerged in offshore markets. As the RMB was not convertible and arbitrage not possible in the offshore NDF market, the pricing mechanism could only be based on market expectations of the future development of the RMB exchange rate. Since it was possible for some institutions to conduct arbitrage between the NDF market and the domestic market, the NDF quotations had some influence on the prices of the forward purchase and sale of foreign exchange in the domestic market.

After the reform of the exchange rate regime on July 21, 2005, the PBC formally

[1] Arbitrage refers to the practice whereby investors invest in domestic and foreign money markets as well as foreign exchange spot and forward markets to secure risk-free profits. For instance, investors may borrow RMB from the domestic money market (at domestic interest rates), convert the borrowed money into foreign currency (at spot exchange rates), invest it in the overseas money market (at foreign interest rates), and hedge the exchange rate risk and sell the future foreign currency income in the forward market (at the forward exchange rate).

established an inter-bank RMB forward market on August 15, 2005. Given the short period of time since the start of the reform and the lessons of other emerging economies in developing a foreign exchange forward market, and following the principle of a self-initiated, controllable, and gradual approach, the PBC decided to temporarily keep the prevailing guidelines on managing the comprehensive positions of the foreign exchange designated banks and to continue cash basis management for foreign exchange purchase and sale positions. The forward position of banks could not be squared on the spot market. Market participants still mainly priced the RMB forward exchange rate on the basis of expectations of the future development of the RMB exchange rate. To a certain extent, the domestic forward exchange rate remained subject to the influence of the offshore NDF market. However, the forward market with different layers centralized demands of all market participants and provided market participants with the possibility of squaring forward transactions. Although interest rate parity could not be used by the forward market, the increasingly active inter-bank forward market fostered the capacity of market participants to quote forward rates. In pricing the forward rates, the domestic RMB forward market based on real demand gradually moved away from the influence of the overseas NDF market.

As the reform of the exchange rate regime advanced and the foreign exchange spot market developed smoothly, the PBC, when introducing market makers on January 4, 2006, adopted an accrual based management system for the foreign exchange purchases and sales positions of market makers to replace the prevailing cash based system. As a result, market makers were able to square forward positions on the spot market and a forward pricing mechanism based on interest rate parity was thus established. On June 2, 2006, the PBC further expanded the coverage of the accrual based position management to all foreign exchange designated banks. As a result, the foreign exchange spot market and the RMB forward market were completely linked. Combined with the launch of the inter-bank foreign exchange swap transactions on April 24, 2006, this led to the establishment of a RMB forward pricing mechanism based on interest rate parity. The transition from an expectations-based RMB forward pricing mechanism to an interest rate parity based mechanism has been realized, thus removing the influence of the overseas NDF market and starting to affect price movements in the NDF market. Presently, the overseas NDF discount is basically stabilized around the discount calculated on the basis of interest rate parity. The inter-bank RMB forward market has played a dominant role in the pricing of the RMB forward exchange rate.

The establishment of a RMB forward pricing mechanism based on interest rate parity is conducive to bringing the forward market price back to its appropriate level and to boosting the market, thus allowing domestic enterprises, households, and financial institutions to better manage exchange risks and to adapt to the new exchange rate regime, contributing to further reform of the RMB exchange rate regime. Moreover, given the establishment of the RMB forward market pricing mechanism based on interest rate parity, the spot exchange rate, forward exchange rate, domestic interest rate, and foreign exchange rate are inter-linked and this linkage among the markets will become stronger. An increasingly active RMB forward market is also helpful to promoting a market-based RMB interest-rate reform.

VIII. Reform of the foreign exchange management system reform at a faster pace

In the first six months of 2006, to serve the central task of promoting a balance in the BOP, the reform of exchange management was further deepened and management was strengthened to promote a balance in cross-border inflows and outflows. First, the authorities abolished the approval procedure for opening foreign exchange accounts under the current account, increased the retention limits on foreign exchange accounts of domestic institutions under the current account, and allowed enterprises that need to make import payments to purchase foreign exchange in advance. Second, the authorities further simplified the procedures for domestic individuals to purchase foreign exchange. In this regard, an annual quota limit is set and purchases above the quota limit will be allowed on the basis of bank examinations. Third, the authorities simplified procedures certifying foreign exchange purchases and payments for the services trade and raised the quota limit on banks to approve foreign exchange purchases and payments for the services trade. Fourth, qualified banks were allowed to raise RMB funds from domestic institutions and individuals, purchase foreign exchange within a certain quota limit, and invest in overseas fixed-income instruments. Fifth, qualified securities companies such as fund management companies were allowed to raise foreign exchange funds within a certain limit from domestic institutions and individuals and to invest in foreign securities. Sixth, qualified insurance companies were allowed to purchase foreign exchange and invest in fixed-income and money market instruments overseas.

Part 3 Financial Market Performance

The first half of 2006 witnessed overall sound financial market performance, featuring sufficient liquidity in the money market, smooth bond issuance, and brisk trading activities in the market. Financial market product innovation accelerated, and great progress was achieved in institution building and further improving operational mechanisms.

I. An overview of financial market performance

In the first half of 2006, the financing structure of domestic non-financial institutions (including the household, enterprise, and government sectors) changed remarkably. In particular, debt financing by enterprises, especially short-term financing bills, expanded rapidly, with the share of enterprise debt financing clearly rising; the stock market traded briskly, with the share of equity financing climbing modestly; and the share of government securities and bank loans declined. In the first half of the year, the share of bank loans, equities, government securities, and corporate bonds in the total financing of the non-financial sectors was 86.8, 5.6, 1.4, and 6.1 percent respectively.

Table 3: Financing by Domestic Non-financial Sectors in the First Half of 2006

	Volume of Financing (100 million yuan)		As a percentage of total financing (%)	
	First half of 2006	First half of 2005	First half of 2006	First half of 2005
Financing by domestic non-financial sectors	25629	18089	100	100
Bank loans	22251	15882	86.8	87.8
Equities	1442	908	5.6	5
Government securities	361	996	1.4	5.5
Corporate bonds	1575	303	6.1	1.7

Source: Financial Survey and Statistics Department, People's Bank of China.

1. Trading in the money market was brisk, and market interest rates gradually rebounded

In the first half of 2006, the turnover of bond repo in the inter-bank market climbed remarkably to 10.82 trillion yuan, 3.93 trillion yuan over that in 2005, and the daily average turnover registered a year-on-year growth of 57 percent to 88.7 billion yuan. In particular, the turnover of bond pledged repo transactions totaled 10.67 trillion yuan, a growth of 3.87 trillion yuan over that in 2005, and outright bond repo transactions totaled 147.9 billion yuan, an increase of 58.2 billion yuan from the same period of the previous year. In terms of the maturity structures of the bond pledged repo transactions, the market share of overnight products posted 46.8 percent, 6.6 percentage points higher than that of the 7-day products, reflecting an evident trend in the shortening maturity in fund use. In the first half of 2006, the accumulated turnover of government securities repo on organized exchanges was 0.57 trillion yuan, down 58.9 percent year on year.

In the first half of 2006, inter-bank borrowing totaled 707.5 billion yuan, up 70.2 billion yuan year on year, representing a daily average turnover of 5.8 billion yuan and an increase of 11 percent compared with that in 2005. The lion's share was concentrated in two types of short-term instruments, i.e., 7-day and overnight products, with the market share of overnight products increasing by 9.6 percentage points year on year, and that of 7-day products declining by 11.1 percentage points.

Money market interest rates gradually climbed. The monthly weighted average rate of bond pledged repo transactions and inter-bank borrowing registered 1.74 percent and 1.88 percent respectively in January, before experiencing a slight fall in February. Starting from late March, market interest rates rebounded gradually due to factors like stronger expectations of a market interest-rate hike, intensified open market operations, growing lending by financial institutions, and recovery of the financing function in the domestic equity market. In June, the monthly weighted average bond pledged repo rate and inter-bank borrowing rate moved up to 1.87 percent and 2.08 percent respectively, the highest points since the cut in the excess reserve rate in March 2005, representing a gain of 0.52 and 0.5 percentage points respectively compared with the lowest points in February, and up 0.77 and 0.62 percentage points year on year.

With respect to net fund flows in the repo market, state-owned commercial banks were still the largest net fund providers through both bond pledged and outright bond repo transactions, with net lending in the first half-year increasing 1.37 trillion yuan year on year to 5.29 trillion yuan. Net borrowing by other commercial banks[2] declined to some extent over the same period of the previous year, registering a year-on-year decrease of 327.3 billion yuan. Net borrowing by other financial institutions[3] and foreign financial institutions picked up, with a year-on-year increase of 1.40 trillion yuan and 0.30 trillion yuan respectively, suggesting an expanded fund demand. In the inter-bank borrowing market, other commercial banks were the largest net fund providers, with net lending in the first half-year increasing 9.4 billion yuan year on year to 215.8 billion yuan. Among net borrowers, the net borrowing by other financial

[2] Other commercial banks include joint-stock commercial banks and city commercial banks.
[3] Other financial institutions include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies.

institutions[4] dropped, largely due to an evident decline in net borrowing by securities companies. Net borrowing by foreign financial institutions accelerated.

