China Monetary Policy Report
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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the third quarter of 2007, the Chinese economy maintained a momentum of steady and rapid growth. Primary industry, secondary industry, and the services industry all realized relatively rapid growth with enhanced economic efficiency and improvement in the people's livelihood. In the first three quarters, GDP grew by 11.5 percent and the CPI rose by 4.1 percent year on year.

Since the third quarter, the PBC, according to the State Council's overall arrangements, implemented an appropriately tight monetary policy to strengthen macro-economic management, address the excess liquidity in the banking system and ease the pressures on money and credit expansion, and strike a balance at the aggregate level. On three occasions, the PBC increased the reserve requirement ratios of financial institutions by 0.5 percentage points and raised the benchmark interest rates on loans and deposits of financial institutions. Meanwhile, efforts were made to guide the optimization of the credit structure, steadily promote financial institutional reform, further enhance the elasticity of the RMB exchange rate, and speed up foreign exchange administration reform to promote harmonious economic and financial development.

In the third quarter, financial performance generally remained stable, but there were still great pressures on money and credit expansion, and deposits continued to tilt toward demand deposits while loans grew rapidly. At end-September 2007, outstanding broad money M2 amounted to 39.3 trillion yuan, an increase of 18.5 percent year on year and up 1.7 percentage points from the previous year. Outstanding RMB loans grew by 17.1 percent year on year to 25.9 trillion yuan, up 1.9 percentage points from the same period of 2006, representing an increase of 3.36 trillion yuan over the beginning of the year and an acceleration of 607.3 billion yuan. The elasticity of the RMB exchange rate was further strengthened with the exchange rate moving in both directions. At end-September, the central parity of the RMB against the US dollar was 7.5108 yuan per US dollar, an appreciation of 3.97 percent over the end of 2006.

In general, against a background of a robust domestic economy, China is likely to maintain its steady and rapid growth momentum. However, it should be noted that problems such as overinvestment, an excessively large trade surplus, and too much expansion of credit are yet to be resolved. Furthermore, economic operations are plagued by newly emerging problems of heightened inflationary pressures and a persistent rise of asset prices. Increased uncertainties in global economic and financial operations also add to the potential risks of the domestic economy.

In line with the overall strategy of the CPC Central Committee and the State Council, the PBC will continue to implement a sound monetary policy stance featuring moderate tightening and will apply a mix of policy measures to appropriately strengthen macro-economic adjustments, so as to keep money and credit growth at a reasonable level, to prevent the economy from growing at a relatively fast pace to overheating, and to promote economic development in a good and relatively rapid manner. The PBC will adopt a combination of sterilization measures to further strengthen liquidity management and effectively ease the excess liquidity in the banking system. The leveraging role of prices in macro-economic adjustments will be strengthened by improving coordination between interest rate and exchange rate policies to stabilize inflation expectations. The market-based interest rate reform will be steadily advanced, and the establishment of a benchmark interest rate system in the money market will be promoted. The PBC will continue to follow the policy of improving the RMB exchange rate formation mechanism in a self-initiated, controllable, and gradual manner, further giving market supply and demand a fundamental role in the RMB exchange rate formation, strengthening the RMB exchange rate flexibility, and maintaining the exchange rate at an adaptive and equilibrium level. Reform of the foreign exchange management system will be strengthened to improve monitoring, guidance, and administration of capital flows. The PBC will further improve window guidance and the direction of credit policy for financial institutions and will guide the commercial banks to prevent risks arising from rapid business expansion and to improve the credit structure.

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Part 1 Monetary and Credit Performance

In the third quarter of 2007, the national economy continued to grow steadily and rapidly, with the financial industry performing in a sound manner. However, great pressures still remained on money and credit expansion, and deposits continued to tilt toward demand deposits while loans grew rapidly.

I. Money supply still grew somewhat rapidly

At end-September 2007, outstanding broad money M2 amounted to 39.3 trillion yuan, an increase of 18.5 percent year on year, up 1.7 percentage points from the previous year. Narrow money M1 reached 14.3 trillion yuan, an increase of 22.1 percent year on year, up 6.4 percentage points over the same period of 2006. The relatively fast growth of the money supply was mainly due to the good performance of enterprises and the active capital market. Broken down by the components of the money supply, the high growth of M1 was mainly attributable to the rapid growth of demand deposits; among the various components of quasi-money in M2, time deposits of enterprises witnessed rapid growth, and other deposits, especially deposits in margin accounts of securities companies, grew rapidly, but growth of households' savings deposits continued their decline since 2006. Cash in circulation M0 grew by 13 percent year on year to 2.9 trillion yuan, down 2.3 percentage points over the same period of 2006. Net cash injections in the first three quarters of 2007 totaled 195.8 billion yuan, 30.2 billion yuan more than in the previous year.

II. Deposits of financial institutions continued to tilt toward demand deposits

At end-September 2007, outstanding deposits of all financial institutions denominated in both RMB and foreign currencies increased by 16 percent year on year to 39.5 trillion yuan, a deceleration of 0.4 percentage points from the previous year. In particular, outstanding RMB deposits rose by 16.8 percent year on year to 38.3 trillion yuan, a deceleration of 0.4 percentage points from the previous year, but 4.75 trillion yuan more than that at the beginning of 2007 and 589.3 billion yuan more than the increase during the same period of 2006. Outstanding foreign currency deposits totaled US$159.3 billion, down 0.8 percent from the previous year.

Broken down by sectors and maturities, household RMB deposits grew slowly while

RMB deposits of non-financial companies accelerated. Moreover, both households and enterprises preferred demand deposits. At end-September, outstanding household RMB deposits grew by 6.9 percent year on year to 17.2 trillion yuan, representing a deceleration of 9.2 percentage points from a year earlier and an increase of 762.1 billion yuan from the beginning of 2007, but 971 billion yuan less than the increase during the same period of 2006. In particular, the growth of household demand deposits decelerated by 40.5 billion yuan, whereas household time deposits increased by 930.5 billion yuan less than during the same period of 2006. Against the background of consecutive interest rate hikes, cuts in the interest tax, and increasing risks in the capital market, the willingness of households to save recovered, so the decline in household deposits was 213 billion yuan less than that during the second quarter. At end-September, outstanding non-financial corporate deposits stood at 18.3 trillion yuan, representing growth of 24.9 percent year on year and up 9.1 percentage points from the previous year. Outstanding corporate deposits increased by 40 percent year on year to 15 trillion yuan, representing an increase of 2.4 trillion yuan from the beginning of 2007 and an acceleration of 1.2 trillion yuan from the same period of 2006. In particular, corporate demand deposits and time deposits accelerated by 509.8 billion yuan and 714.7 billion yuan respectively. Outstanding fiscal deposits grew by 44 percent to 2.1 trillion yuan at end-September, representing an increase of 1 trillion yuan from the beginning of 2007 and an acceleration of 352.7 billion yuan from a year earlier.

III. Loans of financial institutions grew relatively rapidly

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 27.4 trillion yuan at end-September 2007, representing a growth of 17.3 percent year on year and an acceleration of 2.7 percentage points from the same period of 2006, an increase of 3.6 trillion yuan from the beginning of 2007 and an acceleration of 765.6 billion yuan. In particular, outstanding RMB loans grew by 17.1 percent year on year to 25.9 trillion yuan, up 1.9 percentage points from the same period of 2006, representing an increase of 3.36 trillion yuan over the beginning of the year and an acceleration of 607.3 billion yuan. Outstanding foreign currency loans rose by 27.3 percent year on year to US$205.7 billion, up 19.6 percentage points from the same period of 2006, representing an increase of US$37 billion over the beginning of 2007 and an acceleration of US$25.2 billion from the previous year. Broken down by institutions, RMB loans of the various financial institutions accelerated.

Table 1:RMB Lending by Financial Institutions in the First Three Quarters of 2007

Unit: 100 million yuan

	The first three quarters of 2007 New Loans	The first three quarters of 2006 New Loans
Policy banks	3354	2171
State-owned commercial banks	12657	11209
Joint-stock commercial banks	6671	5879
City commercial banks	2749	2362
Rural financial institutions	5682	4468
Foreign financial institutions	1114	604

Note: Rural financial institutions include rural cooperative banks, rural commercial banks, and rural credit cooperatives.

Source: The People's Bank of China.

In terms of the sectoral distribution and maturity of the RMB loans, outstanding loans to households accelerated markedly and outstanding loans to non-financial companies and other sectors declined somewhat. With the remarkable surge in housing prices in some regions and the improvement in households' income expectations, household borrowing demands increased significantly, especially demands for medium and long-term consumer loans that focused on housing loans. At end-September 2007, outstanding loans to households increased by 30.4 percent year on year, up 11.8 percentage points from the same period of 2006, representing an increase of 1.1 trillion yuan from the beginning of 2007 and an acceleration of 516.4 billion yuan from the same period of 2006. In particular, consumer loans increased by 687.3 billion yuan from the beginning of 2007, and medium and long-term consumer loans increased by 583.7 billion yuan from the beginning of 2007. Loans to non-financial companies and other sectors increased by 14.4 percent year on year, down 0.2 percentage points from a year earlier, representing an increase of 2.3 trillion yuan from the beginning of 2007 and an acceleration of 90.9 billion yuan year on year. The growth rate of paper financing dropped rapidly, 148 billion yuan less than at the beginning of 2007, whereas medium and long-term loans grew by 1.4 trillion yuan from the beginning of 2007.

In terms of loan destinations, the bulk of RMB medium and long-term loans went to infrastructure sectors, the real estate industry, and the manufacturing sectors, but the share of new medium and long-term loans to the real estate industry and high-energy-consuming industries declined. In the first three quarters of 2007, the total RMB medium and long-term loans of major financial institutions (including policy banks, state-owned commercial banks, joint-stock commercial banks, and city commercial banks) to the infrastructure sectors (including the transportation, storage and postal services, electricity, gas, and water production and supply, water conservancy, and environmental and public facility management sectors), the real estate industry, and the manufacturing industries amounted to 1.1 trillion yuan, accounting for 54.3 percent of the total new medium and long-term loans. The shares of medium and long-term loans to the real estate industry and six high-energy-consuming industries (including the steel, non-ferrous metals, construction material, electricity, oil refinery and coking, and the chemical industries) were 15 percent and 11 percent respectively, down 5.2 and 5.7 percentage points respectively from the same period of 2006.

IV. Base money grew at a stable pace after deducting the effect of the reserve requirement ratio hikes, and the excess reserve requirement ratio remained stable

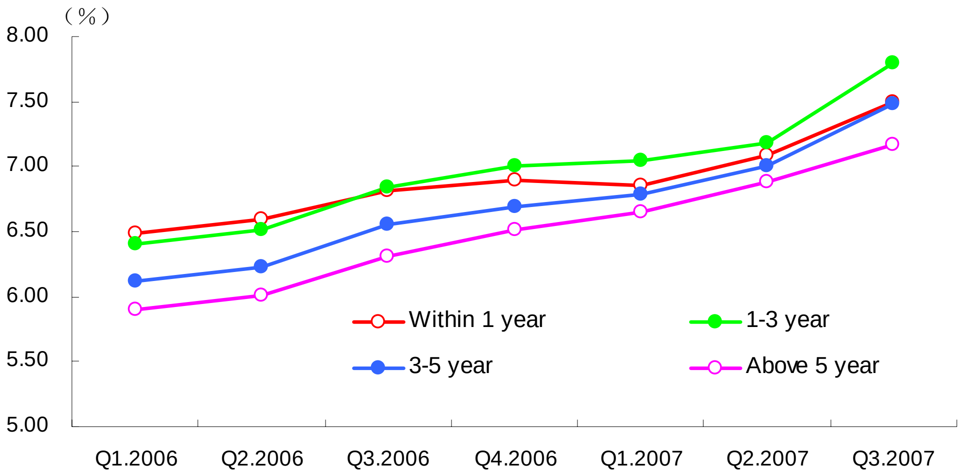
At end-September, the outstanding balance of base money increased by 33 percent year on year to 8.8 trillion yuan, representing an increase of 1 trillion yuan from the beginning of 2007 and an acceleration of 843.7 billion yuan from a year earlier. The rapid growth of base money was mainly caused by several hikes in the reserve requirement ratios since the second half of 2006, the reason being that according to the current statistical coverage, required reserves are included in the base money but central bank bills are not. If liquidities frozen by the hike in the reserve requirement ratio since 2006 were instead sterilized by the issuance of central bank bills, the current growth of base money would be lower than 10 percent. Meanwhile, the money multiplier continued to decline. At end-September, the money multiplier (broad money M2/base money) was 4.46, down 0.55 from a year earlier. The excess reserve ratio of financial institutions averaged 2.8 percent at end-June, up 0.28 percentage points from a year earlier, but down 0.2 percentage points from end-June. In particular, the excess reserve ratio of the state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 1.97 percent, 4.10 percent, and 5.14 percent respectively.

V. Lending rates of financial institutions rose steadily

In the third quarter of 2007, the weighted average interest rates of 1-year, 1-3 years, 3-5 years, and above 5-year loans of financial institutions were 7.50 percent, 7.80 percent, 7.43 percent, and 7.16 percent respectively, up 0.41 percentage points, 0.62 percentage points, 0.42 percentage points, and 0.28 percentage points from the previous quarter. The weighted average interest rate of 1-year RMB loans of commercial banks was 7.15 percent, up 0.4 percentage points from the second quarter.

Among all loans issued by financial institutions, the share of loans with interest rates floating downward from the benchmark rate was up 1.74 percentage points from the second quarter, whereas the share of loans with interest rates at the benchmark rate declined by 2.48 percentage points and the share of loans with interest rates floating upward from the benchmark rate increased by 0.74 percentage points.

Figure 1: Lending Rates for Different Maturities by Financial Institutions since 2006



Source: The People's Bank of China.