Table 4: Fund Flows of Financial Institutions in the First Half of 2006

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	First half of 2006	First half of 2005	First half of 2006	First half of 2005
Four State-Owned Commercial Banks	-52917	-39225	-1307	-1789
Other Commercial Banks	15385	18658	-2158	-2064
Other Financial Institutions	32815	18812	2540	3195
Of which: Securities and Fund Management Companies	10811	4268	1540	2192
Insurance Companies	7706	3498	—	—
Foreign Financial Institutions	4717	1755	925	659

Note: A negative sign indicates a net fund outflow; a positive sign indicates a net fund inflow.

Source: China Financial Market Monthly Statistical Bulletin, People's Bank of China.

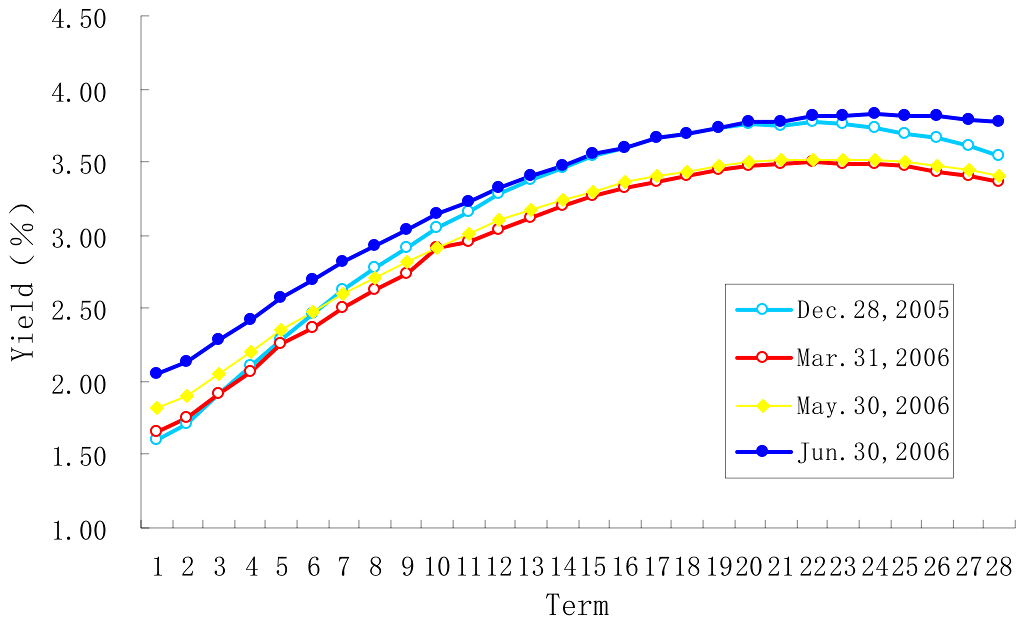
2. The bond market expanded significantly and the market operational mechanism further improved

The bond market traded briskly. In the first half of the year, the accumulated turnover of spot transactions in the inter-bank bond market increased by 2.55 trillion yuan over the same period of the previous year to 4.93 trillion yuan, while the daily average turnover soared by 1.1-fold year on year to 40.4 billion yuan. The turnover of government bond spot transactions on organized exchanges totaled 98.4 billion yuan, 39.4 billion yuan less than that recorded in the first half of 2005.

The bond indices in the inter-bank market and stock exchanges moved slightly upward. The bond index in the inter-bank market rose by 0.7 points, or 0.62 percent, from 113.42 points at the beginning of 2006 to 114.12 points at end-June. The government securities index on the organized exchanges rose by 0.45 points, or 0.41 percent, from 109.19 points at the beginning of the year to 109.64 points at end-June.

[4] Other financial institutions include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, and securities companies.

Figure 1 Yield Curve of Government Securities in the Inter-bank Bond Market in the First Half of 2006



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

The yield curve of government securities in the inter-bank bond market shifted slightly upward, and the yield of medium- and long-term bonds displayed a clearly upward trend compared with the end of 2005. The performance of the yield curve can be divided into two phases. First, in the first five months of 2006, higher yields of short-term bonds due to steady price declines and lower yields of long-term bonds due to price hikes caused the entire yield curve to flatten; second, in June 2006, due to a series of adjustment measures, yields across the entire maturity spectrum edged up, causing the yield curve to shift steadily upward.

Financing activities were brisk in the primary bond market and the market operational mechanism further improved. In the first half of 2006, a total of 995.9 billion yuan worth of bonds was issued, up 414.6 billion yuan or 71.3 percent year on year. In particular, a total of 426.0 billion yuan of government securities was issued, with a year-on-year increase of 109.5 billion yuan or 34.6 percent. A total of 346.2 billion yuan of policy financial bonds was issued, an increase of 156.2 billion yuan or 82.2 percent. A total of 195.5 billion yuan worth of corporate bonds (including short-term corporate financing bills worth 144.7 billion yuan) was issued, representing an increase of 165.2 billion YUAN from the same period of the previous year.

Affected by the abundant liquidity in the market, the issuing rates of bonds showed an obvious declining trend in the first quarter, but rose slightly in the second quarter, yet still below the level in the previous year. The 3-year and 5-year bearer's treasury bonds issued in the first half of the year offered interest rates of 3.14 percent and 3.49 percent respectively, 0.23 percentage points and 0.32 percentage points lower than those of the same period of the previous year. The issuing rate of book-entry treasury bonds issued in May of this year (6th issue) was 2.62 percent, 0.11 percentage points higher than that of the 7-year book-entry treasury bonds (1st issue) issued in February and down 0.39 percentage points compared with that of the 13th issue book-entry treasury bonds issued in November 2005.

3. The commercial paper market grew smoothly and quickly

In the first half of 2006, a total of 2.71 trillion yuan worth of bills was issued by the corporate sector, up 30.25 percent year on year; the amount of discount bills totaled 4.44 trillion yuan, up 48.75 percent compared with the same period of 2005, while that of rediscount bills reached 559 million yuan, representing a year-on-year decrease of 1.58 billion yuan. At end-June, the outstanding balance of commercial paper stood at 2.34 trillion yuan, up 38.56 percent year on year; the outstanding balance of discount bills was 1.73 trillion yuan, up 44.65 percent; and the outstanding balance of rediscount bills was 559 million yuan, 696 million yuan less than that recorded in the previous year.

4. The stock market traded briskly

Supported by favorable factors including sustained economic growth, substantial progress in the reform of non-tradable state shares, and smooth progress in restructuring securities companies, investors' confidence in the stock market strengthened gradually, as reflected in the brisk trading activities and evident rise in the stock price indices. In the first half of the year, the total turnover of the Shanghai and Shenzhen Stock Exchanges reached 3.81 trillion yuan, up 2.38 trillion yuan year on year, with the daily average turnover up 2.7 times year on year to 32.8 billion yuan. In particular, the turnover of A-shares reached 3.75 trillion yuan, 2.36 trillion yuan more than that during the same period of the previous year, with the daily average turnover registering 32.3 billion yuan, 2.7 times that in the same period of the previous year.

In June the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index edged up to 1696 points and 438 points respectively, both posting their highest levels since May 2004. At end-June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index closed at 1672 and 433 points respectively, up 44 percent and 55.2 percent from end-2005, indicating a clear recovery of market confidence.

In the first half of the year, a total of 144.17 billion yuan (including IPOs, additional offerings, and rights issues) was raised by Chinese enterprises on the equity market at home and abroad, 53.37 billion yuan or 58.8 percent more than that in the corresponding period of 2005. In particular, a total of 36.68 billion yuan and US$13.43 billion was raised in the A-share and H-share markets respectively.

Securities investment funds continued to grow rapidly. At end-June, the number of securities investment funds totaled 257, which is 39 more than the number at the end of 2005. The volume of the funds declined by 4 percent year on year to 426.2 billion yuan, while their net assets expanded by 30.9 percent year on year to 511.4 billion yuan.

Enhancing the development of the capital market is an important step to improve the transmission mechanism for monetary policy. Efforts should be made to boost direct financing, improve the modern market system, and make the market play a fundamental role in resource allocation to a greater extent through cultivating a capital market with a transparent and efficient framework, rational structure, a full-fledged mechanism, and effective functions and safe operations.

5. The insurance industry continued to flourish and its asset structure diversified further

In the first half of the year, the total premium income of the insurance industry reached 308.0 billion yuan, up 13.7 percent; accumulated insurance claim payments grew by 19.2 percent to 64.2 billion yuan. At end-June, the total assets of insurance companies grew by 27.2 percent year on year to 1.73 trillion yuan, reflecting continued rapid growth.

The assets of insurance companies further diversified with the expansion of investment channels, rapid growth of the bond market, and improvement of the market operation mechanism. Excluding government securities and securities investment funds, other investments (including investments in financial bonds, corporate bonds, and equities) increased considerably by 75.9 percent year on year, with their share in total assets growing evidently, while the share of bank deposits declined markedly.

Table 5: Use of Insurance Funds at end-June 2006

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	First half of 2006	First half of 2005	First half of 2006	First half of 2005
Total assets	17341	13633	100	100
Of which, Bank deposits	5667	5065	32.7	37.2
Investment	10141	7381	58.5	54.1
Government securities	3685	3270	21.3	24
Securities investment funds	783	885	4.5	6.5
Other Investment	5673	3226	32.7	23.7

Source: China Insurance Regulatory Commission.

6. Trading of foreign currency pairs in the inter-bank market was active

In the first half of the year, the cumulative turnover of RMB forward transactions in the inter-bank foreign exchange market totaled 7.41 billion yuan. The combined turnover of all 8 currency pairs trading in the inter-bank foreign exchange market totaled US$37.3 billion, with most transactions in the currency pairs of USD/HKD, USD/JPY, and EUR/USD accounting for 83.6 percent of the total trading volume, reflecting active trading in the inter-bank foreign exchange market.

II. Financial market institution building

1. Steadily advance the development of the money market and bond market

Taking innovation of financial products as a breakthrough, the PBC actively and steadily advanced the development of money and bond markets, and expanded financing channels for economic entities and optimized the structure of financial assets. The issuance of short-term financing bills by enterprises increased in volume and common financial bonds and subordinated bonds were issued smoothly. The pilot reform of credit asset securitization and interest rate swaps was promoted and the trading volume of bond forward transactions grew steadily; straight-through processing and the registration and settlement system operated smoothly, further contributing to market efficiency.

2. Significant progress in reform of non-tradable shares and restructuring of securities companies proceeded firmly

By June 30, a total of 1,092 companies listed on the Shanghai and Shenzhen Stock Exchanges had accomplished or launched a non-tradable shares reform, accounting for 81 percent of the A-share-listed companies to be reformed, 80 percent of their market capitalization, and 78 percent of equity, reflecting significant progress in the non-tradable shares reform. With the advance of the non-tradable shares reform, recovery of the financing function of the market became an intrinsic requirement for market development. On May 6 and May 17, 2006, the China Securities Regulatory Commission (hereinafter referred to as CSRC) promulgated *Administrative Measures for Securities' Issuance of Listed Companies* and *Administrative Measures for IPOs and Listings* to introduce the principle that all shares of new IPOs must be tradable and to gradually recover the financing function of the stock market. On May 25, the China CAMC Engineering Co. released its prospectus and became the first company to have all IPO shares tradable. The resumption of IPOs in the A-share market indicated a marked accomplishment of the goal of making all IPO shares tradable in the non-tradable shares reform.

Based on the overall arrangement of the State Council and the principle of seeking both a temporary solution and a permanent cure but focusing on the latter, the PBC and other relevant government agencies continued to advance the restructuring of securities companies with valuable potential and social impact. In the first half of the year, the People's Bank of China and the China Securities Regulatory Commission, with the support of the People's Government of Shandong Province and the People's Government of Chongqing Municipality, completed the restructuring of Tiantong Securities and Southwest Securities respectively. According to the restructuring plan approved by the State Council, Tiantong Securities Co., Ltd. was closed and its securities business and assets were brought under the custody of Qilu Securities Co., Ltd. While addressing problems such as inadequate capital and liquidity difficulties in securities companies, emphasis was also placed on promoting the transformation of the operational mechanism, advancing the establishment of a corporate governance structure and a strict internal control system in line with a modern enterprise system, and encouraging the institutional building and innovation of securities companies.

3. Actively promote development of the insurance market

To speed up the development of the insurance sector, the State Council promulgated the *Guidelines of the State Council on Reform and Development of the Insurance Industry* (thereinafter referred to as the *Guidelines*) on June 26 to clarify the role of the insurance industry in economic and social development and to define the guidelines, overall objectives, and main tasks for development of the insurance industry. The *Guidelines* pointed out that reform of the operational mechanism should be deepened for utilization of insurance funds through such channels as direct or indirect capital market investment, equity investment in commercial banks, or investment in asset-backed securitization products.

In addition, on July 3, 2006 the China Insurance Regulatory Commission and the

China Banking Regulatory Commission jointly promulgated the *Notice of the China Insurance Regulatory Commission and the China Banking Regulatory Commission on Regulating the Banks' Commission Insurance Business* to strengthen management of banks' commission insurance business in seven respects, such as the commission institution's qualifications, internal control of the commission business, commission charges, sales employees qualifications, insurance product sales regulations, supervision, and monitoring, and communication within and outside the industry.

Part 4 Analysis of Macroeconomic Developments

I. The global economic and financial situation

Since the beginning of 2006, the global economy has continued to maintain a momentum of steady growth. The US economy showed signs of a slowdown in the second quarter following robust growth in the first quarter. The euro zone saw sustained recovery. The Japanese economy picked up steadily. The major emerging market and developing economies maintained a momentum of vigorous growth. High international crude oil prices, rising trade protectionism, and global imbalances remained major risks for global economic growth. In April 2006, the International Monetary Fund (IMF) projected that the global growth rate would be 4.9 percent in 2006, up 0.6 percentage points compared with its projection in September 2005.

1. Economic development of the major economies

The US economy slowed down. Following strong GDP growth of 5.6 percent in the first quarter of 2006, the US economy showed signs of a slowdown in the second quarter, as reflected in an annualized quarter-on-quarter growth rate of 2.5 percent. Due to the impact of rising international oil prices, inflationary pressures persisted. The CPI registered 3.5 percent, 4.2 percent, and 4.3 percent respectively in April, May, and June on a year-on-year basis, averaging 4 percent, up 0.4 percentage points compared with that recorded in the first quarter. US employment was broadly stable, with an unemployment rate of 4.7 percent, 4.6 percent, and 4.6 percent respectively in April, May, and June, averaging 4.7 percent, on the same level as that in the first quarter but 0.4 percentage points below that recorded in the same quarter of 2005. In the first five months of 2006, the US trade deficit further increased to US$317.9 billion, up US$36.17 billion over that recorded in the same period of 2005.

The economies in the euro zone continued to recover. In the first quarter of 2006, GDP grew by 1.9 percent year on year. Since the start of the second quarter, the economies have continued to recover at a moderate pace. Inflationary pressures have built up. The monthly year-on-year HICP registered 2.4 percent, 2.5 percent, and 2.5 percent respectively in April, May, and June, averaging 2.5 percent, up 0.2 percentage points over that in the first quarter. Employment strengthened, with the unemployment rate registering 8.0 percent, 7.9 percent, and 7.8 percent respectively in April, May, and June, all markedly lower as compared with the same period of the previous year. In the first five months of 2006, the trade deficit of the euro zone posted EUR17.4 billion, compared with a surplus of EUR9.6 billion in the same period of 2005.

The Japanese economy picked up steadily. In the first quarter of 2006, real GDP grew by 3.5 percent on a year-on-year basis. Since the start of the second quarter, the economy has continued to pick up, consumer consumption and domestic investment in equipment have grown rapidly, and exports have increased with a strong momentum. In the second quarter of 2006, the year-on-year CPI registered 0.4 percent, 0.6 percent, and 1.0 percent respectively in April, May, and June, seeing positive figures for six straight months. The unemployment rate dropped further, with the monthly unemployment rate registering 4.1 percent, 4.0 percent, and 4.2 percent respectively in April, May, and June and averaging 4.1 percent, down 0.3 percentage points over the same period of the previous year. In the first half of 2006, the trade surplus was JPY3.4 trillion, down JPY1.1 trillion from that recorded in the same period of the previous year.

Since the beginning of 2006, the major emerging market and developing economies (regions) have continued robust growth, yet inflationary pressures have built up. In particular, the emerging economies in Asia have maintained strong growth supported by domestic demand and foreign trade. The Latin American economies have slowed down from their high growth in the first quarter.