Table 2: Share of Loans with Floating Rates in Various Ranges in the Third Quarter of 2007

Unit：percent

	Total	Floating downward	At bench-mark	Floating upward				
		[0.9,1.0)	1	Subtotal	(1.0,1.3]	(1.3,1.5]	（1.5,2]	Above 2
Total	100	28.59	26.65	44.76	26.35	7.61	9.35	1.53
State-owned commercial banks	100	34.41	28.71	36.88	34.50	1.94	0.41	0.03
Joint-stock commercial banks	100	41.17	32.65	26.19	25.39	0.47	0.16	0.15
Regional commercial banks	100	38.13	17.75	44.12	30.99	8.46	4.02	0.65
Urban and rural credit cooperatives	100	2.50	4.48	93.02	19.99	26.83	39.79	6.41
Policy banks	100	22.61	75.86	1.53	1.55	0	0.01	0.01

Source: The People's Bank of China.

The inter-bank deposit rate of financial institutions continued to rise. Inter-bank demand deposits accounted for 92.83 percent, with a weighted average interest rate of

1.45 percent, up 0.04 percentage points from the previous quarter; the share of inter-bank time deposits was 7.17 percent, with a weighted average interest rate of 3.14 percent, up 0.56 percentage points from the previous quarter.

The interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) increased month by month. In the third quarter, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 5.28 percent, up 0.78 percentage points from the previous quarter; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 5.15 percent, up 0.59 percentage points from the previous quarter.

The interest rates of large-value foreign currency deposits and foreign currency loans in China fluctuated slightly.

Table 3:Average Interest Rates of Large-value Dollar Deposits and Loans January through September of 2007

Unit：percent

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.
I. Large-value Deposits:									
Within 3 months	4.3192	4.1626	4.3773	4.3949	4.4756	4.5441	4.2490	4.5101	4.4244
3-6 months	5.1244	5.2424	5.1802	4.7302	4.9277	5.2338	5.2404	5.1916	4.9672
6-12 months	5.0632	5.3322	4.8745	5.2713	5.0535	5.3547	5.0300	4.9929	4.7331
1 year	5.0020	4.3134	4.7066	5.0930	4.8413	5.0009	4.2010	5.3843	4.9235
II. Loans:									
1 year (fixed)	6.2037	6.0972	6.0174	6.1770	6.1330	6.1259	6.1226	6.0023	6.0240
1 year (monthly floating)	6.0936	6.2679	6.1866	6.1435	6.1963	6.1656	6.2601	6.2388	6.2053

Source: The People's Bank of China.

VI. The elasticity of the RMB exchange rate was further strengthened, with the exchange rate floating in both directions

The fundamental role of market supply and demand continued to function well, and in general the RMB exchange rate appreciated. At end-September, the central parity of the RMB against the US dollar was 7.5108 yuan per US dollar, an appreciation of 2979 basis points or 3.97 percent over the end of 2006; the central parity of the RMB against the euro and the Japanese yen was 10.6312 yuan per euro, and 6.5091 yuan per 100 Japanese yen, a depreciation of 3.43 percent and an appreciation of 0.83 percent respectively. Beginning with the exchange rate regime reform in 2005 up until the end of September 2007, the RMB cumulatively appreciated by 10.19 percent and 12.24 percent against the US dollar and the Japanese yen respectively, but it cumulatively depreciated by 5.80 percent against the euro.

The RMB exchange rate fluctuated in both directions, with its elasticity further strengthened, and the linkage of the RMB exchange rate with the major currencies was obvious. The peak and bottom central parities of the RMB against the US dollar were 7.5050 yuan per US dollar and 7.8135 yuan per US dollar respectively. Among the 182 trading days in the first three quarters, the inter-bank foreign exchange market saw RMB appreciations for 108 days and RMB depreciations for 74 days. In 36 trading days, the central parity of the RMB against the US dollar appreciated above 0.1 percent, and the largest appreciation in a single business day was 0.41 percent (310 basis points) above 0.3 percent before May 21, 2007. In 14 trading days, the central parity of the RMB against the US dollar depreciated above 0.1 percent, and the largest depreciation in a single business day was 0.27 percent (209 basis points). The daily fluctuation of the central parity averaged 57 basis points, much larger than the average of 40 basis points recorded in 2006. At the same time, the fluctuation of the RMB exchange rate against the US dollar in the inter-bank foreign exchange market intensified; in particular, the daily volatility in the OTC market was above 0.1 percent in 63 trading days, more than one-third of the total trading days, with the largest volatility reaching 0.27 percent (207 basis points). In the automatic matching market, the daily volatility was above 0.1 percent in 33 trading days, more than one-sixth of the total trading days, with the largest volatility of 0.38 percent (300 basis points).

Part 2 Monetary Policy Conduct

In the third quarter of 2007, given the continued excess liquidity in the banking system and huge pressures on money and credit expansion, the PBC, according to the State Council's overall arrangements, implemented an appropriately tight monetary policy to strengthen macro-economic management, address the excess liquidity in the banking system and ease the pressures on money and credit expansion, and strike a balance at the aggregate level. Moreover, the PBC made efforts to guide the optimization of the credit structure, steadily promote financial institutional reform, further enhance the flexibility of the RMB exchange rate, and speed up foreign exchange administration reform so as to promote harmonious economic and financial development.

I. Comprehensive measures were taken to strengthen liquidity management

In the third quarter of 2007, the PBC carried out its monetary policy by means of open market operations and reserve requirement policies in an effort to siphon off the liquidity in the banking system.

In open market operations, first, the PBC strengthened the issuance of central bank bills. Since July 2007, due to the complicated uncertainties that affect liquidities in the banking system, the PBC properly arranged a combination of open market operation instruments and their duration with consideration of factors that affect the supply of liquidity, such as the RMB counterpart of foreign exchange reserves and maturities of central bank bills and fiscal deposits in the central bank as well as changes in the financial market. The issuance of central bank bills totaled 991 billion yuan, up 175 billion yuan from a year earlier, with outstanding central bank bills amounting to 3.9 trillion yuan at end-September, an increase of 0.9 trillion yuan from end-2006. Second, in addition to issuing central bank bills, the PBC conducted repos with special treasury bonds to assist siphoning off the excess liquidity in the banking system. On August 29, 2007, the PBC bought from domestic commercial banks 600 billion yuan of the first tranche of special treasury bonds issued by the Ministry of Finance. On September 4, 2007, in addition to the central bank bills, the PBC initiated repo business pledged with special treasury bonds to increase the flexibility of open market operations. As of November 1, total withdrawn liquidity through repo with special treasury bonds amounted to 230 billion yuan. Third, the market-based issuance of central bank bills was combined with specialized issuances. To maintain an appropriate growth of money and credit, the PBC issued 353 billion yuan of 3-year special central bank bills in July, August, and September respectively to effectively absorb liquidity and halt the relatively rapid increase of credits of banks that experienced fast credit growth and held sufficient liquidity. At the same time, the PBC maintained the intensity of market-based issuances of central bank bills. Fourth, the issuance rate of central bank bills was driven up properly. In the third quarter of 2007, in line with the hike in the benchmark deposit and lending rates, the issuance rate for 3-month, 1-year, and 3-year central bank bills rose by 16, 35, and 32 basis points respectively, affecting market interest rate movements so as to adjust fund supply and demand through the interest rate.

To enhance the efficiency and more actively absorb liquidity, the PBC raised the reserve requirement ratio on August 15, September 15, and October 25 by 0.5 percentage points respectively to meet the need for liquidity management. Furthermore, the PBC continued to differentiate the reserve requirement ratios of different financial institutions, namely, financial institutions whose capital adequacy ratio is below a certain threshold and whose NPL ratio is above a certain number will be charged with a relatively high reserve requirement ratio. In September, in line with the standard for the differentiated reserve requirement ratios, a financial institution whose capital adequacy ratio and other indicators reached certain standards would be allowed to implement the normal reserve requirement ratio. Accordingly, the number of financial institutions charged with the differentiated reserve requirement ratio fell markedly. In general, since the implementation of the differentiated reserve requirement ratio, good results have been achieved in containing the blind credit expansion of financial institutions whose capital adequacy ratio is relatively low and that have rather poor quality assets, and in promoting the financial institutions' sound operations. Financial institutions charged with the differentiated reserve requirement ratio actively took measures to increase their capital and to adjust the structure of their assets and liabilities so that their capital adequacy ratios were enhanced significantly.

II. Interest rates played a leveraging role

In the third quarter, the PBC raised the benchmark interest rates on loans and deposits of financial institutions on three occasions, namely July 21, August 22, and September 15, 2007. The 1-year benchmark deposit rate was raised by 0.27 percentage points on each occasion to 3.87 percent from the original of 3.06 percent. The 1-year lending rate was raised by 0.27, 0.18, and 0.27 percentage points respectively from 6.57 percent to 7.29 percent. Interest rates on deposits and loans of other maturities were adjusted accordingly.

From the beginning of 2007, the PBC raised the benchmark interest rates on loans and deposits on five occasions. The 1-year benchmark deposit rate and lending rate were cumulatively raised by 1.35 percentage points and 1.17 percentage points respectively. The cumulative effect of the interest rate policy will gradually play a role: first, the appropriate increase in funding costs will help adjust money and credit expansion and restrain excess investment; second, consecutive interest rate hikes will help guide the direction of households' capital movements and stabilize market inflation expectations. Against the background of increasing price levels, this will help the central bank protect depositors' interests by increasing deposits' returns and maintaining a positive real interest rate. According to the households' savings questionnaire, the decline in households' willingness to save slowed down markedly. Under the current price and interest rate levels, the proportion of households considering "more savings" as reasonable declined by 5.6 percentage points, 4 percentage points, and 0.9 percentage points in the first quarter, second quarter, and third quarter respectively. In the third quarter, the drop in the outstanding balance of savings deposits was moderate to a certain extent. During the period of 5 hikes in the benchmark deposit and lending rate, the PBC appropriately narrowed the interest rate spread of financial institutions. For example, the 1-year benchmark interest rate spreads after each interest rate adjustment were 3.6 percent, 3.51 percent, 3.51 percent, 3.42 percent, and 3.42 percent respectively, representing a narrowing of the interest rate spread from 3.6 percent at the beginning of 2007 to 3.42 percent, cumulatively 0.18 percentage points less than that at the beginning of 2007.

The establishment of a benchmark interest rate system in the money market was advanced steadily. After the Shanghai Inter-bank Offered Rate (Shibor) was formally launched on January 4, 2007, it functioned well. The Shibor's rationality and stability were strengthened continuously and its relation with the inter-bank borrowing rate and repo rate in the money market was gradually normalized. Furthermore, the role of the Shibor in guiding pricing was enhanced. Many key products in the money market used the Shibor as the benchmark rate, and many new financial products on the basis of the Shibor emerged in the market, especially interest rate derivatives; for example, interest rate swaps based on the Shibor witnessed very brisk trading.

III. Window and credit policy guidance was strengthened

In the third quarter of 2007, the PBC continued to strengthen the role of window and credit policy guidance to convey the purpose of the macro-adjustment measures, alert the commercial banks of the risks arising from an excessively rapid growth of loans and of the problems stemming from the maturity mismatch between assets and liabilities, and guide them in controlling the size and pace of credit extension. The PBC also focused on guiding commercial banks to optimize the credit structure, control medium and long-term loans for infrastructure, strongly limit lending to weak enterprises in industries with high energy consumption, heavy pollution, or excess production capacity, strengthen credit support to the rural economy, job creation, students, small and medium-sized enterprises, energy conservation and environmental protection, and self-initiated innovation, expand their fee-based businesses, strengthen financial product innovation, and transform profit-generating modes. The credit policy for commercial real estate was revised to stringently manage housing loans, focus on supporting the borrowing needs of customers to purchase their first owner-occupied residential housing, and to increase the down payment ratio and interest rate for second housing loans.

IV. Reform of financial institutions was promoted

Great achievements were made in the joint-stock reform of state-owned commercial banks, and the new institutions and new regimes gradually showed their effects. Through the share-holding reform, the state-owned commercial banks, according to international practices, improved their corporate governance structure, earnestly transformed their management mechanism, strengthened internal control and risk management, and accelerated the transformation of their business, establishment of process-oriented banks, and reform of branch networks. The reforming banks gradually realized cooperation with their strategic investors, and launched new cooperation in global cash management, corresponding bank business, trade services, etc. Service quality and efficiency, capital adequacy ratio, asset quality, profitability, and other financial indicators of the state-owned commercial banks improved markedly. As of end-September 2007,[1] the capital adequacy ratio of the Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Bank of Communications reached 13 percent, 13.4 percent, 12.5 percent, and 14.4 percent respectively, with NPL ratios of 3.1 percent, 3.6 percent, 2.8 percent, and 2.1 percent and profits before taxes of 91.4 billion yuan, 75.5 billion yuan, 83.8 billion yuan, and 22.6 billion yuan respectively. The China Construction Bank successfully issued 9 billion A-shares and raised 58.1 billion yuan after its IPO on the Shanghai Stock Exchange on September 25, 2007. As a result, the four reforming banks had realized IPOs in both Hong Kong and Shanghai, which not only offered good investment opportunities for investors but also further supported the domestic capital market. The

[1] The capital adequacy ratio and the NPL ratio for the Bank of China are as of end-June 2007.

fundamental share-holding reform of the Agricultural Bank of China has registered great achievements, and relevant government departments are making efforts to discuss the feasibility of the reform plan.

The reform of the rural financial cooperative institutions also underwent important advances and produced good results. First, a financial support policy was gradually implemented to resolve the historical burdens. The special bills on a pilot basis began to be redeemed. At end-September, 54.8 billion yuan worth of special bills in 835 counties (cities) of Jiangsu and 20 other provinces (autonomous regions and municipalities) were redeemed. With the implementation of the financial support policy, the quality of assets of rural financial cooperative institutions was improved remarkably. At end-September, according to the four-category loan classification system, the outstanding balance of the non-performing loans of the rural financial cooperative institutions totaled 293.8 billion yuan, a decline of 220.7 billion yuan from end-2002. The NPL ratio was 9.2 percent, down 27.7 percentage points from end-2002. Accumulated losses stood at 47.3 billion yuan, a reduction of 84.1 billion yuan from end-2002. The capital adequacy ratio reached 10.9 percent. Second, businesses developed rapidly and capital strength was enhanced markedly. By end-September, the deposits and loans of the rural financial cooperative institutions increased by 118 percent and 121 percent respectively compared with end-2002, securities and investment were up1.6-fold, the outstanding balance of equities was up 3.99-fold, and the share of their loans to the total credits of all financial institutions increased from 10.6 percent to 12.3 percent. Third, their credit support to the rural economy and rural households increased steadily. At end-September, the share of outstanding agricultural loans of the total loans of the rural financial cooperative institutions increased from 40 percent at end-2002 to 46 percent. Their share in the total agricultural loans issued by all financial institutions surged from 81 percent at end-2002 to 93 percent. Outstanding rural households’ loans reached 1.2 trillion yuan, with the number of rural household borrowers above 77 million, accounting for 33 percent of the total rural households. Fourth, the reform of the property rights regime was launched with the preliminary establishment of a corporate governance structure. As of end-September, 14 rural commercial banks, 97 rural cooperative banks, and 1,616 rural credit cooperatives with a unified legal entity at the county (city) level were established nationwide. In spite of the achievements made in the reform of the rural financial cooperative institutions, many difficulties and problems still exist, such as the great difficulty in resolving the historical burdens and improving the quality of assets, the few substantive improvements in the ownership structure and corporate governance, the urgency to reform the extensive operation mode and improve the weak management, the necessity to improve systematic and institutional support for the sustainable development of rural finance, including rural financial cooperative institutions. Achieving the targets of the reform of the rural financial cooperative institutions is an arduous task.

V. The RMB exchange rate formation mechanism was improved, the reform of the foreign exchange management system was accelerated, and a broadly balanced external sector was promoted

Efforts have been made to continue to improve the managed floating exchange rate regime based on market demand and supply and with reference to a basket of currencies, to further promote the fundamental role of market supply and demand in the RMB exchange rate formation mechanism, to strengthen the flexibility of the RMB exchange rate, and to keep the RMB exchange rate broadly stable at an adaptive and equilibrium level. At the same time, reform of the foreign exchange management system was accelerated to promote a BOP equilibrium. First, starting from August 12, 2007, the ceiling on the foreign exchange account of domestic institutions under the current account was removed so that domestic institutions could determine their foreign exchange revenues under the current account according to their own needs. Second, effective on July 30, 2007, the value of OTC forward foreign exchange purchases and sales by major banks was included in their positions. Commercial banks were encouraged to square their foreign exchange positions and cultivate a proper risk management approach. The speculation costs in the forward market were increased to reduce pressures on the foreign exchange market. Third, foreign exchange outflow channels were expanded in an orderly fashion. Preliminary rules for the administration of overseas investment of insurance funds were issued and insurance companies were allowed to invest overseas with their own or purchased foreign exchange. On the one hand, insurance funds were encouraged to go abroad, while, on the other hand, relevant risk management was also strengthened. The overseas portfolio investment of the QDIIs was steadily enlarged. As of end-September, the authorized overseas portfolio investment quota reached US$42.2 billion, and cumulatively US$10.9 billion (excluding social security funds) was remitted outside of China. Research on pilot overseas portfolio investments by domestic individuals under the precondition of controllable risks was conducted. Fourth, efforts were made to diversify foreign exchange market instruments. RMB swaps against foreign currencies in the inter-bank market were launched as a more flexible exchange rate and interest rate risk management instrument for both enterprises and individuals. Fifth, foreign exchange administration policies for export processing zones, bonded zones, and bonded logistics parks were consolidated to abolish policy disparities between the bonded areas and other areas, and to facilitate the enterprises' foreign exchange income and expenses. Sixth, efforts were made to strengthen foreign exchange inspection, launch a special examination of the short-term external debts of commercial banks, and punish illegal activities. Additionally, a coordination mechanism for monitoring abnormal foreign exchange movements by various departments was established to strengthen supervision of abnormal capital movements.

Part 3 Financial Market Analysis

In the first three quarters of 2007, the financial market continued to perform in a sound and stable manner, featuring brisk trading on the money market and the capital market, good bond issuances, a modestly increased bond issue rate, an overall upward trend in the bond yield curve, stable performance on the foreign exchange market, and expansion of innovative products. The institutional building of the financial market continued to improve.

Equity financing in the financing structure of the domestic non-financial sector (including households, enterprises, and the public sector) grew at a fast pace, playing a larger role in allocating social funds. Excluding special government securities (600 billion yuan), the share of government securities financing in total financing remained unchanged compared to that in the previous year. The volume of corporate bond financing decelerated on a year-on-year basis.

Table 4:Financing by the Domestic Non-financial Sectors in the First Three Quarters of 2007

	Volume of financing (RMB 100 million yuan)		As a percentage of total financing （%）	
	First three Quarters of 2007	First three Quarters of 2006	First three Quarters of 2007	First three Quarters of 2007
Financing by the domestic non-financial sectors	43043	32849	100	100
Bank loans	35881	28234	83.4	86
Equities	3681	969	8.6	2.9
Government securities	2450	1883	5.7	5.7
Corporate bonds	1031	1808	2.4	5.5

Notes: 1.Equity financing does not include the financing by financial institutions in the stock market.
2. Excluding RMB 600 billion yuan of special treasury bonds.

Source: The People's Bank of China

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I. An overview of financial market analysis

1. Trading on the money market was active, and interest rate fluctuations increased

Transactions on the inter-bank repo market and borrowing market were active, and the demand for funds, affected by the concentration of pre-IPO capital verifications, displayed an obvious trend of shortening maturities. In the first three quarters of 2007, the turnover of bond repo registered 31.7 trillion yuan, with the daily turnover averaging 168.9 billion yuan and a year-on-year growth of 72.1 percent. Inter-bank borrowing registered 6.4 trillion yuan, with the daily turnover averaging 33.9 billion yuan (a record high level) and growth of 3.6 times year on year. Most of the transactions were overnight products, accounting for 69.9 percent and 53.7 percent on the borrowing and repo markets respectively.

As market-based interest rate reform pressed ahead steadily and interest rate fluctuation risks accumulated, investors actively utilized interest rate derivatives to manage and hedge risks associated with interest rate fluctuations, resulting in the rapid development of bond forward and RMB swap agreements. The Shibor-based interest rate swap business performed well, totaling 146 transactions in the first three quarters of 2007 and accounting for 11 percent of the total RMB interest rate swap transactions. The total turnover reached 8 billion yuan, representing 5 percent of the total.

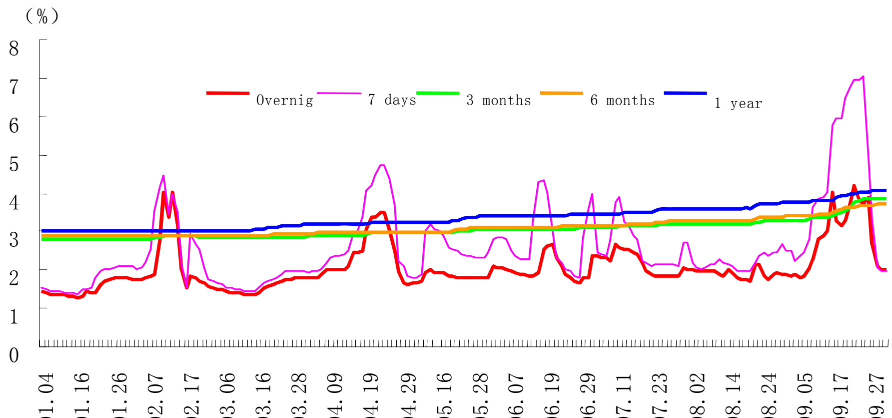
Table 5: Transactions of Interest Rate Derivatives

	Bond forward transactions		RMB interest rate swaps	
	Transactions	Turnover (RMB 100 million)	Transactions	Nominal principal (RMB 100 million)
2005	108	177.99	-	-
2006	398	664.46	103	355.70
Q1 2007	253	357.19	276	393.64
Q2 2007	291	648.95	636	639.02
Q3 2007	364	576.46	565	622.53
Total	1414	2425.05	1580	2010.89

Note: Bond forward transactions were launched in June 2005; the RMB interest rate swap started in February 2006.
Source: China Foreign Exchange Trading Center

Affected by such factors as the concentration of pre-IPO capital verifications, the interest rate on the money market fluctuated greatly. In September, the weighted average interest rates of inter-bank borrowing and pledged bond repo were 3.36 percent and 4.03 percent respectively, up 1.5 and 2.4 basis points respectively from January. At end-September, the Shibor with maturities of 7 days, 3 months, and 1 year stood at 1.9878 percent, 3.8534 percent, and 4.0554 percent, growth of 46, 105, and 105 basis points respectively from the beginning of the year.

Figure 2:Movements of the Shibor in the First Three Quarters of 2007



Source: National Inter-bank Funding Center

In the first three quarters, in both the repo market and the inter-bank borrowing market, state-owned commercial banks and other commercial banks retained a net lending position, while other financial institutions and foreign financial institutions were net purchasers. Affected by the rapid loan expansion, foreign financial institutions showed a strong demand for capital and registered net purchases on the two markets equivalent to 3.4 times year on year.

Table 6: Fund Flows among Financial Institutions in the First Three Quarters of 2007

Unit: RMB100 million yuan

	Repo		Inter-bank Borrowing	
	First three quarters of 2007	First three quarters of 2006	First three quarters of 2007	First three quarters of 2006
State-owned Commercial Banks	-97167	-86262	3431	-2028
Other Commercial Banks	5497	38219	-17431	-3189
Other Financial Institutions	64494	39962	8466	3594
Of which: Securities and Fund Management Companies	10794	13602	5513	3085
Insurance Companies	19832	10027	—	—
Foreign Financial Institutions	27176	8081	5534	1623

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

Sources: The People's Bank of China

2. Brisk spot bond transactions were accompanied by a steady rise in bond issue rates

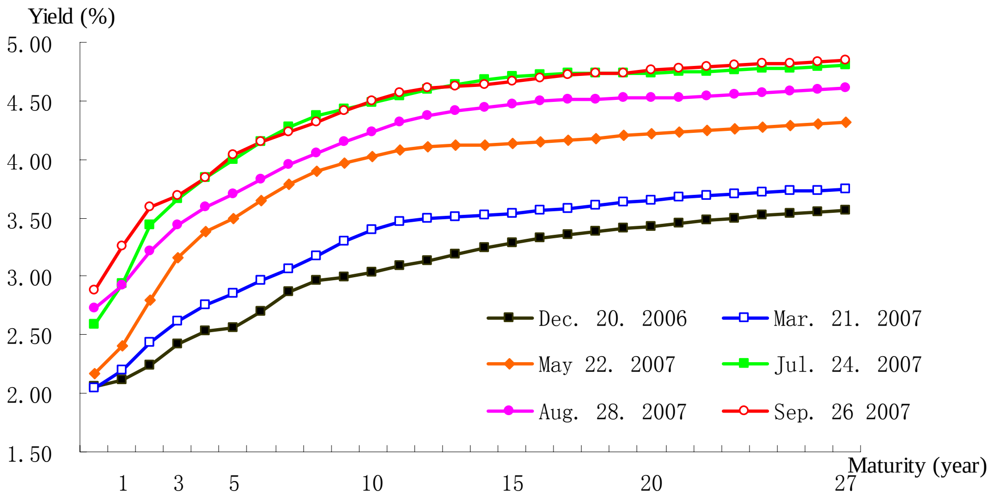
Due to the continued rapid growth of the national economy and the booming capital market, the spot market traded briskly. In the first three quarters of 2007, the turnover of spot transactions on the inter-bank bond market totaled 10.5 trillion yuan, with the daily turnover increasing by 36.3 percent to 55.7 billion yuan, hitting a historical high. The turnover of government bond spot transactions on the organized exchanges registered 92.5 billion yuan. On the inter-bank spot transaction market, the state-owned commercial banks were the largest net purchasers, with net purchases of 440.7 billion yuan, a year-on-year decrease of 9.2 percent. Other commercial banks, securities companies, and fund companies were net sellers, and the net sales by other commercial banks saw an increase of 19.1 percent year on year.

Bond derivative transactions expanded steadily, accompanied by an increased volume of direct financing. At end-September, the outstanding balance of ordinary financial bonds of the commercial banks reached 103.5 billion yuan. In the first three quarters, commercial banks issued 30.5 billion yuan of subordinate bonds and hybrid capital bonds. By end-September, the outstanding volume stood at 227.8 billion yuan, playing an active role in supplementing capital to improve the capital adequacy ratio of the commercial banks. Short-term financing bills continued a momentum of rapid development. In the first three quarters, 204 corporate short-term financing bills were issued, totaling 258.1 billion yuan in book value, an increase of 19.5 percent year on year. At end-September, the outstanding volume was 298.37 billion yuan. On September 26, the first corporate bond was issued on the exchange market (2007 Corporate Bond I of China Yangtze Power Co., Ltd.) with an issue volume of 4 billion yuan.

The yield curve of treasury bonds in the inter-bank market displayed an overall upward trend. Specifically, from January to July, the bond price in the inter-bank market gradually declined, and the yield curves went upward across the spectrum and suddenly became steeper. Around August, the short-term yield curve edged up, while the medium and long-term yield fell with flattening yield curves. In September, the bond yields of various maturities climbed moderately.

Figure 3: Yield Curves of Government Securities on the Inter-bank Bond Market

in 2007



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

The issue rates of bonds edged up and financing costs continued to rise. Affected by expectations of inflation and a series of macro-economic management measures, especially the required reserve ratio hikes, the interest rate on 7-year book-entry treasury bonds issued in August 2007 was 3.9 percent, up 0.16 and 0.97 percentage points respectively from May and February; the interest rate on 5-year fixed rate bonds issued by policy banks rose to 4.55 percent, up 1.05, 0.99, and 0.55 percentage points respectively from January, April, and June; the interest rate on 10-year corporate bonds was 5.3 percent, up 0.82 and 0.47 percentage points respectively from May and June.

The Shibor has become an important indicator in pricing medium and long-term corporate bonds. In the first three quarters, 65.7 billion yuan of Shibor-based corporate bonds were issued with their prices determined by market supply and demand, accounting for 92.6 percent of all the medium and long-term bonds. The issue rate of corporate bonds edged up. In September, the issue rate of 10-year corporate bonds increased by 144~178 basis points based on the 1-year Shibor, with the coupon rate ranging from 5.2 percent~5.7percent, 110 basis points higher than that at the beginning of the year.