2. Developments in international financial markets

Since the start of 2006, in general, the US dollar has weakened against other major currencies. In early May, the US dollar reached its lowest level since the start of the year, followed by fluctuations and rebounds to varying degrees. On June 30, 2006, the euro closed against the US dollar at US$1.2786 per euro and the US dollar closed against the yen at JPY114.43 per dollar. The dollar depreciated by 7.99 percent and 2.96 percent against the euro and the yen respectively over that recorded at end-2005.

The yields of major bonds rose steadily. On June 30, 2006, the yield of 10-year government bonds in the US, the euro zone, and Japan closed at 5.14 percent, 4.06 percent, and 1.92 percent respectively, up 0.75, 0.76, and 0.45 percentage points over that recorded at end-2005.

In the first four months of 2006, amid fluctuations stock markets around the world rallied to varying degrees. Starting from early May 2006, however, the major stock markets fell sharply due to the rising prices of primary commodities and concerns about inflation. It was only in mid-June that the major stock markets stabilized and began to rebound. On June 30, 2006, the Dow Jones Industrial Average closed at 11,150 points, up 2.79 percent over that recorded at the beginning of 2006, while the Nasdaq Composite Index closed at 2,172 points, down 3.17 percent from the beginning of 2006. The Stoxx 50 in the euro zone closed at 3379 points, up 0.57

percent over that at the beginning of 2006. The Nikkei 225 Stock Average ended at 15,505 points, up 42.94 percent over that at the beginning of 2006.

Box 4: Cross-border Capital Flows and their Management

In recent years, with the development of outward-oriented economies from country to country and deepening economic globalization, the size of global cross-border capital flows has been growing rapidly. Generally, cross-border capital flows help make up for the shortage of savings in developing countries and thus promote investment and economic growth. However, a large inflow and outflow of short-term funds may also be a shock to the economic and financial systems and become potential destabilizing factors. For example, a large-scale inflow of capital may cause such problems as excessive monetary expansion, heightened inflationary pressures, appreciation of the real exchange rate, increased risks in the financial sector, and wider current account deficits. In addition, a large inflow of capital may intensify fluctuations in the financial market. Once expectations of returns on assets change and a herding effect emerges in the financial market, the cross-border capital inflow may stop suddenly and even could reverse to a large capital outflow, giving rise to turmoil in the economic and financial systems. Mexico in 1994 and 1995, the Asian economies in 1997, and Russia in 1998 learned this lesson in the hard way. Therefore, many countries have actively strengthened monitoring and management of cross-border capital flows when they effectively utilize international capital.

Internationally, with respect to management of cross-border capital flows, there are mainly two types, i.e., controls and non-control means. Controls apply to the countries with capital controls or to special crisis circumstances by directly or indirectly regulating the size, structure, and maturity of capital flows. In terms of mechanisms, controls can in turn be divided into administrative controls and price controls. Administrative controls are mainly foreign exchange controls like bans or strict examination and approval procedures to limit cross-border capital flows. Typical policies may include direct bans or restrictions on certain types of cross-border flows, strict administrative examination and approval of and authenticity checks on such short-term capital flows like external debts, and permissions for domestic bond issuances to replace overseas bond issuances, etc. Price controls include such measures as zero-interest deposits reserves and cross-border capital transactions taxes to regulate capital flows by changing the costs of cross-border flows. For example, in 1991 Chile adopted the arrangement of zero-interest reserves requiring depositing 20 percent of all new external debts (excluding export credits) in the central bank, with maturities ranging from 90 days to one year; in May 1992, the zero-interest reserves requirement was extended to foreign currency deposits and the reserves proportion increased to 30 percent, with a uniform maturity of one year. A country may also regulate cross-border capital flows through non-control means: First, by reinforcing the role of the exchange regime in regulating cross-border capital flows through a flexible exchange rate. Second, by expanding outflow channels to reduce net capital inflows. Third, by strengthening prudent supervision on and early-warning for the financial industry. For example, in the wake of the Asian crisis, Korea strengthened coordination and data integration among different agencies and established a monitoring and early-warning system for cross-border capital flows, which helped prevent and dissolve financial risks in a timely manner.

In recent years, with the gradual progress in RMB convertibility under the capital account and the rapid development of an outward-oriented economy, China has experienced larger and larger cross-border capital flows. Although most capital flows had an authentic background of trade and investment, we cannot rule out the possibility that some speculative short-term capital entered China in the name of trade financing, remittances, donations, domestic investment by domestic enterprises with funds from overseas public offerings, and loans by shareholders of foreign-funded enterprises, etc. In recent years, departments of foreign exchange administration, for the purpose of safeguarding national economic and financial security, have strengthened administration of cross-border capital flows and achieved some results. Looking forward, we should continue to promote RMB convertibility under the capital account in a proper and orderly manner, step up the development of the financial market, improve the interest rate and exchange rate discovery mechanisms, establish and improve a monitoring and early-warning system of cross-border capital flows, and promote balanced development of the economy.

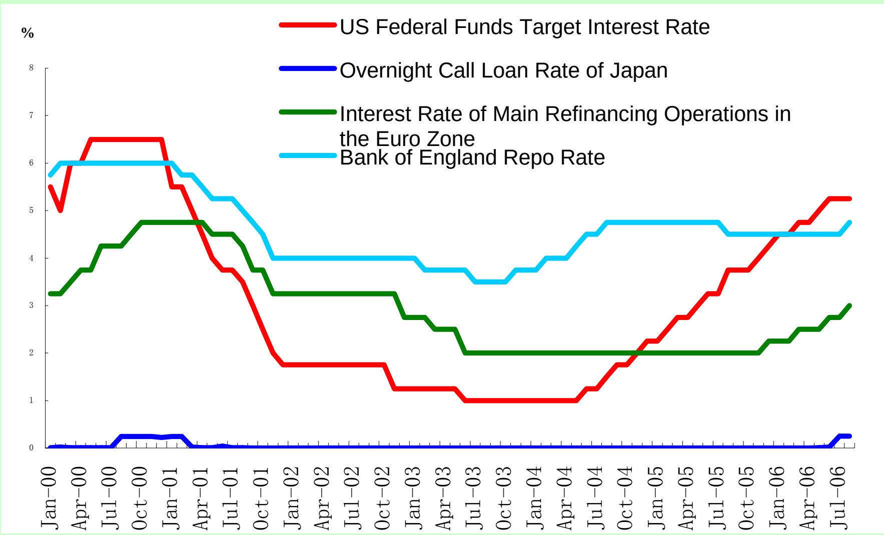
3. Monetary policies of the major economies

The Federal Open Market Committee (FOMC) raised the target of the federal funds rate to 5.25 percent by increments of 25 basis points on January 31, March 28, May 10, and June 29 respectively. The European Central Bank (ECB) raised the interest rate of the main refinancing operations to 3 percent by 25 basis points on March 2, June 8, and August 3 respectively, with the rate reaching its highest level in three years. The Bank of Japan (BOJ) decided on March 9 to end the current ultra-loose “quantitative easing” monetary policy and changed the operational target of the monetary policy from the upper limit of the total current account balance held with the BOJ by commercial banks to the unsecured overnight call loan rate and raised the rate from zero percent to 0.25 percent on July 4, the first rate hike by the BOJ in 6 years. The Bank of England also raised the repo rate by 25 basis points to 4.75 percent on August 3.

Box 5: Global Inflationary Pressures Built Up and Major Central Banks Tightened Monetary Policy

Since 2004, the world economy has grown steadily, international crude oil prices and prices of metals and raw materials have been rising, and global inflationary pressures have been increasing. In response to the potential inflationary risks and in order to maintain sustained and steady economic growth, the central banks of the major economies have tightened monetary policy. A new round of rate hikes has gradually come into being. This round of rate hikes was started by the UK. In November 2003, the Bank of England raised the target interest rate by 25 basis points to 3.75 percent, to be followed by four rate hikes, one rate cut, and another rate hike on August 2006. Presently, the interest rate is 4.75 percent. Starting from June 2004 the Fed raised its target rate by increments of 25 basis points 17 consecutive times to the current level of 5.25 percent. The European Central Bank raised the interest rate four consecutive times beginning in December 2005 to the current level of 3 percent. In July 2006, the Bank of Japan (BOJ) raised the target overnight call loan rate from zero to 0.25 percent, ending the six-year-long zero-interest era. In addition, the central banks of Canada, Sweden, Australia, Korea, India, Argentina, and Hungary all raised their target interest rates to varying degrees.

Figure 2 : Monetary Policy Target Rates of the Central Banks of the Major Economies



Source: Web Sites of the Respective Central Banks.

Monetary tightening by the central banks of the major economies will be conducive to global economic growth at a sustainable pace. First, steady and orderly rate hikes will help ease excessive global liquidities, cool down the real estate market, and control inflation. Between 2001 and 2003, due to such factors as the global deflation, the IT bubble burst, and the terrorist threat, the central banks cut rates substantially in succession. The worldwide ultra-loose monetary policy, while spurring economic recovery, resulted in soaring prices of real estate and staple commodities in the international market, causing inflationary pressures to build up. Second, the target rate hikes to varying degrees by the central banks of the major economies have altered the pattern of international capital flows and influenced movement in the exchange rates of the major currencies. Between June 2001 and October 2004, the target of the federal funds rate was lower than the target rates of the ECB and the Bank of England. With the consecutive rate hikes by the Fed, the federal funds rate surpassed the target rates of the ECB and the Bank of England in December 2004 and March 2006 respectively, which facilitated international capital flows back to the US and restrained the US dollar from depreciating dramatically. According to statistics of the US Treasury Department, US net inflows of international capital amounted to US$763.6 billion in 2004 and to US$838.1 billion in 2005, up 9.8 percent; net inflows of international capital further intensified in 2006, in particular, net inflows reached US$69.6 billion in May 2006, more than offsetting the trade deficit of US$63.84 billion in May. Third, rate hikes by the central banks of the major economies may influence the international bond market by pushing up the long-term yields in the bond market. Up till now, however, the yields of long-term US bonds have not moved up by a large margin and there has been no “strong response” in the international financial market.

The tightening of monetary policy by the central banks of the major economies has some influence on the Chinese economy. First, in the long run, the sustained and steady growth of the global economy, especially the successful soft landing of the US economy, will create a favorable external environment for China’s economic development. Second, the many rate hikes by the central banks of the major economies will change the interest rate differential between the RMB and foreign currencies, creating more room for China’s monetary policy in macro management. In addition, rate hikes will reduce liquidities in the international market, and will, to some degree, reduce the inflow of hot money, winning more time for the exchange rate regime reform. There are, however, many uncertainties in the monetary policies of the major economies. On August 8, 2006, the Fed decided to halt the rate hike and to keep the federal funds target rate at the level of 5.25 percent. Meanwhile, however, the Fed noted, the timing and extent of any future tightening would depend on incoming economic data. It is not clear how long it will take the Bank of Japan to drain liquidities and at what pace, or whether the BOJ will again raise its target rate. If liquidities were to be tightened sharply, this would have a great impact on the financial market and even on the real economy. But if the liquidities were to be absorbed too slowly, speculation would emerge and inflation would pick up. The PBC will continue to implement a sound monetary policy, to take active measures to make precautionary plans against various kinds of uncertainties under the circumstances of economic globalization and financial market integration. On the one hand, we will continue to steadily promote market-based interest-rate reform and the RMB exchange rate regime reform, to coordinate the relationship between the RMB interest rates and the interest rates of foreign currencies, and to strengthen financial macro management. On the other hand, we shall pay close attention to international capital flows, and short-term flows in particular, so as to take timely measures to forestall financial risks.

II. Analysis of China's macroeconomic performance

In the first half of 2006, the national economy maintained steady and rapid growth, with generally good performance. Demands were strong in terms of investment, consumption, and net exports. There was a bumper harvest of summer grain. Industrial structural adjustments were promoted. The supporting conditions for coal, electricity, and transportation improved. Household and enterprise income and fiscal revenues increased further, and the standard of living improved. Prices remained basically stable. And yet, prominent contradictions and problems still persisted, such as excessive growth of fixed-asset investment, excessive money and credit supplies, intensified imbalances in international payments, excessive energy consumption, and heightened environmental pressures. In the first half of 2006, GDP totaled 9.1 trillion yuan, up 10.9 percent, accelerating by 0.9 percentage points on a year-on-year basis; the unit GDP energy consumption rose by 0.8 percent on a year-on-year basis, which fell short of not only the target of reducing unit energy consumption by 4 percent in 2006 but also the requirement of a 20 percent reduction in unit energy consumption during the 11th Five-year Plan period. The CPI rose by 1.3 percent, decelerating by 1.0 percentage points on a year-on-year basis; the trade surplus registered US$61.45 billion, up US$21.8 billion over the same period in 2005.

1. Domestic demand was strong; in particular, fixed-asset investment growth was unduly rapid; external demand did not moderate; and the trade surplus continued to expand.

Growth of household income accelerated and consumer demand increased. The contribution of final consumption to economic growth became larger. In the first half of 2006, the per capita disposable income of urban residents stood at 5,997 yuan, representing an inflation-adjusted real growth of 10.2 percent and an acceleration of 0.7 percentage points on a year-on-year basis. The per capita net cash earnings of farmers amounted to 1,797 yuan, representing a real growth of 11.9 percent and a deceleration of 0.6 percentage points year on year. The income growth of urban and rural residents pushed up consumer demand. In the first half of 2006, the total volume of retail sales was 3.6 trillion yuan, representing an inflation-adjusted real growth of 12.4 percent and an acceleration of 0.4 percentage points on a year-on-year basis. A sample survey of urban household income indicated that in the first half of 2006, monthly average per capita expenditures by urban residents amounted to 967 yuan, representing a real growth of 10 percent. A sample survey of rural household income indicated that in the first half of 2006 the monthly average per capita cash spending by rural residents amounted to 188 yuan, representing a real growth of 9.7 percent. Generally, final consumption contributed more to economic growth. In the first half of 2006, the contribution of final consumption accounted for 37.4 percent of economic growth, up 14.4 percentage points on a year-on-year basis.

Fixed-asset investment grew excessively rapidly and tended to rise with each passing quarter. Investment remained the primary driver behind economic growth. In the first half of 2006, total fixed-asset investment posted 4.2 trillion yuan, representing a growth of 29.8 percent and an acceleration of 4.4 percentage points, both on a year-on-year basis, and an acceleration of 2.1 percentage points on a quarter-on-quarter basis. In inflation-adjusted terms, the real growth was 28.8 percent, representing an acceleration of 5.5 percentage points over the same period of the last year, and an acceleration of 8.4 percentage points over that recorded in the first half of 2004 when investment was over-heated. In terms of the urban and rural breakdown, urban fixed-asset investment was far larger than rural fixed-asset investment. Urban fixed-asset investment grew 31.3 percent, while rural fixed-asset investment grew 21.8 percent on a year-on-year basis. In terms of industry breakdown, investment apparently increased rapidly in all industries, with that in the primary industry registering the highest growth. The growth of investment in primary, secondary, and tertiary industries posted 40.2 percent, 35 percent, and 28.2 percent respectively. In terms of the sectoral breakdown, the mining sector realized a growth of 45.6 percent in investment, the manufacturing sector 38.6 percent, the power, gas, and water production and supply industries 17.5 percent, and the transportation, storage, and warehousing and postal service industries 27 percent. In the rapid growth of fixed-asset investment, industries with high energy-intensity, high-pollution, and excess capacity still continued to expand blindly, with an apparently similar product mix. In terms of newly started projects, in the first half of 2006 there were nearly 100,000 new projects, up 18,000 over the same period of the previous year. The total planned investment of the new projects was 3.7 trillion yuan, up 22.2 percent on a year-on-year basis. Generally, since the start of 2006 the size of fixed-asset investment was excessively large and its growth excessively fast. The contribution of capital formation to economic growth was as high as 52.9 percent, up 15.9 percent over the same period of the previous year, making capital formation the primary driver behind economic growth. At present, strong pressure remains for the excessive fixed-asset investment to rebound, a possibility that must be resolutely contained.

The growth of exports fell from a high level, while the growth of imports accelerated markedly; yet the growth of exports remained higher than that of imports, further expanding the trade surplus. In the first half of 2006, the total volume of exports and imports reached US$795.7 billion, increasing by 23.4 percent and accelerating by 0.2 percentage points on a year-on-year basis. Specifically, exports posted US$428.6 billion, up 25.2 percent, a deceleration of 7.5 percentage points on a year-on-year basis; imports registered US$367.2 billion, up 21.3 percent, an acceleration of 7.3 percentage points. Of the total imports, products such as crude oil, refined oil products, autos and auto chassis, and planes grew substantially by 53.9 percent, 71.8 percent, 77.5 percent, and 92 percent respectively. Due to the sharp rise in the prices of imports, the real growth of imports in terms of quantity was far lower than that in terms of amount. For example, in terms of quantity, imports of crude oil and refined oil products grew only 15.6 percent and 16.1 percent respectively. Generally, exports still grew faster than imports, resulting in a surplus of US$61.4 billion, up US$21.8 billion over the same period of the previous year. In the first half of 2006, net exports of goods and services accounted for 9.7 percent of the economic growth, a deceleration of 30.3 percentage points on a year-on-year basis.