3. Growth of commercial paper financing slowed down

In the first three quarters of 2007, the growth of commercial bills slowed down and the outstanding discount declined. At end-September, a total of 4.5 trillion yuan of commercial bills was issued by the corporate sector, up 11.1 percent year on year; discount bills totaled 8 trillion yuan, up 23.7 percent year on year; outstanding commercial bills amounted to 2.6 trillion yuan, up 16.5 percent year on year; outstanding discounts stood at 1.6 trillion yuan, representing a year-on-year decrease of 10.4 percent. With strengthened micro-economic control, some small and medium-sized financial institutions experienced tight liquidity and showed a stronger demand for re-discounts. In the first three quarters, re-discounts totaled 9.23 billion yuan, up 6.54 billion yuan; at end-September, outstanding discount loans amounted to 5.61 billion yuan, representing an increase of 3.47 billion yuan.

4. The stock market traded briskly and the index rallied

The positive effects of the non-tradable shares reform unfolded, transactions were active in the stock market, and investors had a remarkably strong willingness to invest in the stock and fund markets. In the first three quarters of 2007, 47.61 million new investment accounts were opened, 9 times the total in 2006; market transactions and prices climbed to new highs. The total turnover of the Shanghai and Shenzhen Stock Exchanges reached 37.1 trillion yuan, up 31.1 trillion yuan year on year, 4.1 times the total turnover in 2006. Daily trading averaged 203.9 billion yuan, representing a year-on-year increase of 5.4 times.

The stock market index fluctuated but displayed an overall upward trend. At end-September, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index soared to 5552 points and 1533 points respectively, increasing by 107 percent and 178 percent, both reaching their highest levels. The average P/E ratio of A-shares on the Shanghai Stock Exchange remained over 64, up from 33 and 17 at end-2006 and end-2005 respectively.

The financing functions of the stock market improved remarkably. In the first three quarters of 2007, a total of 534.6 billion yuan was raised by Chinese enterprises through IPOs, additional offerings, and rights issues on equity markets at home and abroad, reaching a record high and increasing year on year by 1.5 times. In particular, funds raised on the A-share markets increased by a large margin, reaching 465.5 billion and a growth of 4.4 times year on year; while a total of US$8.09 billion was raised on the H-share market.

The fund market developed very fast. Fueled by the soaring index and wider recognition of fund products, investors had a rising demand for wealth management products in funds. In the first three quarters of 2007, a total of 40 securities investment funds were launched, and new fund units amounted to 1328.8 billion, 1344.7 billion units more than the increase recorded a year earlier. At end-September, the net value of the funds reached 3.1 trillion yuan, an increase of 584.1 percent from the previous year, up 569 percentage points.

5. Assets in the insurance industry expanded rapidly and investment assets accounted for more than 60 percent of the total

The premium income and total assets in the insurance industry grew at a fast pace. In the first three quarters of 2007, the total premium income in the insurance industry amounted to 532.8 billion yuan, up 23.6 percent year on year, with an increase of 35.9 percent in property insurance. With a large number of life insurance policies coming due, claim payments and benefits increased by 68.1 percent to 164.3 billion yuan. In particular, life insurance payments grew 2.8-fold to 81.4 billion yuan. At end-June, total assets in the insurance industry reached 2.8 trillion yuan, up 54.5 percent over the previous year.

With strengthened management of insurance funds, the investment structure obviously changed. Investment assets grew rapidly in the first three quarters of 2007, with year-on-year growth of 66.6 percent. Equity-type and securities-type funds grew remarkably fast.

Table 7: Use of Insurance Funds at end-September 2007

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	End-Sep., 2007	End-Sep., 2006	End-Sep., 2007	End-Sep., 2006
Total assets	27954	18096	100	100
Of which, Bank deposits	7368	5543	26.4	30.6
Investment	17673	10611	63.2	60.1

Source: China Insurance Regulatory Commission.

6. The inter-bank foreign exchange market performed in a sound manner and RMB swap transactions continued to be active

The inter-bank spot foreign exchange market operated smoothly and the dominant role of the OTC market was strengthened. The trading volume of swaps far exceeded that of forwards, and they grew at a fast pace. In the first three quarters of 2007, the turnover in the RMB swap market reached US$234 billion, 4.6 times the turnover in 2006. The turnover in the inter-bank forward market increased by 32 percent year on year to US$15 billion, with most transactions in the USD/RMB currency pair. The number of participants in the foreign exchange market further increased. At end-September, the number of members on the inter-bank foreign exchange spot market, forward market, and swap market came to 269, 80, and 75 respectively. The trading volume of currency pairs increased somewhat. In the first three quarters of 2007, the turnover of eight "currency pairs" totaled US$70.9 billion, up 8 percent, with transactions in the major currency pairs of the USD/HKD, USD/JPY, and EUR/USD accounting for 78 percent of the total trading volume, down 4 percentage points from the previous year, mainly due to a large year-on-year decrease in the USD/HKD currency pair.

II. Financial market institutional building

1. Enhance Self-disciplined Management of the Financial Market

The National Association of Financial Market Institutional Investors, a self-regulatory organization comprised of members in the inter-bank bond market, borrowing market, notes market, foreign exchange market, and gold market, was established on September 3, 2007. The purpose of its establishment was to mobilize market participants to exercise self-disciplined management, shift government functions, cater to market demands, and promote market-based innovation and development.

2. Financial derivative products were diversified

First, the forward interest rate agreement business was launched on the inter-bank securities market to provide more instruments to manage interest rate risks, hence being conducive to enhancing market stability, uplifting market efficiency, and improving price discovery as a reference to the monetary policy operations of the central bank. Second, RMB foreign currency swaps were introduced onto the inter-bank foreign exchange market, including the five currency pairs of RMB/USD, RMB/EUR, RMB/JPY, RMB/HKD, and RMB/GBP. The launch of new products further diversified the products available in the inter-bank foreign exchange market, which was beneficial to enhancing the market forces in the inter-bank foreign exchange market and satisfying the requirements of various market participants to hedge exchange rate risks.

3. Pilot programs of credit asset-backed securities were expanded

First, information disclosure was regulated. Trustee institutions, originating institutions, and other financial service institutions engaged in securitization were requested to work hard to disclose information concerning underlying asset pools. Specific rules and regulations concerning information to be disclosed and approaches to access all the information about underlying asset pools during the issuance period were promulgated. Second, asset-backed securities became more liquid because they were allowed in pledged repo transactions in the national inter-bank bond market.

4. Fundamental institutional building in market supervision was strengthened in

light of the new situation after all shares became floatable

First, the Methods on Determining Insider Trading and Methods on Determining Market Manipulation came into force on a tentative basis, which clarified the standards on how to determine insider trading and market manipulation. The relevant regulations detailed how to recognize insiders; extended the scope of insiders and insiders' information; reasonably divided the burden of proof on constructive insiders, statutory insiders, prescribed insiders, and other people who may access insiders' information. Some typical insider trading activities such as falsified statements, early trading, seduced trading, special trading, and manipulation of the closing market were included. The tentative regulations will speed up the investigation and punishment of insider trading and market manipulation, and reinforce deterrence against involved parties. Second, a series of regulations concerning the M&A and restructuring of listed companies and non-public offerings were issued to further strengthen the requirements for information disclosure on the part of listed companies and other parties concerned, to intensify efforts to crack down on fake information, insider trading, and other criminal behavior, hence being conducive to the improvement of the market order and the betterment of the structure and quality of listed companies. Third, a system to coordinate cross-market supervision of stocks and stock futures took initial form. On August 13, the Shanghai Stock Exchange, Shenzhen Stock Exchange, China Financial Futures Exchange, China Government Securities Depository Trust and Clearing Company, and China Futures Margin Monitoring Center signed a series of agreements governing the coordination of supervision of different markets in Shanghai, signaling the formal establishment of a coordinating system covering cross-market supervision of securities and futures. Such cooperation encompassed an information exchange mechanism, a risk pre-warning mechanism, a common risk control mechanism, and a joint investigation mechanism. Its establishment will strengthen communications among the various parties concerned, improve supervisory efficiency, enabling different parties to take effective joint supervisory measures within their respective jurisdictions, preventing and quickly cracking down on cross-market manipulation, insider trading, and other illicit activities, and guaranteeing the smooth launching and functioning of stock index futures.

5. Reinforce regulation of the insurance market

First, asset management of insurance companies was improved. From July 25, insurance companies were allowed to make overseas investments with their own or purchased foreign currencies. This move will help insurance companies improve their asset allocations, diversify risks, increase profits, enhance competitiveness, and ease pressures on RMB appreciation. Second, management of the capital margin of insurance companies was also strengthened, and new regulations concerning the provision and handling of the capital margin were released. Third, compliance management was reinforced to clarify the system, organizational structure, and responsibilities of compliance management in insurance companies, and to require insurance companies to identify and preemptively prevent or resolve compliance risks. This is of great importance to regulating the corporate governance structure, strengthening risk management, and achieving effective internal control in insurance companies.

Part 4 Macro-economic Analysis

I. Global Economic and Financial Development

Since July 2007, on balance the world economy has maintained a momentum of stable growth, but potential risks have intensified, including the climbing crude oil prices and the apparently stronger inflationary pressures. Affected by the sub-prime mortgage turbulence in the U.S., major stock and bond markets have all experienced large fluctuations. In October 2007, the IMF projected growth of the world economy in 2007 to be 5.2 percent, the same as the projection in July 2007, but 0.2 percentage points lower than the growth in 2006. The projected growth of the U.S. economy in 2007 was lowered from 2 percent to 1.9 percent, that of the euro area was lowered from 2.6 percent to 2.5 percent, Japan from 2.6 percent to 2.0 percent, 1 percentage point, 0.3 percentage points, and 0.2 percentage points respectively lower than their actual growth in 2006. Robust growth is still expected in the emerging market economies.

1. Development in the Major Economies

The U.S. economy continued to grow. In Q3, annualized growth after seasonal adjustments was 3.9 percent, an acceleration of 3.3 percentage points and 0.1 percentage points from Q1 and Q2 respectively. Inflation remained moderate, with the year-on-year CPI in July, August, and September being 2.4 percent, 2.0 percent, and 2.8 percent respectively, averaging 2.4 percent, 0.3 percentage points lower than that in Q2 but similar to that in Q1. The employment situation was basically stable, as the Q3 unemployment rate moved up by 0.2 percentage points from that in the first two quarters to 4.7 percent, a level similar to that in Q3 of 2006. In the first eight months, the trade deficit posted US$471.85 billion, a reduction of US$45.6 billion year on year. The fiscal deficit shrank significantly. In FY2007 that ended on September 30, 2007, the federal budget deficit declined by 34.4 percent from a year earlier to US$162.8 billion, the smallest deficit in 5 years.

Growth in the euro area was stable. In Q1 and Q2, GDP grew 3.2 percent and 2.5 percent in real terms respectively year on year. Inflationary pressures remained, with the monthly HICP averaging 1.9 percent and posting 1.8 percent, 1.7 percent, and 2.1 percent year on year respectively in the three months, roughly on par with that in Q1 and Q2. It is worth noting that, driven by continuous energy and food price hikes, the monthly HICP in September rose 2.1 percent, surpassing the European Central Bank target of 2.0 percent for the first time since September 2006. Employment improved further. The monthly unemployment rate in Q3 registered 7.4 percent, 7.3 percent, and 7.3 percent respectively. Export growth was strong. In the first eight months, a trade surplus of 19.1 billion euro was registered, as compared with a deficit of 23.5 billion euro in the corresponding period of 2006.

The Japanese economy continued to expand. GDP grew 2.6 percent and 1.6 percent year on year in real terms in Q1 and Q2 respectively. Prices were generally stable, as the monthly CPI in Q3 was 0 percent, minus 0.2 percent, minus 0.2 percent, and minus 0.2 percent respectively year on year, averaging minus 0.1 percent, similar to the level in Q1 and Q2. Employment improved as a whole. The monthly unemployment rate registered 3.6 percent, 3.8 percent, and 4.0 percent respectively, averaging 3.8 percent, a decrease of 0.2 percentage points from that in Q1 of 2007 but similar to that in Q2. In Q3, the trade surplus expanded by 984.8 billion yen year on year to 3 trillion yen.

Growth in the major emerging market economies and developing countries was still robust, but inflationary pressures were on the rise. Stable growth continued in the Latin American countries.

2. Financial market developments

The exchange rates of the major currencies moved modestly. The US dollar weakened against the euro and the yen. On September 29, the euro to dollar and dollar to yen exchange rates closed respectively at 1.43 dollar per euro and 114.79 yen per dollar, indicating a depreciation of the greenback against the euro by 8.33 percent and against the yen by 3.58 percent since the beginning of 2007.

The yields of major bonds rebounded gradually since early September after declines in July and August. On September 28, the returns of ten-year government securities in the U.S. and Japan closed at 4.59 percent and 1.68 percent respectively, down 0.1 and 0.04 percentage points from the beginning of 2007, and down 0.44 and 0.19 percentage points from the end of Q2; the returns of ten-year government securities in the euro area closed at 4.34 percent, up 0.4 percentage points from the beginning of 2007, but down 0.22 percentage points from the end of Q2.

Due to the turmoil associated with the sub-prime mortgage loans in the U.S., interest rates in international financial markets fluctuated by large margins. Dollar Libors declined, with the one-year Libor reaching 4.85 percent on September 20, its lowest since the beginning of 2006 before climbing back to 4.9 percent on September 28, down 0.43 percentage points from the beginning of 2007. Due to several rate hikes by the European Central Bank, euro interest rates edged up gradually, a trend starting in

2006. On September 28, the one-year Euribor reached 4.73 percent, up 0.7 percentage points from the beginning of 2007.

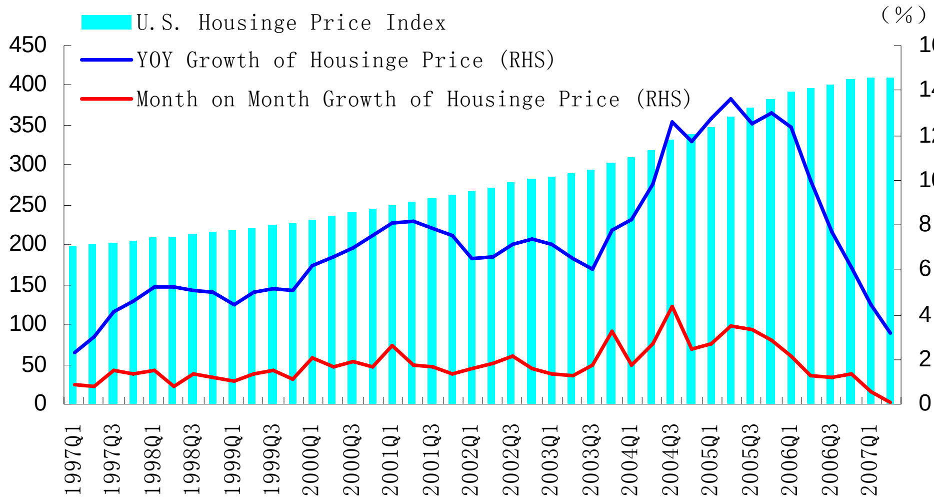
Major stock indices had large ups and downs. After the slump on February 27, major indices around the world gradually recovered, but began to decline after mid-July due to the turmoil in the U.S. sub-prime mortgage market. The Dow Jones Industrial Average, NASDAQ, STOXX50, and FTSE all reached a quarter low at the end of August, and the Nikkei 225 declined to a quarter low on September 18. After joint intervention by the major central banks, the major stock indices rallied modestly. On September 28, the Dow Jones Industrial Average and NASDAQ closed at 13896 and 2702 points respectively, up 3.63 percent and 3.80 percent from the end of Q2; the STOXX50, FTSE, and Nikkei 225 closed at 3820 points, 6467 points, and 16786 points respectively, down 3.22 percent, 2.13 percent, and 7.45 percent from the end of Q2.

3. Development of Housing Markets in the Major Economies

Since 1997, housing prices in the major industrial countries have generally increased rapidly. In recent years, the growth of housing prices in the Netherlands, Australia, U.K., and U.S. have moderated. In particular, with the sub-prime mortgage problems unfolding and the subsequent turmoil, adjustment in the U.S. housing market became even more intense. However, prices in Ireland, France, Spain, Sweden, and other European countries continued to rise rapidly. In contrast, due to the land price slump in Japan, there was negative movement of housing prices in Japan.

As the problems in the sub-prime mortgage market emerged, the U.S. housing market recently cooled down. In Q2 of 2007, the Housing Price Index went up 3.2 percent year on year, the smallest growth since Q3 of 1997. Dragged down by the sub-prime mortgage market disruption, in September the number of new home constructions, new home sales, and the inventory of new homes posted 1.191 million, 770,000, and 523,000 respectively after the seasonal adjustments, down 30.8 percent, 23.3 percent, and 6.6 percent respectively year on year.

Figure 4: U.S. Housing Price Index



Source: Housing Price Index, Office of Federal Housing Enterprise Oversight. http://www.ofheo.gov

In some European countries, trading on the housing market remained brisk. Despite moderation in growth, housing prices in the U.K. remained high. Prices in Ireland, Spain, Greece, and so forth moved up quickly, with the growth rate in 2006 posting 12 percent, 15 percent, and 14 percent respectively, an acceleration of 2 percentage points, 10 percentage points, and 8 percentage points from the previous year. The housing market in Germany, Portugal, and some other countries stagnated.

Land prices in Japan continued to fall, and housing prices moved into negative territory. Land prices fell consistently after the bursting of the economic bubble. At end-March and end-September 2006, the National Land Price Index declined 4.8 percent and 3.5 percent year on year. The trend continued into 2007. At end-March 2007, the Index registered a fall of 2.1 percent year on year.

4. Monetary policy in the major economies

On August 17 and September 18, the Federal Open Market Operations Committee cut the discount rate by 50 basis points respectively to 5.25 percent. Meanwhile, the Federal Open Market Operations Committee lowered the federal funds target rate by 50 percentage points and 25 percentage points respectively on September 18 and October 31 to 4.5 percent. The European Central Bank announced on July 5, August 2, and September 6 respectively to keep the benchmark interest rate unchanged at 4 percent. The Bank of Japan decided at three regular meetings on July 12, August 23, and September 19 to keep the uncollateralized overnight call rate on hold at 0.5 percent. The Bank of England raised the official interest rate by 25 basis points on

July 5, and then kept it unchanged on August 2 and September 6 respectively.

5. Major risks in the global economy

Global economic growth face real and potential risks, including the impact of the U.S. sub-prime mortgage market disruptions on global financial markets, the resurge of trade protectionism, higher crude oil prices, stronger inflationary pressures, etc.

Problems in the U.S. sub-prime mortgage market triggered turbulence in global financial markets. Due to the liquidity crunch, private equity funds, hedge funds, and other financial institutions found it difficult to finance mergers and acquisitions, and companies with good profit records faced higher debt financing costs. If the impact on financial markets and the corporate sector cannot be contained effectively, growth of the real economy may be undermined, leading to greater risks in the outlook for the U.S. and world economy.

Box 1: Pay Close Attention to the Mid-Term Impact of the U.S. Sub-prime Mortgage Turmoil

In April 2007, with the New Century Financial Corporation on the verge of collapse, the sub-prime mortgage turbulence begun to unfold in the U.S. The default rates kept rising in the sub-prime market, and a large number of mortgage companies and funds with exposure to the sub-prime mortgage market were in distress or became insolvent. Subsequently, the turbulence spread to international financial markets. In October, the IMF and other institutions lowered projections for the 2008 growth rate and forecasted greater uncertainty in global financial markets. They tended to believe that the cooling of the real estate market, tighter credit market, and larger fluctuations in the foreign exchange market will last for some time.

The direct cause of the sub-prime mortgage market problem was the cooling of the U.S. housing market. Yet, at a deeper level, weakening market discipline against the background of global excess liquidity was a major factor. First of all, the long-running low-interest rate policy boosted a risk preference across the globe. The global pursuit of high returns by excess capital drove up real estate prices. In an environment of low interest rates and high housing prices, given the low risk and high returns of leveraged mortgage lending, financial institutions relaxed their mortgage credit standards and loosened their risk awareness. As a result, borrowers with lower credit scorings were able to borrow easily, and the sub-prime mortgage market expanded by leaps and bounds. Second, there was an over reliance on financial derivatives and mismanagement of risks. In recent years, asset securitization was very popular in the mortgage credit market. In order to transfer risks, financial institutions repackaged and sold the credit risks of low-credit-rated products after rating by rating agencies. Such products encouraged lenders to switch from focusing on loan quality to quantitative expansion. With the risks of these products under priced by some rating companies, investors were misled and over optimism grew in the market for these products. Mortgage derivatives were purchased by government trust funds, pension funds, and other conservative funds. Third, it was caused by the combination of a lack of market discipline and inadequate regulation. As a result of the good performance of financial markets in recent years, market discipline and regulation weakened. Though the authorities began to pay attention to loose credit standards at the beginning of 2004, they failed to exercise effective regulation due to coordination difficulties, communication failures, and other problems and they missed the opportunity to make adjustments.

Judging from the current situation, the sub-prime mortgage turbulence is likely to continue for a while. It is not advisable to underestimate its impact on the world economy and finance. At the moment, the repercussions have spread mainly to Europe. The impact in China has been limited. However, it may spread to other regions through a multiple of channels such as investors, derivative instruments, market expectations, and the real economy. Higher risk premiums across the globe may also produce pressures on asset prices, and asset price adjustments may alter the credit risk outlook in the banking sector. Therefore, to protect China's financial stability and security, it is necessary to pay close attention to the impact of the sub-prime mortgage problems on international financial markets and their potential impact on China, and to take measures to enhance risk management and prevention. Recently, the People's Bank of China and the China Banking Regulatory Commission jointly released the Notice on Strengthening Management of Commercial Real Estate Credit and the Announcement on this matter, requiring institutions participating in credit asset securitization to strengthen disclosure of the pool underlying the assets in order to protect investors' interests, prevent risks, safeguard legitimate rights and interests, and promote the healthy development of credit asset securitization. Meanwhile, major financial institutions have moved to adjust the terms of mortgage loans. In the future, the PBC will further enhance information exchanges with regulatory agencies, closely watch developments in the market, improve transparency regulations over the financial market, and gradually promote implementation of international standards for CAR regulation. Financial institutions should also further improve the risk control mechanism and enhance the risk pricing and management capability while steadily carrying out the "going-abroad" strategy.

Since the beginning of 2007, trade protectionism, triggered by the persistent global imbalances, has gained more ground. In the U.S. Congress, currency-related bills were tabled time and again to put pressure on China and some other countries; the Department of Commerce launched many anti-subsidy investigations against countries including China and intensified pressure on many multilateral occasions. Such practices have spread from the U.S. to other countries. This means that trade frictions have intensified and the focus has moved from specific products to policy issues. Trade disputes may adversely affect the sustainable growth of the world economy and the orderly unwinding of global imbalances.

Global inflationary pressures became stronger. On the one hand, as a growing contingent of low-cost labor and other factors of production have been included in production chains across the globe, the effect of economies of scale has become stronger. On the one hand, higher supply abilities have contained price hikes of general goods, especially tradable goods; on the other hand, rapid industrial and economic growth driven by globalization has produced tensions on the supplies of energy and staple goods and has pushed up their prices; in addition, the global oversupply of liquidity has further exacerbated upward pressures on general prices. Since 2006, the prices of primary goods such as petroleum, metal, and grain have all increased. Despite the slump in global non-ferrous metal prices in July in response to the sub-prime mortgage market disruption in the U.S., the prices of copper, lead, and tin rebounded on the world market in the middle of September. Major grains witnessed large price hikes, with wheat prices reaching a record high and the prices of rice and soybeans approaching peak levels. Recently, international oil prices have climbed to new highs. In early November, the price of crude oil reached a new high, close to US$100 per barrel. At the moment, as a result of the sound performance of the world economy, demand for oil has apparently gone up, making it difficult for the international supply of crude oil to catch up. Should there be any geo-political turbulence, especially political turmoil in the oil-producing and oil-exporting countries, this may disrupt the stable supply of crude oil and cause oil prices to go up further.

II. Analysis of China's macro-economic performance

In the third quarter of 2007, the Chinese economy maintained a momentum of steady and rapid growth. All three industries expanded at a good speed, economic efficiency further accelerated, and the people's livelihood improved. However, the trade surplus continued to grow, and the CPI was on the rise. Inflationary risks intensified against the background of BOP imbalances. In the first three quarters, GDP grew 11.5 percent year on year to 16.6 trillion yuan, an acceleration of 0.7 percentage points from the same period of the last year, but similar to the first half of 2007; the CPI was up 4.1 percent year on year, 2.9 percentage points higher than during the same period of the last year; the trade surplus registered US$185.7 billion, up US$75.8 billion from the same period of the last year.

1. Urban consumption growth accelerated, investment growth remained high, and the trade surplus expanded further

Household income made fresh gains, and the growth of urban demand accelerated. In the first three quarters of 2007, the per capita disposable income of urban residents was up 13.2 percent in real terms to 10,346 yuan, an acceleration of 3.2 percentage points; the per capita cash earnings of rural residents were up 14.8 percent in real terms to 3,321 yuan, an acceleration of 3.4 percentage points over the same period of the last year. Strong income growth supported an expansion of consumer demand. In the first three quarters of 2007, the total volume of retail sales reached 6.4 trillion yuan, up 15.9 percent year on year in nominal terms or 12.3 percent in real terms (the highest level since 1998), a deceleration of 0.3 percentage points. It is worth noting that the total volume of retail sales included not only consumer spending, but also corporate purchases and material expenditures for rural home building, which are listed as investments in the national accounting system. Despite the deceleration in the volume of retail sales, according to the statistics of the urban household survey, the growth of consumption expenditures accelerated. Total urban consumption per capita was up 14.9 percent year on year, or 9.8 percent in real terms, an acceleration of 2.3 percentage points. Cash expenditures of rural residents for consumption were up 13.9 percent in nominal terms or 8.8 in real terms, a deceleration of 2.7 percentage points. The slowdown in real growth of rural consumption expenditures was caused by moderated growth of rural expenditures for purchases and home building and furnishings. In the first three quarters, rural resident expenditures for living were up 23.2 percent, a deceleration of 2.2 percentage points from the same period of the last year.

Fixed-asset investment growth slowed modestly but remained high. In the first three quarters, fixed-asset investments grew 25.7 percent to 9.2 trillion yuan, a deceleration of 1.6 percentage points and 0.2 percentage points from the same period of the last year and the first half of 2007 respectively. Urban fixed-asset investments totaled 7.8 trillion yuan, up 26.4 percent, a deceleration of 1.8 percentage points and 0.3 percentage points from the same period of the last year and the first half of 2007. Within urban investments, the primary, secondary, and tertiary industries grew 41.1 percent, 29.3 percent, and 24 percent respectively; investments in the eastern, central, and western regions were up 21.4 percent, 36.2 percent, and 29.6 percent respectively; and urban and rural investments increased 26.4 percent and 21.2 percent respectively.

Exports and imports continued to expand rapidly and the trade surplus further widened. In the first three quarters, imports and exports totaled US$1.6 trillion, up

23.5 percent year on year. Among this total, exports grew 27.1 percent, an acceleration of 0.6 percentage points from the same period of the last year, and imports grew 19.1 percent, a deceleration of 2.6 percent; the trade surplus posted US$185.7 billion, larger than that for the entire year of 2006.

2. All three industries registered rapid growth

In the first three quarters, the added-value of primary industry was up 4.3 percent to 1.8 trillion yuan, a deceleration of 0.6 percentage points from a year earlier; the added-value of secondary industry was up 13.5 percent to 8.3 trillion yuan, an acceleration of 0.2 percentage points; the added-value of tertiary industry was up 11 percent to 6.4 trillion yuan, an acceleration of 1.5 percentage points.