2. Output grew rapidly, and industrial growth accelerated markedly.

In the first half of 2006, the added value of the farming, forestry, animal husbandry, and fishery industries grew 5.1 percent year on year to 0.8 trillion yuan, accounting for 4.5 percent of the economic growth, a decline of 0.5 percentage points from the previous year; the added value of the industry and the construction sector grew by 13.2 percent to 4.7 trillion yuan, accounting for 60.6 percent of the economic growth, 5.8 percentage points higher than in the previous year, effectively becoming the primary driver behind the economic growth; the services industry realized 3.6 trillion yuan of added value, up 9.4 percent from the previous year, and accounted for 34.9 percent of the economic growth, a deceleration of 5.3 percentage points.

The performance of the agricultural sector was good. Summer grain achieved a bumper harvest for the third consecutive year. Total output reached 113.8 billion kilos in the first half of 2006, up 7.0 percent. Total output of pork, beef, mutton, and poultry reached 36.05 million tons, up 4.4 percent on a year-on-year basis. The prices of agricultural products, however, only rose by a small margin, and grain prices even dropped, presenting some difficulties for farmers to further increase their income. In the first half of 2006, the production prices of agricultural produce (i.e., the prices at which producers directly sell their products) decreased by 2.1 percent. Specifically, the production price of grain and livestock decreased by 0.2 percent and 15.2 percent respectively on a year-on-year basis. The income of farmers from selling agricultural produce rose by 6.5 percent, representing a deceleration of 11.6 percentage points year on year. To some extent, less-than-desirable income expectations dampened the investment enthusiasm of farmers and the growth of their fixed-asset investment declined. In the first half of 2006, fixed-asset investment by farmers amounted to 176.9 billion yuan, a growth of 13.3 percent and a deceleration of 3.0 percentage points on a year-on-year basis.

The growth of industrial production accelerated, and enterprise profits surged. In the first half of 2006, the statistically large enterprises realized an added value of 4 trillion yuan, representing a growth of 17.7 percent and an acceleration of 1.3 percentage points on a year-on-year basis. The ratio of sales to total output by the statistically large enterprises maintained a high level of 97.5 percent. The statistically large industrial enterprises realized a total profit of 810.7 billion yuan, an increase of 28 percent and an acceleration of 8.9 percentage points on a year-on-year basis. The 2006 Second Quarter Survey of 5,000 Industrial Enterprises by the PBC indicated that the overall business activities index of enterprises reached a record high of 27.2 percent, up 3.0 and 6.6 percentage points over that in the previous quarter and that in the same period of the previous year respectively. The index of domestic orders and overseas orders registered 8.8 percent and 7.9 percent respectively, surpassing their respective historical records of 6.5 percent and 4.9 percent at end-2005.

In terms of the services industries, the added value of the financial industry, the accommodations and catering industry, and the wholesale and retail industry grew rapidly at 13.9 percent, 12.9 percent, and 11.3 percent respectively. Other services industries, the real estate industry, the communication, transportation, warehousing industry, and the postal services and telecommunications industry grew relatively slowly at 8.6 percent, 7.9 percent, and 6.3 percent respectively.

3. Various price indices were basically stable, but inflationary pressures built up.

(1) The year-on-year growth of the Consumer Price Index increased from a low level. In the first half of 2006, the CPI grew 1.3 percent, a deceleration of 1 percentage point on a year-on-year basis. Specifically, the prices of consumer goods, services, food, and non-food items increased by 1.1 percent, 1.9 percent, 1.9 percent, and 0.9 percent respectively. Due to the price hike of up-stream products like oil, non-ferrous metals, and steel products and the adjustment in the prices of public utilities like electricity, water, and pipeline gas and taxi services, the CPI showed clear signs of rising year on year. In the second quarter, the monthly rise of the CPI averaged 1.4 percent, up 0.2 percentage points over that in the first quarter.

(2) The rise in the Producer Price Index (PPI) decelerated on a year-on-year basis, yet the purchasing prices of industrial raw materials, fuels, and power still grew faster than the factory prices of industrial products. In the first half of 2006, the purchasing prices of industrial raw materials, fuels, and power increased by 6.1 percent year on year, a deceleration of 3.8 percentage points over the same period in the preceding year. The factory prices of industrial products increased by 2.7 percent year on year, a deceleration of 2.9 percentage points. The differential between the rise in the purchasing prices of industrial raw material, fuels, and power and the rise in the factory prices of industrial products was 3.4 percentage points, down 0.9 percentage points over that in the same period of the previous year, indicating that pressures continued to ease for enterprises to absorb the price hikes of up-stream products.

Due to the strength of aggregate demand, growth of fixed-asset investment accelerated. Also, due to the elevated prices of crude oil and non-ferrous metals, the year-on-year growth of the purchasing prices of industrial raw materials, fuels, and power and that of the factory prices of industrial products both accelerated. In April, May, and June, the purchasing prices of industrial raw materials, fuels, and power rose by 4.9 percent, 5.5 percent, and 6.6 percent respectively on a year-on-year basis; the factory prices of industrial products increased by 1.9 percent, 2.4 percent, and 3.5 percent respectively. Among industrial products, the factory prices of production materials continued to rise and constituted the main factor pushing up the factory prices of industrial products. Yet, the factory prices of livelihood materials dropped steadily. In the first half of 2006, the factory prices of the mining industry, the raw materials industry, and the processing industry rose by 18.7 percent, 6.4 percent, and 0.4 percent respectively, while the factory prices of livelihood materials decreased by 0.3 percent on a year-on-year basis. In terms of the product breakdown, the factory prices of crude oil, gasoline, kerosene, diesel oil, and non-ferrous metals rose substantially by 30.8 percent, 25.4 percent, 26.3 percent, 21.9 percent, and 18.8 percent respectively. The price of coal, however, dropped with each passing month, with the growth of its factory price decreasing from 12.4 percent in January to 3.2 percent in June. The year-on-year rises in the prices of various steel materials dropped sharply, but the prices tended to rise on a month-on-month basis in March.

(3) Growth of export prices and import prices were broadly at the same level,

and the terms of trade improved modestly. In the first and second quarters of 2006, the rise in the customs prices of exports posted 0.8 percent and 2.6 percent; specifically, the rise in the first quarter decelerated by 6.8 percentage points on a year-on-year basis, while that in the second quarter was similar to that in the same quarter of 2005. The increase in the customs prices of imports registered 1 percent and 2.6 percent in the first and second quarters respectively, a deceleration of 9.1 and 3.6 percentage points over the same quarter in the previous year. The terms of trade index posted 99.8 percent and 100 percent in the first and second quarters respectively, improving by 2.1 and 3.4 percentage points over the corresponding period of the previous year. The terms of trade were slightly better.

(4) Labor compensation grew fairly rapidly. In the first half of 2006, the average salary of urban employees was 9,275 yuan, up 14.3 percent on a year-on-year basis. In particular, the average salary of employees in state-owned units posted 9,796 yuan, up 15.3 percent; that of employees in collectively owned units was 5,566 yuan, up 15.6 percent; and that of employees in other units was 9,165 yuan, up 11.6 percent.

(5) The GDP deflator continued to drop. In the first half of 2006, the nominal GDP growth rate was 14.3 percent, while the real GDP growth rate was 10.9 percent. The GDP deflator (the differential between the nominal and real GDP growth rates) was 3.4 percent, down 0.4 percentage points on a year-on-year basis.

4. Fiscal revenue grew substantially and the expenditure structure improved.

In the first half of 2006, fiscal revenue amounted to 2 trillion yuan, growing 22 percent and accelerating by 7.4 percentage points over the same period of the previous year; fiscal expenditures amounted to 1.5 trillion yuan, growing 17.5 percent and accelerating by 2.5 percentage points. Netting revenue and expenditures, fiscal revenue surpassed fiscal expenditures by 540.5 billion yuan, up 143.5 billion yuan on a year-on-year basis.

Fiscal revenue grew rapidly mainly because all major tax categories maintained rapid growth. In particular, the enterprise income tax increased by as much as 40.3 percent on a year-on-year basis. In addition, due to brisk trading activities and rallying stock indices on the Shanghai and Shenzhen Stock Exchanges, stamp duties for securities transactions grew by 1.3 times on a year-on-year basis in the first half of 2006. Due to higher resources tax standards for coal, crude oil, and natural gas, the resources tax grew at a high rate of 47.3 percent on a year-on-year basis. Fiscal expenditures proceeded normally, and the fiscal expenditure structure improved. First, expenditures on rural areas, farmers, and agriculture grew rapidly, and expenditures on agriculture grew 25.8 percent on a year-on-year basis. Second, expenditures on the social safety net grew rapidly by 9.6 percent. Third, expenditures on social development such as education, science, and public health grew rapidly by 14.3 percent. Fourth, expenditures on capital construction slowed down, growing by 9.7 percent and decelerating by 23 percentage points over the same period of the previous year.