There were good prospects for agricultural production. According to preliminary statistics, summer grain output was up 1.3 percent year on year; the output of early rice was similar to the level of the last year; and a bumper harvest of autumn grain and a fourth straight year of high grain output was expected. With the implementation of various policy measures, production of raw pigs recovered. The output of pork, beef, mutton, and poultry rose further. In the first three quarters, the producer prices of major agricultural products were up 17.4 percent year on year, an acceleration of 8.6 percentage points and 17.7 percentage points from the first two quarters and the corresponding period of the last year respectively. Faster growth in the producer prices of agricultural products compared with the prices of the factors of agricultural production was a positive factor in the increase in rural incomes.

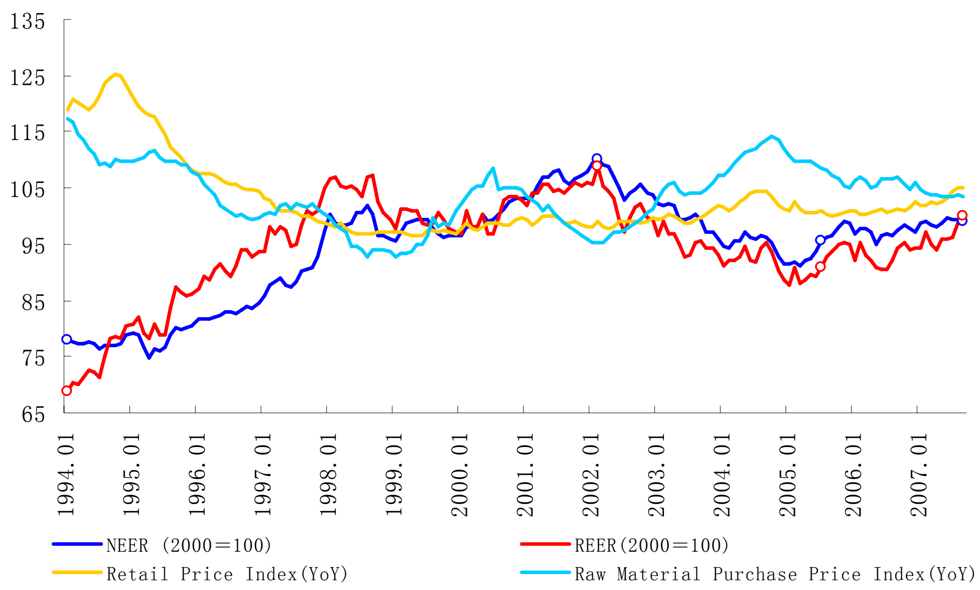
Industrial production expanded rapidly and profits of industrial enterprises surged. In the first three quarters, the added-value of statistically large enterprises was up 18.5 percent year on year, an acceleration of 1.3 percentage points. The efficiency of industrial enterprises further improved. In the first nine months, the profits of statistically large enterprises were up 37 percent year on year, an acceleration of 7.9 percentage points. The higher profits of industrial enterprises were attributed to brisk trading in the financial markets and stronger investment returns of enterprises, and also were related to the adoption of new accounting standards by listed companies. According to the Quarterly Survey of 5000 Enterprises by the PBC, the sales profits of enterprises were up 25.7 percent and investment returns were up 66.5 percent, indicating a differential of 40.7 percentage points, down 1.5 percentage points from the same period of the last year. Meanwhile, the investment returns of listed companies were up 78.7 percent, 22.5 percentage points higher than that of non-listed companies.

3. Stronger Inflationary Pressures

The growth of the CPI accelerated. In the first three quarters of 2007, the CPI was up 4.1 percent, and the quarterly average was up 2.7 percent, 3.6 percent, and 6.1 percent year on year for the three quarters. Rising food prices were the driving force behind the higher CPI, whereas non-food prices remained fairly stable. In the first three quarters, food prices grew 10.6 percent and moved the CPI up by 3.5 percentage points; non-food prices increased 1.0 percent, moving the CPI up by 0.6 percentage points. Consumer goods prices increased faster than service prices. In the first three quarters, consumer goods prices were up 4.9 percent, contributing 3.5 percentage points to CPI growth, as compared with the 1.7 percent growth of service prices and a contribution of 0.4 percentage points. The new price hike factor already surpassed the base-period factor. In the first three quarters, the base period factor was 1.9 percent, up 1.3 percentage points from the same period of the last year, while the new price hike factors were 2.2 percent, up 1.5 percentage points.

The purchasing prices of raw materials, fuels, and power increased modestly, while the factory prices of industrial goods declined, and the prices of factors of agricultural production continued to rise quickly. In the first three quarters, the purchasing prices of raw materials, fuels, and power were up 3.8 percent year on year, with the quarterly averages up 4.1 percent, 3.6 percent, and 3.7 percent respectively in Q1, Q2, and Q3; the factory prices of industrial goods were up 2.7 percent, with the quarterly averages up 4.2 percent, 6.2 percent, and 8.7 percent respectively.

Figure 5: RMB Effective Exchange Rate and Domestic Price Movements since 1994



Source: Bank for International Settlements; National Bureau of Statistics.

The growth of import prices moderated while that of export prices accelerated. In September, import and export prices were up 2.3 percent and 6 percent respectively, and the terms of trade index posted 103.6 percent, representing an improvement from the previous month. Analyses using economic theory and empirical evidence from other countries show that a stronger domestic currency helps to rein in domestic inflation. Given the growing dependence on imports of resource products, a modest appreciation of the domestic currency helps curb the growth of domestic currency-denominated import costs. Despite the time-lag in transmission, in the long run movement in the nominal effective exchange rate will have an impact on the Retail Sales Price Index and the Producer Price Index.

Labor compensation crept up quickly. In the first three quarters, the average monthly salary of employees in urban units was up 18.8 percent to 1,853 yuan. In particular, the average monthly salary of employees in state-owned units posted 1,980 yuan, up 20.8 percent; that of employees in collectively-owned units was 1,111 yuan, up 18.0 percent; and that of employees in other units was 1,794 yuan, up 15.6 percent. The average monthly salary of migrant rural workers was 1,015 yuan, up 11.8 percent.

The GDP deflator was higher. In the first three quarters of 2007, with nominal GDP growth at 16.2 percent and real growth at 11.5 percent, the GDP deflator (nominal GDP growth minus real growth) was 4.7 percent, up 2.0 percentage points.

Pricing reform of resource goods advanced further. In September, the National Development and Reform Commission, Ministry of Finance, and National Electricity Regulatory Committee released a Notice to further implement differentiated electricity tariffs and to abolish the favorable tariff treatment to enterprises with high energy consumption. The localities also further differentiated water tariffs, raised the water charge collection standard, and collected sewage treatment fees across the board. Given the rising international oil price, the increasingly serious distortions in domestic crude oil and refined oil prices, and the subsequent tensions in supply and demand, the National Development and Reform Commission decided to raise the per ton price of gasoline, diesel, and aviation kerosene by 500 yuan each as of zero hour, November 1, 2007, in order to secure the domestic supply of refined oil and encourage energy conservation. In addition, the factory price of liquefied gas was also raised to reduce the price difference between natural gas and renewable energy.

Cheap resources were an important factor contributing to the internal and external imbalances in the Chinese economy. The abundant supply of cheap resources kept the costs of domestic products artificially low, spurred investment expansion and ballooning exports, and resulted in a ballooning trade surplus. Deepening the resource pricing reform might cause stronger inflationary pressures in the short run. However, if the reform is delayed, the damage might be even more serious as the distortions will become more severe. In the process of controlling inflation and actively pressing ahead with the resource pricing reform, consideration should be given to the trade-offs between the two. Actively promoting resource pricing reform helps nurture various factor markets, further enhances the fundamental role of the market in resource allocations, curbs over consumption of resources, promotes energy conservation and emission reduction, and transforms the extensive growth mode. It is conducive to economic structure optimization, reducing the trade surplus and balancing the BOP. While advancing the reform, it is necessary to fully consider the impact on low-income people and to take possible measures, including subsidies, to ease their burdens.

Box 2: Stabilize Inflationary Expectations and Keep the Price Level Basically Stable

Inflationary expectations are public expectations of the direction and pace of movement in the inflation rate. Inflationary expectations have an impact on consumption, savings, and investment behavior and subsequently affect the level of future inflation. At the moment, as food prices drive up the CPI, people have increasingly stronger inflationary expectations, and this might push up inflation. Due to the time-lag between adoption of monetary policy measures and their impact on inflation, monetary policy should be forward-looking. Therefore, it is an important task for a central bank to study the dynamics of inflationary expectations and to control such expectations.

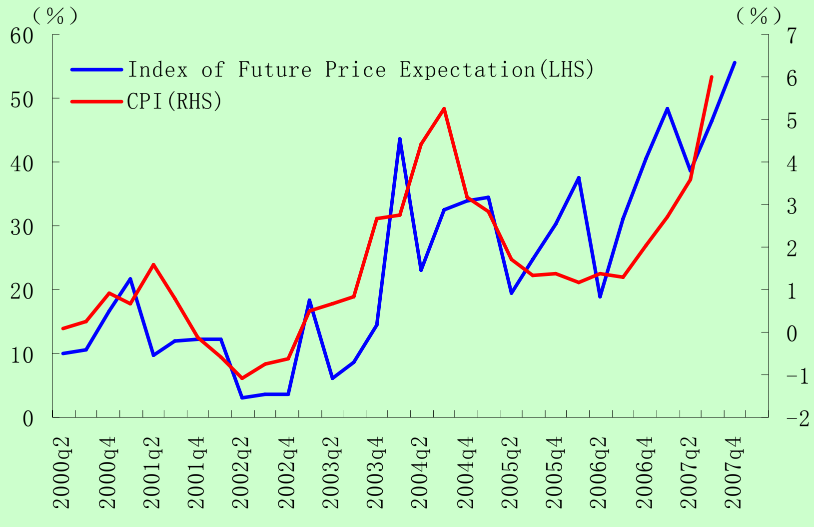
1. The Impact of Inflationary Expectations on Economic and Financial Performance

Inflationary expectations alter the expectations of the real interest rate, change the public's savings and investment decisions, and subsequently have an impact on aggregate supply and demand and on the real inflation rate in the future. With higher inflationary expectations, the public will save less and spend more on consumption. As a result, aggregate demand increases and pushes up general price levels. There will be a cost-driven effect on aggregate supply. As inflationary expectations become stronger, workers will require higher wages and enterprises will raise the prices of their products. If prices are not adjusted promptly, enterprises will reduce output and subsequently aggregate supply will shrink. More demand and less supply will mean higher price levels in the future. In addition, whether inflationary expectations are stable will affect the real inflation level in the future. When inflationary expectations are stable, one-time price hikes of some products (such as energy) will only alter their comparative prices, rather than leading to a permanent increase in the general price level. If one-off price hikes change inflationary expectations and lead to spiral wage increases and price hikes, they will drive up inflation. Moreover, higher inflationary expectations will increase the opportunity costs of holding cash, prompting the public to rebalance their asset portfolio toward securities, real estate, and tangible assets, and thus cause asset price hikes.

2. Measuring and Assessing Inflationary Expectations

There are four ways to measure inflationary expectations. The first one is to estimate the yield differential between nominal bonds and inflation indexed bonds; the second one is to monitor the movements of long-term interest rates in relation to short-term rates. Higher long-term interest rates in relation to short-term rates often mean bond investors will demand compensation for inflationary risks. A third approach is to look at asset price movements, because investors usually will look for a safe haven against inflation in times of high inflation, i.e., they will purchase metals and other staple commodities, property, or other tangible assets. A fourth measure is to conduct an inflationary expectations survey. The central bank or commercial banks in the U.K., Poland, Germany, Turkey, and some other countries have a survey system to measure inflationary expectations. The People's Bank of China also conducts a quarterly survey on inflationary expectations. Empirical analysis shows that since 1999, the Index of Future Price Expectations compiled by the Financial Survey and Statistics Department of the PBC is highly related to the CPI and the correlation coefficient between the two is more than 70 percent.

Figure 6: Movements in the of Index of Future Price Expectations and the CPI Since 1999



Source: PBC; National Statistics Bureau.

3. Major factors affecting inflationary expectations

The level of inflationary expectations is affected by many factors, including the level of the current inflation rate, the duration of the previous inflation rate, the current economic situation and macro-economic and financial policies, the credibility of relevant policies, and in particular the credibility of monetary policy. Generally, the higher the current inflation rate is, the stronger the inflationary expectations become; the longer the inflation lasts, the higher the inflationary expectations grow. Moreover, an elevated inflation rate leads to the creation of large uncertainties in inflationary expectations. In addition, inflationary expectations are related to monetary policy factors such as transparency in monetary policy, central bank independence, the record of the central bank in controlling inflation, etc. If the public has confidence in the determination and ability of the central bank to control inflation, their inflationary expectations are likely to remain stable and unchanged even after one-off changes in the prices of some products.

4. Practice of the Major Central Banks in Keeping Inflationary Expectations Stable

In recent years, a large number of central banks have strengthened control over inflation and guidance of inflationary expectations. In order to improve the effectiveness of monetary policy in terms of price stability, countries like New Zealand, U.K., Canada, Australia, etc. have adopted inflation targeting and have set a nominal anchor to stabilize public expectations of inflation. Central banks that have not adopted inflation targeting have still attached great importance to stabilizing inflationary expectations. According to Chairman Bernanke of the Federal Reserve, public expectations of inflation have become much more stable than previously and this has effectively promoted economic stability. Since 1999, the interest rate differential of nominal 10-year bonds and indexed 10-year bonds has remained around 2 percent, indicating public expectations of a long-term inflation rate of around 2 percent. In light of the relatively rapid increase in the CPI since 2006, the PBC raised benchmark lending and deposit rates on seven occasions in order to stabilize inflation and inflationary expectations and to preserve the stability of the general price level. In total, the one-year deposit rate is up 1.62 percentage points, and the one-year lending rate is up 1.71 percentage points.

4. Fiscal Revenues Continued to Grow Rapidly

In the first three quarters of 2007, total budget revenues (excluding debt income) totaled 3.9 trillion yuan, up 31.4 percent year on year and an acceleration of 6.8 percentage points compared with the same period of the last year. Among the total, tax revenue increased 32.2 percent year on year to 3.5 trillion yuan. Fiscal expenditures amounted to 2.9 trillion yuan, up 25.3 percent and an acceleration of 9.2 percentage points. Netting revenues and expenditures, fiscal revenues exceeded expenditures by 990.1 billion yuan, 343.6 billion yuan more than during the same period of the last year. Rapid growth of fiscal revenues was supported by substantially higher profit gains of enterprises and higher tax revenue against the background of rapid economic growth, by the large contribution of tariff revenue to fiscal income expansion due to robust import and export growth, by bulky stamp duty revenue from brisk trading in the stock market, and by a significant increase in local tax revenue due to local taxation efforts and policy adjustments.

5. There remained a large surplus in the BOP

In the first half of 2007, the balance of payments account still registered a twin surplus. The surplus in trade of goods hit another new high and drove the rapid growth of the current account surplus. The capital and financial account surplus widened significantly, and the deficit in portfolio investment declined. In the first three quarters, a total of 28,206 enterprises with foreign direct investment were approved for establishment, down 6 percent year on year; actual utilization of foreign capital totaled US$47.2 billion, up 10.9 percent year on year. At end-September 2007, official foreign exchange reserves posted US1433.6 billion, an increase of US$367.3 billion from the end of 2006 and US$198.3 billion more than the increase during the same period of the last year.

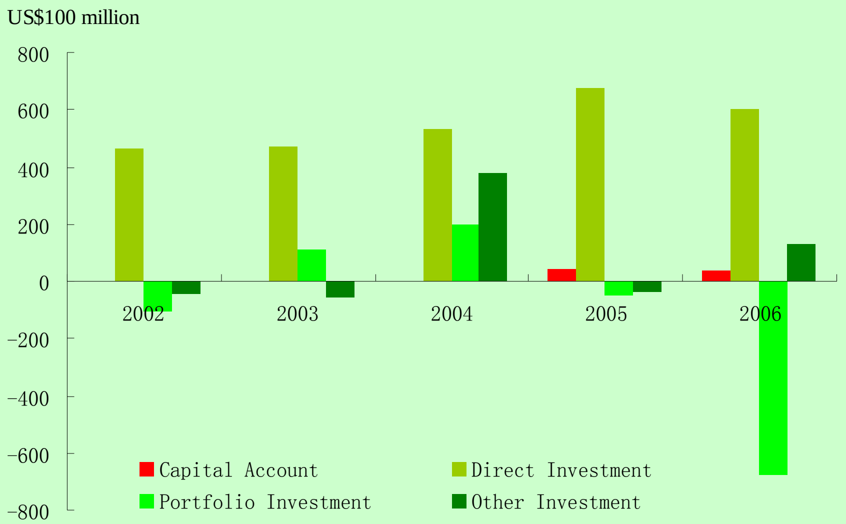
Growth of the external debt slowed down as the balance of the registered external debt experienced negative growth and the share of the short-term debt declined, both for the first time ever. At end-June, the outstanding balance of the external debt posted US$327.8 billion, up 1.5 percent year on year and a deceleration of 4.5 percentage points from the same period of the last year. The balance of the registered external debt amounted to US$216.7 billion, down 0.1 percent year on year; the balance of the short-term debt posted US$184.9 billion, up 0.7 percent from end-2006 and accounting for 56.4 percent of the total external debt, a share 0.5 percentage point smaller than that at the end of 2006.

Box 3: Actively Promote a BOP Equilibrium and Gradually Realize Capital Account Convertibility

In recent years, the capital and financial account of the balance of payments has remained in surplus. Between 2002 and 2006, the accumulation of the capital and financial surplus reached US268.7 billion, about 32 percent of the BOP surplus.

Under the capital and financial account, the main source of the surplus was direct investment, and a larger deficit in portfolio investment was the major factor behind the shrinking surplus. The balance of other investments showed large fluctuations. Between 2002 and 2006, the contribution of direct investment, portfolio investment, and other investments to the surplus under the capital and financial account was 102 percent, minus 19 percent, and 14 percent respectively. The persistent capital and financial account surplus is caused by three factors. First of all, massive FDI inflows were recorded as a result of improvements in the investment environment, low-cost labor, and rapid economic growth in China; second, Chinese enterprises have a strong preference for financing abroad and transferring funds to China for domestic use. Between 2003 and 2006, domestic enterprises raised a total of US$94.6 billion in overseas stock markets. Third, against the background of a global oversupply of liquidity, expectations of a stronger RMB and domestic asset price hikes have lured a substantial amount of overseas capital.

Figure 7: Composition of Capital and Financial Account Surplus, 2002-2006



Source: 2006 China BOP Annual Report; 2006 China BOP Report.

In recent years, in order to promote development of the external sector and an equilibrium in the BOP account, the foreign exchange administration authority has steadily advanced capital account convertibility and expanded channels for capital outflows, while enhancing regulations over short-term capital inflows. Measures have been taken to support the “going abroad" strategy, lift restrictions on foreign exchange purchases for outward investment, and allow advance transfers of funds for pre-investment expenditures; allowing banks and insurance and securities firms to make overseas financial investments with their own or purchased foreign exchange; simplifying procedures for foreign exchange purchases, adopting quota management of US$50,000 for purchases of foreign exchange by individuals, and satisfying reasonable demands exceeding this quota after verification; allowing outward transfers of legitimate wealth by individuals; allowing international development institutions to issue RMB-denominated bonds in China and reducing foreign exchange inflows, etc. Although the authorities have encouraged outward direct and financial investments, the overall size of such investments has been constrained by factors such as enterprise competitiveness and risk management capability.

Easing capital controls and advancing capital account convertibility are long-term institutional arrangements and an important part of the efforts to improve the socialist market economy. Orderly and sequenced liberalization of the capital account will make it possible to effectively take advantage of the market and resources both at home and abroad, improve the quality of foreign capital utilization, promote development of the domestic financial market and integration with the international market, and help market participants to make outward investments, diversify risk allocation, and seek higher returns. China's large current account surplus is the outcome of domestic imbalances between savings and investments, and between aggregate supply and demand, and can be attributed to deep-rooted structural and institutional causes.

Therefore, the current account is likely to remain in surplus for a period to come. It is necessary to allow the capital account to play an adjustment role by expanding channels for capital outflows, to contain surplus growth or even turn it into a deficit, and to promote a BOP equilibrium. However, given that China remains an economy in transition with an underdeveloped domestic financial system and enterprise reform has yet to be completed, it is necessary to continue to improve macro-economic management, maintain the momentum of sustained and rapid growth, and lay a solid foundation for orderly capital account liberalization. We need to coordinate measures of advancing capital convertibility with progress in a market-based interest rate and exchange rate, development of the financial market, enterprise institutional reform, strengthened financial supervision, and an improved cross-border capital flow monitoring system, in order to prevent shocks in cross-border capital flows and possible risks.

6. Industrial analysis

The industrial structural adjustment made further progress. First, though the output of some high- energy-consuming sectors remained high, the growth of their output and exports both declined. In Q3, six major high-energy-consuming sectors whose energy consumption accounted for 70 percent of the total energy input registered output growth of 19.6 percent, a decline of 0.5 percentage points from that in the first half of 2007; investment grew 22.6 percent cumulatively in the first nine months, a decline of 1.1 percentage points from that in the first half of 2007; profits grew 79 percent cumulatively in the first eight months, a substantial moderation from the 120 percent in the first five months. In addition, the exports of cooper, aluminum, lead, and other high-energy products all declined by 50 percent; and month-on-month growth of steel exports also decelerated since July 2007. Second, the supply of coal, electricity, and transportation services continued to grow rapidly. In the first three quarters, the output of raw coal, crude oil, and electricity and the volume of transported freight was up 11.0 percent, 1.4 percent, 16.4 percent, and 11.7 percent respectively year on year. But generally, the structural imbalances have not seen remarkable improvement and economic growth has relied heavily on secondary industry, especially heavy industry. In the first three quarters, the share of secondary industry continued to rise while that of services industry declined. Within the secondary industry, growth of heavy industry outpaced that of light industry by 3.5 percentage points, an acceleration of 0.2 percentage points from the same period of the last year.

(1) The real estate sector

In the first three quarters, the real estate sector continued to boom. The added-value of this industry took up a 4.9 percent share in GDP, up 0.2 percentage points from the same period of the last year; the growth of this industry, among the highest in the services sector, posted 13 percent, an acceleration of 5.9 percentage points from a year earlier. The structure of the industry improved, as more affordable and low-rent housing was built. In the first three quarters, affordable housing investment was up 30.5 percent year on year, an acceleration of 21.6 percent from the same period of the last year; its share in residential housing investment was 4.4 percent, up 1.2 percentage points from the same period of the last year. At end-June 2007, 586 out of the 656 cities, or 89.3 percent of all, had put in place low-rent housing systems. Despite the acceleration in real estate investment, housing prices also displayed a momentum of accelerated growth due to the strong demand and tensions over the supply and demand relationship. The housing price hike in some cities remained large.

Real estate development investment increased by a large margin. In the first three quarters, a total of 1.68 trillion yuan was invested in real estate development, up 30.3 percent year on year and an acceleration of 6 percentage points from the same period of the last year. Among the total, 1.2 trillion yuan, or 71.7 percent, went to commercial housing development, representing an increase of 32.8 percent year on year and an acceleration of 3.3 percentage points from the same period of the last year. The share of investment in floor plans up to 90 square meters in size in commercial housing investment was 15.2 percent.

The area of purchased land grew rapidly, but that of developed land slowed down. In the first three quarters, purchased land totaled 283 million square meters, up 17.8

percent, as compared with a decline of 3 percent in the same period of the last year; developed land totaled 182 million square meters, up 11.3 percent year on year, down 22.7 percentage points from the same period of the last year.

The growth of sold commercial housing remained high, but the floor space of unsold commercial housing declined and that of completed commercial housing remained smaller than that of sold commercial housing. In the first three quarters, a total of 474 million square meters of commercial housing was sold, up 32.1 percent, an acceleration of 21.6 percentage points from a year earlier. At end-September, the floor space of unsold commercial housing posted 118 million square meters, down 2.4 percent year on year. The floor space of sold commercial residential housing totaled 433 million square meters, and that of completed commercial residential housing posted 200 million square meters; the floor space of unsold commercial residential housing was 58 million square meters, down 11.6 percent year on year.

The growth of housing prices picked up, and housing prices in some cities rose by a fairly large margin. In September, housing prices in 70 large and medium-sized cities were up 8.9 percent year on year, an acceleration of 0.7 percentage points from the previous month. In particular, the price of newly completed commercial residential housing was up 10.0 percent, an acceleration of one percentage point from the previous month; the price of pre-owned homes was up 7.6 percent, a deceleration of 0.3 percentage points. Price hikes in Shenzhen, Beihai, Urümqi, Beijing, and several other cities accelerated. Shenzhen, in particular, saw more than a 10 percent year-on-year increase in housing prices for 20 straight months, with growth in September reaching 20.5 percent; similarly, housing prices in Beijing rose by more than 8 percent year on year for 17 months in succession, and the rise in September was 13.3 percent. The price of land also increased rapidly by 15 percent in Q3, an acceleration of 5.2 percentage points and 1.5 percentage points from Q1 and Q2 respectively. Rental growth was far lower than that of housing and land prices, and posted 3.0 percent in Q3, up 1.2 percentage points and 0.5 percentage points from Q1 and Q2 respectively.

There were sufficient funds for real estate development, and the use of foreign investment grew rapidly. In the first three quarters of 2007, 2.5 trillion yuan was invested in real estate development, up 37.9 percent year on year and an acceleration of 9.4 percentage points from the same period of the last year. Among the total, with a combined share of 78.2 percent, self-raised funds and other funds were the major source of real estate development investment, up 37.4 percent and 41.3 percent respectively; with a share of just 1.7 percent, the use of foreign investment grew 63.2 percent year on year; and with a share of 20.2 percent, domestic lending increased

30.1 percent.

Growth of real estate development lending moderated, but growth of housing purchase loans accelerated. At end-September, outstanding loans to commercial housing projects totaled 4.62 trillion yuan, 941 billion yuan more than that at end-2006, up 29.6 percent year on year and an acceleration of 5.2 percentage points. In particular, outstanding real estate development loans reached 1.76 trillion yuan, 349.1 billion yuan more than that at end-2006, up 26.9 percent year on year and a deceleration of 2.0 percentage points; outstanding housing purchase loans posted 2.86 trillion yuan, 592.4 billion yuan more than that at end-2006, up 31.4 percent and an acceleration of 13.5 percentage points.

In general, the main problems in the real estate market in China include serious structural imbalances in housing supply, apparently irrational factors in the rising housing prices in some cities, and the tendency for higher default risks associated with the ballooning housing mortgage loans whereby any large fluctuation in the housing price might give rise to a large volume of non-performing loans in commercial banks. In order to strengthen housing credit management and prevent risks in housing loans, the PBC and the China Banking Regulatory Commission jointly released the Notice on Strengthening Commercial Real Estate Credit Management to enhance regulation over the housing credit market from both the supply and demand sides in combination with a market-based discipline measure of credit information reporting. As the next step, it is necessary to strengthen and improve management and adjustment of the housing market, improve the structure of home supply, increase effective supply, and promote sound development of the real estate market.

(2) Iron and Steel Industry

The iron and steel industry, as a basic industry in the national economy, provides support for industrialization. But it is a high-energy-consuming and highly polluting industry. Since 2000, strong demand from both the domestic and external markets spurred the expansion of the iron and steel industry in China. China’s iron and steel output has been the largest in the world since 1996 when it overtook that of Japan. In 2006, China, previously a net steel importer, became a net exporter. In the first three quarters of 2007, the performance of the iron and steel sector was characterized by strong output and sales growth and handsome profits.