5. The international balance of payments continued to maintain "twin surpluses."

In the first half of 2006, China's BOP still maintained a substantial amount of "twin surpluses," and the surplus under the current account was the main source of the BOP surpluses. The actual utilization of foreign direct investment (FDI) amounted to US$28.4 billion, down 0.5 percent on a year-on-year basis. Foreign exchange reserves grew rapidly. At end-June 2006, China's foreign exchange reserves reached US$941.1 billion, up US$122.2 billion over that at end-2005.

Growth of the total external debt was stable, with the short-term external debt accounting for a large share. At end-March 2006, the total external debt amounted to US$287.91 billion, growing 2.4 percent over that at end-2005, a deceleration of 11.1 percentage points over that recorded in the previous year. Specifically, the medium- and long-term external debt totaled US$126.86 billion, growing 1.6 percent over that at end-2005; the short-term external debt totaled US$161.04 billion, growing 3.1 percent, a deceleration of 20 percentage points. The short-term external debt accounted for 55.9 percent of the total external debt, up 0.3 percentage points over that recorded at end-2005.

6. Industrial analysis.

In the first half of 2006, sales of all major industries performed well, growth of production accelerated, profits increased substantially, and investment grew rapidly. Of 39 industries, 25 industries saw a ratio of sales to production of over 97 percent; 31 industries had a ratio of profits over costs after interest and tax (hereinafter referred to as the profit ratio) above 4 percent. In particular, the oil and natural gas exploration industry had the highest profit ratio of 130.5 percent; 27 industries registered a higher profit ratio compared with that in the previous year. Most processing industries and some raw materials industries witnessed rapid growth of added value. At present, the capacity utilization ratio is close to 80 percent. With expectations of higher profits, enterprises have been keen for investment. In contrast to the investment boom in the chemical and heavy industries in the past two years, the growth of investment in the raw materials industry and the textiles and other light industries began to accelerate. In the first half of 2006, the growth of investment in the food, beverage, and garments, footwear, and headgear manufacturing industries registered 65.1 percent, 67.2 percent, and 55.2 percent respectively; the growth of investment in the timber processing and furniture manufacturing industries posted 52.9 percent and 58.6 percent respectively.

The growth in supplies of coal, electricity, and transportation accelerated, further easing the shortage of these goods and services. In the first half of 2006, the output of crude coal, crude oil, and power generation reached 960 million tons, 91.66 million tons, and 1.2687 trillion kilowatt-hours respectively, growing 12.8 percent, 2.1 percent, and 12 percent respectively on a year-on-year basis. The volume of rail freight increased by 6.3 percent to 1.4 billion tons; the turnover of water freight increased by 11 percent to 2.5060 trillion ton-kilometers; and the volume of freight handled by the major ports rose by 17.6 percent to 1.64 billion tons.

(1) The real estate industry

In the first half of 2006, investment in real estate development and commercial housing sales rebounded. The growth of commercial real estate loans accelerated with each passing month. The rise in housing prices tended to slow down broadly, yet the price of newly completed commercial residential housing posted a sharp rise in a small number of cities.

The growth of real estate investment rebounded. In the first half of 2006, the cumulative investment in real estate development amounted to 769.5 billion yuan, growing 24.2 percent and accelerating by 0.7 percentage points over the same period of the preceding year. Specifically, investment in commercial residential housing reached 531.8 billion, growing 28.2 percent and accelerating by 6.9 percentage points on a year-on-year basis.

Growth in the area of commercial housing sales rebounded. In the first half of 2006, the area of housing sales posted 230 million square meters, growing 16.5 percent on a year-on-year basis and accelerating by 6.3 percentage points over that recorded in the first quarter. The amount of housing sales reached 795.7 billion yuan, growing 24.5 percent on a year-on-year basis. At end-June 2006, commercial housing vacancies registered 121 million square meters, up 17.2 percent on a year-on-year basis. Specifically, residential housing vacancies posted 67.15 million square meters, up 14.1 percent.

Investment in land development grew rapidly, yet the area of purchased land continued to drop. In the first half of 2006, investment in land development amounted to 45.9 billion yuan, growing 86.5 percent and accelerating by 82.8 percentage points on a year-on-year basis. The completed area of land development registered 110 million square meters, growing 34 percent and accelerating by 31 percentage points on a year-on-year basis. The area of purchased land, however, posted only 157 million square meters, decreasing by 6.16 million square meters or 3.8 percent on a year-on-year basis.

The rise in housing sales prices stabilized, yet some localities saw large rises in housing prices. In the second quarter of 2006, housing sales prices in 70 large- and medium-sized cities rose by 5.7 percent on a year-on-year basis, a slight acceleration of 0.2 percentage points over that recorded in the previous quarter. In terms of the breakdown by category, the sale prices of economically affordable housing and high-end housing grew 5.4 percent and 8.2 percent respectively on a year-on-year basis; the prices of ordinary housing rose by 5.3 percent. In terms of geographic locations, four cities registered a year-on-year rise in housing prices of above 10 percent, i.e., Shenzhen reaching 14 percent, Huhhot 12.2 percent, Dalian 11.7 percent, and Nanchang 10 percent. The sale prices of previously-owned housing increased by 5.8 percent on a year-on-year basis; the sale prices of newly-completed non-residential commercial housing rose by 4.5 percent.

The growth of commercial real estate loans accelerated with each passing month. Specifically, real estate development loans grew substantially on a year-on-year basis. At end-June 2006, outstanding commercial real estate loans totaled 3.4 trillion yuan, up 20.6 percent on a year-on-year basis, and up 395.2 billion yuan or accelerating by 162 billion over that recorded at the beginning of 2006. Outstanding real estate development loans amounted to 1.3 trillion yuan, growing by 213.2 billion over that in the beginning of 2006, representing an acceleration of 134.6 billion yuan; and up 28.9 percent on a year-on-year basis, an acceleration of 10.2 percentage points respectively on a year-on-year basis. Outstanding mortgage loans totaled 2.1 trillion yuan, growing by 182.0 billion over that at the beginning of 2006, representing an acceleration of 27.5 billion yuan; and up 15.9 percent on a year-on-year basis, a deceleration of 9.7 percentage points.

(2) The textile industry

At present, the textile industry generally shows a good trend of development. Production, sales, exports, and profits all increased substantially. In 2005, the statistically large textiles enterprises realized added value of 499.9 billion yuan, up 25.3 percent. The total sales income reached 2 trillion yuan, up 26.3 percent. The total profits registered 69.0 billion yuan, up 35.8 percent. The sales profit margin was 3.48 percent, up 0.17 percentage points year on year. Total exports of textiles and garments amounted to US$117.5 billion, growing 20.7 percent year on year and accounting for about 24 percent of the total global textiles and garments trade volume or 15.4 percent of the total national exports. At present, there are over 19.60 million employees in the textile industry. Specifically, there are 9.78 million employees in the statistically large enterprises. The textile industry, as one of the major labor-intensive industries, has fully utilized China’s comparative advantage and made very positive contributions to creating employment and improving living standards and economic development.

Following the exchange rate regime reform, the textile industry responded actively to the fluctuations in the RMB exchange rate, and took such measures as upgrading orders, using more settlement currencies, assessing the internal costs in terms of the exchange rate, increasing the prices of exports, and strengthening industrial clusters. Due to its efforts to transform the growth patterns and to upgrade technology, and the availability of cheap and skilled labor, to some extent China's textile industry has managed to remain competitive. In 2005, textiles and garments realized a trade surplus of US$100.44 billion. In the first half of 2006, textiles and garments exports amounted to US$62.6 billion, growing 24 percent and accelerating by 3 percentage points on a year-on-year basis.

Generally, China's textile industry grew rapidly and strengthened its competitiveness substantially. With the expansion of the industry and the changes in market demands, however, international competition became fiercer, resource and environmental constraints further intensified, and some persistent and deep-rooted problems became more prominent. First, the industry lacks the capacity for independent innovation. Investment in research and development is less than 1 percent of the sales revenue in the entire industry, and most high-tech and high-end textile equipment must depend on imports. Capability for brand designs and independent marketing is weak, as exports are mainly products processed on behalf of foreign brands. The domestic textile industry has just begun to export its own brands to the international market. Second, structural imbalances are acute. Of the three major categories of textile products, i.e., garments, home textiles, and industrial textiles, the labor-intensive garment processing faces fierce competition, and the proportion of industrial textiles with a high technology content is small. Many enterprises are small and scattered, and not competitive. Large-sized enterprises generally lack core technology and the capability for cross-border resources allocation. There is a large gap between the eastern regions and the central and western regions. Third, resources and the environment represent the main constraints on the development of the industry. Fourth, the development of the textile industry varies greatly from locality to locality, and market competition needs to be regulated.

Confronted by the challenges at home and abroad and the industrial structural imbalances, the textile industry at present faces a pressing task to vigorously promote structural adjustment, transform growth patterns, and facilitate industrial upgrading. In April 2006, the National Development and Reform Commission (NDRC), the PBC, and 8 other agencies jointly issued the *Notice on Some Opinions on Stepping Up Structural Adjustment and Promoting Industrial Upgrading in the Textile Industry*, expounding on the main principles and the overall line of thinking of focusing on the structural adjustments in the textile industry. The textile industry should make use of the current strategic period, adhere to the scientific approach of development, promote technological progress in an all-round way, step up independent innovation, transform the mode of economic growth, and maintain sustained and healthy development.

Part 5 The Monetary Policy Stance to be Adopted in the Period Ahead

I. Macroeconomic outlook

Since 2006, the national economy has maintained steady and rapid growth, with GDP growth in the second quarter reaching another high in this round of the economic cycle. Due to the effects of various policy measures that continue to strengthen macroeconomic management, economic growth in the second half of 2006 is expected to moderate slightly. However, in general, the economy will continue to grow at a steady and relatively fast pace.

With respect to investment demand, a series of recently introduced measures by the government to strengthen land and credit management and to strictly control newly started projects will gradually produce effects. However, factors such as the relatively high household savings rate, the large accumulation of enterprise funds, the continued inflow of foreign investment, and implementation of the Eleventh Five-year Plan projects will continue to promote rapid growth of investment. With respect to consumer demand, domestic consumption will continue to rise. In 2005, the per capita disposable income of China's urban residents increased by 9.6 percent in real terms, representing the fastest growth in the recent five years; the real growth of per capita net income of rural residents registered 6.2 percent, increasing by above 6 percent for two consecutive years. The rapid growth in household income in the first half of 2006, the upgrading of the household consumption structure driven by autos, communication products, and housing, and measures such as increases in the minimum salary of urban residents and in the wages of public servants, the improvement in the minimum living allowance, and the deepening reform of the income distribution system will all continue to improve household expectations of income and expenditures. Therefore, it is predicted that consumption will remain strong in the second half of 2006. As to foreign trade, fairly rapid growth of China's exports will continue to be supported by the acceleration of global economic growth in 2006 and the favorable economic prospects of China's major trading partners, including the United States, Japan, and the European countries.

Uncertainties still remain in terms of future price movements, but the upward risks outweigh the downward risks, leading to increased inflationary pressures. With respect to the downward risks, the excess capacity in production materials in certain sectors and consumer goods will constrain the rise in prices of related products; furthermore, the expected increase in grain output will subject grain prices to downward risks, which is also likely to become a factor lowering the CPI. The upward risks can be summarized as follows. First, since the rapid growth of investment and exports will further boost the demand for production materials and investment goods, the future prices of production materials will be under upward pressures. Second, the reform of the prices of resource goods will continue to push up the level of future prices. Third, the slightly fast growth of money and credit will build pressures on future prices. Fourth, the stricter requirements for environmental protection by enterprises, labor security, and workplace safety will contribute to higher costs for enterprises. Given the acceleration of China's economic growth in the second quarter and the prospects for robust global economic expansion, the general price level is unlikely to fall in the near future, while inflationary pressures will build up, in particular in the prices of services and assets. According to the PBC survey on urban household savings in the second quarter of 2006, 24.4 percent of the respondents thought that prices were unduly high, 2.3 percentage points higher than in the previous quarter, and the future price expectation index rose by 12.3 percentage points from the previous quarter, indicating stronger inflation expectations.

In general, the national economy will continue to grow at a steady and relatively rapid pace. However, serious attention should be paid to monitoring the risks brought about by the excessive growth in fixed-asset investment, the oversupply of money and credit, international payments imbalances, excessive energy consumption, increasing pressures on the environment, and the potential rise in inflationary pressures.

II. Monetary policy stance to be adopted in the period ahead

At present, the terms of supply pose few constraints on China's economic performance, and various parties have strong incentives to accelerate development, while resource and environmental costs are insufficient to constitute effective hard constraints. Against the backdrop of serious structural imbalances and continued "twin surpluses" in the balance of payments, there remains the arduous task of reining in the faster-than-desired growth of money and credit. The PBC will continue to implement the State Council's plans and decisions on economic work and will apply a mix of monetary policy instruments to strengthen liquidity control, appropriately control money and credit growth, and maintain a balance at the aggregate level. Meanwhile, medium- and long-term measures should be taken to speed up the implementation of various policies, such as boosting domestic demand, accelerating economic restructuring, and promoting the basic equilibrium of the BOP so as to switch to a domestic demand-led economic development strategy that stresses both domestic and external demand.

There are various reasons behind the persistently large surpluses in the BOP, including factors such as cross-border outsourcing and acceleration of supply chains restructuring in the process of globalization, and reflecting the structural imbalances of the high savings rate and low consumption rate. Transformation of the growth pattern that is overly dependent on investment and export growth is imperative. Developing an export-oriented economy and promoting the economic opening-up are essential to China’s economic miracles achieved in the past 25 years. However, the development of an export-oriented economy does not contradict efforts to boost domestic demand. The purpose of advancing an export-oriented economy is to bring into play our competitive advantages through participation in the international division of labor to enhance our productivity and promote industrial upgrading. The current development of an export-oriented economy calls for continued efforts to enhance the degree of opening-up and the transformation of the foreign trade growth pattern, which is complementary to a stronger domestic demand. Promoting balanced international payments is key to effectively coordinating the two strategies, which becomes a priority in the current economic strategy transformation and policy selection, and provides an effective way to improve macroeconomic management.

Addressing international payments imbalances cannot rely solely on exchange rate appreciation. Instead, measures should be adopted to boost domestic demand, particularly consumption demand, to reduce the savings rate, adjust the preferential policies for foreign investment, expand exports, and further open the market and other structural policies, along with exchange rate movement to solve the problem of imbalances.

Steps should be taken to expand imports and open the market to reduce trade surpluses. At present, efforts should be made to promote the transformation of the trade growth pattern from quantitative expansion to pursuing quality and efficiency. Imports of advanced technologies, important raw materials, and equipment should be encouraged and an import-promoting mechanism should be established and improved. Meanwhile, restrictions on market access should be appropriately removed, the opening-up of the services trade sector should be promoted, and efforts to protect intellectual property rights and to introduce technologies should be intensified to moderate the growth of trade surpluses under the current account.

Preferential policies for foreign investment should be adjusted to foster fair competition. The unification of the taxation system for domestic and foreign enterprises should be accelerated to promote fair competition. The effective use of foreign investment should be facilitated and behavior to attract foreign investment should be regulated. In addition, foreign trade policies that encourage exports while limiting imports, foreign exchange management policies that relax controls on outflows and impose restrictions on inflows, and excessive import substitution policies should be properly adjusted.

Investment overseas should be promoted and the growth of foreign exchange reserves should be decelerated. Steps should be taken to promote a change in the holding and investing of foreign exchange reserves from the government to the private sector, to implement an “going abroad” strategy, and to establish market-based diversified channels with multi layers for investment overseas and to promote the effective use of foreign exchange resources so as to support a balanced and sustainable growth of the economy.

Efforts should also be made to appropriately give play to the unique role of the exchange rate in achieving balance on an aggregate level, structural adjustments, and the transformation of the economic development strategy. The exchange rate policy, as part of the economic policy package, could play a certain role in adjusting the BOP imbalances. Since the reform of the RMB exchange rate regime on July 21, 2005, China has established a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies, under which the RMB is no longer pegged to the US dollar. Since the reform, overall economic and financial performance has remained stable. As the next step, efforts should be made to further improve the regime in a self-initiated, controllable, and gradual way so as to keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

The most fundamental way to reduce the large BOP surpluses is to boost domestic demand, and efforts should be made in particular to expand consumption and reduce the savings rate, which will not only help to improve the economic growth pattern, but also will directly consume part of the exports and increase the demand for imports. To reduce the savings rate, efforts should be focused on reducing households’ future uncertainties and to stabilize expenditure expectations through a reform of the pension, medical care, education, and housing systems. Measures should also be taken to increase household income, improve the distribution relationship, enhance household consumption capabilities, accelerate the development of the services sector, and promote consumption in rural areas. Enterprises will be encouraged to appropriately reduce the proportion of retained earnings and to increase dividend payments. Moreover, steps should be taken to strengthen the role of fiscal policy in promoting economic restructuring, to optimize the fiscal expenditure structure, to increase the supply of public goods, to intensify support for social undertakings, to speed up the transformation of government functions, and to strengthen social management and public services.