Fixed-asset investments in the iron and steel sector grew at an accelerated pace and structural adjustments progressed. In the first three quarters, fixed-asset investments in the ferrous metal smelting and rolling industry rose 13 percent, an acceleration of 10.5 percentage points. In an effort to implement the decision of the State Council

Working Conference on Closing Down Backward Iron and Steel Production Facilities in April 2007, by September 3 the first ten provinces (autonomous regions and municipalities) that signed the Letter of Responsibility on Closing Down Backward Iron and Steel Production Facilities closed down their production facilities, with a combined output capacity of 9.69 million tons of iron and 8.83 million tons of steel, accounting for 43 percent and 36 percent respectively of the volume of the facilities to be closed down.

Iron and steel output expanded rapidly and enterprises made handsome profits. In the first three quarters, the output of raw iron, crude steel, and rolled steel continued the momentum of rapid growth and went up 15.7 percent, 17.6 percent, and 24 percent respectively to 350 million tons, 360 million tons, and 420 million tons. The international and domestic prices of rolled steel rose further. At end-September, the domestic Steel Price Composite Index and the CRU Steel Price Index both rose 8.2 percent year on year to 115 points and 170 points respectively. Driven by rising steel prices in the domestic and international markets, the sales income of the ferrous metal smelting and rolling industry rose 38 percent, an acceleration of 23 percentage from the same period of the last year; the ratio of profits to costs was up 0.9 percentage points to 6 percent from the same period of the last year.

Exports of iron and steel grew rapidly, but moderated appreciably due to the effect of macro-economic management. In the first three quarters, iron and steel exports and imports totaled US$39.88 billion and US$18.34 billion, up 89 percent and 15.3 percent respectively year on year. In response to the excessive iron and steel exports, the relevant authorities took restrictive measures. Steel export growth moderated from 146 percent year on year in July to 40 percent in August, and further to 9 percent in September. The steel surplus also declined since June.

The cost of steel production increased by a large margin. The price hikes in raw steel squares, iron ore, steel scrap, and raw iron on the domestic market were all above 20 percent in the first nine months of 2007. Due to the increasing dependence on iron ore imports, the import price continued to climb. In September, the import price of iron ore and its concentrate averaged US$91 per ton, up 36.5 percent year on year.

For the sound development of the iron and steel industry, the government adopted a package of macro-economic management measures, such as optimizing the iron and steel product mix, taxing adjustments to contain iron and steel product exports, and speeding up the closing down of backward production facilities. In general, these measures produced some results. However, there are still problems, such as the excessive output growth, the overly large export volume, and the rising production costs. In addition, with their small scale, low efficiency, heavy pollution, and backward production facilities the industry still presents serious threats to the resource and ecological environment. Going forward, it is necessary to intensify structural adjustments and reduce energy inputs and pollutant discharges. Meanwhile, the principle of developing the iron and steel industry to satisfy domestic demand should be upheld, and measures should be taken to reduce reliance on the international iron and steel market, to contain the excessive growth of exports, to optimize the export product mix and regional distribution, and to avoid regional or country concentrations of general goods exports and the possibility of trade frictions.

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

I. Macro-economic outlook

At present, against the background of a robust domestic economy, China is likely to maintain its steady and rapid growth momentum. GDP is expected to grow by over 11 percent and the CPI is expected to rise about 4.5 percent in 2007.

Investment will remain strong. The underlying factors include the following: first, entrepreneurs have continued to feel optimistic about market demand and have shown an increased willingness to invest. The results of the third quarter PBC entrepreneur survey showed 29.2 percent of the entrepreneurs viewed market demand as bullish, up by 0.4 and 4.7 percentage points over the last quarter and the same period of the last year respectively. The fixed-asset investment index of enterprises increased by 2.1 and 2.7 percentage points over the last quarter and the same period of the last year respectively, a record high in the last ten years; second, capacity utilization remained at a high level. According to the survey, 4 percent of the surveyed enterprises reported stresses in capacity utilization while 83.7 percent of the enterprises indicated "normal" utilization of capacity; third, investment funds remained abundant. On the one hand, enterprises continued to report high profits, with 29 percent of the enterprises expecting increased profits in the third quarter, the best performance in the last ten years. On the other hand, the banking industry witnessed continual improvements in performance, and financial institutions showed strong incentives to provide loans to needy enterprises. According to the results of the PBC third-quarter survey of bankers, the business performance index of the banking industry surged dramatically over that during the same period of the previous year. In addition, the growth of domestic direct financing accelerated, helping reduce the constraints faced by enterprises in raising funds. Given the stronger investment willingness and financial strength, investment is likely to continue to grow rapidly, and there exists the possibility of a rebound in investment. Since the beginning of the third quarter, newly started projects and the total planned funding involved both experienced rapid growth. In the first three quarters of this year, the number of newly started projects reached 170,000, 18,000 more than during the same quarter of the last year, while total investment planned for these projects amounted to 6 trillion yuan, up 24.2 percent year on year, displaying a trend of accelerated growth for 5 months in a row.

Demand is expected to gain more speed. It has been identified as a national strategy to boost domestic demand, facilitate economic restructuring, and transform the economic development mode by shifting economic growth from mainly relying on the pulling effect of investment and exports to a balanced use of consumption, investment, and exports as the driving forces. With the rapid progress in the structural change and various policy measures focused on raising incomes and increasing the propensity for consumption gradually taking effect, urban and rural residents have witnessed rising incomes. Since the beginning of the year, the real growth of the cash income of rural households as well as the disposable income of urban households per capita have been continuously higher than GDP growth, making an important contribution to the ongoing expansion of consumption. Furthermore, optimistic expectations formed in a context of a steadily and rapidly growing economy and the wealth effect have also helped boost consumption growth. Consumption is expected to remain steady and strong for the foreseeable future, despite rising prices that may have a somewhat depressing effect on real consumption growth. In the coming periods, efforts need to be focused on strengthening consumption growth and upgrading in the rural areas, while at the same time, prompt action should be taken to comprehensively and innovatively expand the consumer market and improve the consumption environment.

The trade surplus will remain at a relatively high level. Though uncertainties have arisen for world economic growth as the U.S. sub-prime credit turbulence has developed, it is still very likely that the world economy will achieve relatively fast growth, and China’s increased diversification of foreign trade will also help reduce any negative impacts on global trade caused by regional economic slowdowns. Thus, external demand is expected to remain relatively strong. On the domestic side, the strong production and supply capacity built up in recent years has substantially improved the import substitution capacity, making it increasingly difficult to expand imports. Meanwhile, it will take some time for the mix of policy measures aimed at boosting domestic consumption, adjusting regulations on foreign trade, foreign investment, and foreign exchange management to gradually become effective. Furthermore, issues such as the international structural changes in the division of labor and the high domestic savings rate cannot be addressed within a short time. Overall, in the foreseeable future the growth of China’s trade surplus is expected to slow down, but it will still remain at a relatively high level, buttressed by the fast growth of external demand.

Upward price pressures are mounting and inflation risks require attention. First, there still exists the possibility of price increases as grain prices continue to rise. The global grain supply increasingly faces bottlenecks, leading to further rises in the world grain price. Domestically, rapid economic growth and increased demand for grain for industrial use have continued to exert pressures on the grain supply, which may push up the CPI. Second, there are upward pressures on energy prices. International oil prices have risen continuously. On the domestic side, it has become necessary to price resources and energy on a market basis so as to reasonably reflect China's comparative advantage and to strengthen its ability to achieve balanced economic growth. However, reform of energy and resource prices is likely to further push prices up in the short term. Third, as the labor supply faces structural bottlenecks, there will be upward pressures on wages. The growth of the average labor compensation has outpaced the nominal GDP growth rate for 7 successive quarters, and the rise in labor costs is likely to further push up the general price level in the future. In addition, inflation expectations continued to strengthen. The results of the third quarter PBC surveys on urban households and bankers showed that the proportion of households expecting continuous price rises as well as the indices of the general price level, consumer goods, and services expected by the bankers in the fourth quarter all reached record highs. Overall, within the context of rapid economic growth both at home and abroad, the accumulation of the BOP surplus, and the economic structural imbalances, there still exist considerable upward pressures on prices and the overall price level is very likely to remain at a relatively high level in the future.

In general, with effective implementation of various measures aimed at further strengthening and improving macro-economic adjustments, acute problems in economic operations have somewhat eased. However, it should be noted that problems such as overinvestment, an excessively large trade surplus, and an overexpansion of credit have yet to be resolved; furthermore, economic operations are plagued by newly emerging problems of heightened inflationary pressures and continuous rises in asset prices. Increased uncertainties in global economic and financial operations also add to the potential risks in the domestic economy.

II. Monetary policy stance for the rest of the year

In line with the overall strategy made by the CPC Central Committee and the State Council, the PBC will continue to implement a sound monetary policy stance featuring moderate tightening and will apply a mix of policy measures to appropriately strengthen macro-economic adjustments, so as to keep money and credit growth at a reasonable level, prevent the economy from growing at a relatively rapid pace to overheating, and promote economic development in a good and relatively fast manner.

The PBC will adopt a combination of sterilization measures to further strengthen liquidity management. Given the abundance of liquidity in the market, it is necessary to continue the coordinated application of instruments, including open market operations and the required reserve ratio, to strengthen liquidity management in the banking system. At the same time, the role of the special treasury bonds in sterilization operations will be gradually put into play. The leveraging role of prices in the macro-economic adjustments will be strengthened by improving coordination between interest and exchange rate policies to stabilize inflation expectations. The market-based interest rate reform will be steadily advanced, and the establishment of a benchmark interest rate system will be promoted. The PBC will continue to follow the policy of improving the RMB exchange rate formation mechanism in a self-initiated, controllable, and gradual manner, further giving market supply and demand a fundamental role in the RMB exchange rate formation, strengthening the RMB exchange rate flexibility, and maintaining it at an adaptive and equilibrium level. Reform of the foreign exchange management system will be strengthened to improve monitoring, guidance, and administration of capital flows. The foreign exchange needs of domestic institutions will be further satisfied and measures will be taken to expand overseas investments, in particular industrial and financial investments, by enterprises and individuals. Meanwhile, management over capital inflows, especially short-term capital inflows and the surrender of foreign exchange, will be strengthened. Measures will be taken to improve the surveillance and early-warning systems for cross-border capital flows and to strictly control the inflow of speculative funds. While using comprehensive monetary policy instruments to strengthen macro-economic adjustments, the PBC will further improve window guidance and the credit policy direction for financial institutions and will guide the commercial banks to prevent risks arising from rapid business expansion and to improve the credit structure.

It should be recognized that though excess liquidity in the domestic market is directly linked to the persistent balance of payments surplus, it is also a reflection of deeper structural imbalances in the economy such as the high savings ratio and low consumption rate. Sterilizing excess liquidity in the banking system and strengthening adjustments of money and credit growth themselves cannot solve the problem of the continuous accumulation of liquidity and the structural problems in the economy, but will serve to create a stable monetary and financial environment for economic growth and thereby to gain time to accelerate economic restructuring and reform. At present, while strengthening liquidity management of the banking system, a more important task for the country is to advance economic restructuring by taking advantage of the current high economic growth and large increase in fiscal revenues. Efforts should be made to speed up the transformation of public finance by increasing spending on public consumption, improving the social security system, strengthening the provision of housing, and stabilizing the consumption expectations of households. The market system should be allowed to play a leading role in guiding investment distribution and in encouraging appropriate growth of investment in tertiary industry that is beneficial to improving the people's livelihood. Industrial policies for foreign trade and investment will be further adjusted to appropriately expand imports and the market opening. Measures will be taken to guide and encourage less accumulation by enterprises, improve income distribution among enterprises, government, and households, and promote consumption growth. In addition, efforts will be made to improve the price formation mechanism for factors of production, improve and strengthen environmental protection and labor protection standards, and promote transformation of the economic development mode.

Appendix 1:Highlights of China's Monetary Policy in the Third Quarter of 2007

On July 3, the PBC issued *the Administrative Rules on Inter-bank Funding* (PBC Decree [2007] No. 3), effective on August 6, 2007, which marks the most important adjustment of administrative policies on inter-bank funding activities in the last ten years as it comprehensively overhauls the rules governing market access, term structure, quota management, registration, transparency, and the regulatory authority of the inter-bank market.

On July 17, the PBC reported to the Committee of Finance and the Economy of the National People's Congress on monetary policy implementation in the first half of 2007.

On July 21, the PBC decided to raise the benchmark deposit and lending rates of financial institutions. The one-year benchmark deposit rate was raised by 0.27 percentage points from 3.06 percent to 3.33 percent; the one-year benchmark lending rate was raised by 0.27 percentage points from 6.57 percent to 6.84 percent; and the deposit and lending rates of other maturities were adjusted accordingly. The interest rate of housing provident funds was also raised by 0.09 percent.

On July 30, the PBC adjusted administrative measures on the positions of over-the-counter forward foreign exchange accounts, including discounts in the positions of the over-the-counter forward foreign exchange transactions of the major commercial banks.

On July 30, the PBC announced it would raise the RMB reserve requirement ratio of depository financial institutions, effective August 15, 2007, by 0.5 percentage points to 12 percent.

On August 8, the *China Monetary Policy Report, Quarter Two 2007*, was released.

On August 12, the *Notice of the State Administration of Foreign Exchange on Maintaining Current Account Foreign Exchange Income by Domestic Institutions* (SAFE Document [2007] No. 49) was issued to remove quota management over foreign exchange accounts of domestic institutions, and instead to allow them to keep current account foreign exchange income according to their business needs.

On August 17, the *Notice of the People's Bank of China on Issues Regarding Launching RMB Swaps against Foreign Currencies in the Inter-bank Foreign Exchange Market* (PBC Document [2007] No. 287) was issued, introducing RMB swaps against five foreign currencies including the US dollar, the euro, the Japanese yen, the Hong Kong dollar, and the sterling pound in the inter-bank foreign exchange market as a more flexible exchange rate and interest rate risk management instrument for enterprises and individuals.

On August 20, the State Administration of Foreign Exchange issued the *Approval on the Pilot Program for Allowing Domestic Individual Residents to Directly Invest in the Overseas Securities Market* (SAFE Approval [2007] No.276), introducing a pilot program to allow domestic individual residents to invest in overseas securities markets under the precondition of controllable risks.

On August 22, the PBC decided to raise the benchmark deposit and lending rates of financial institutions. The one-year benchmark deposit rate was raised by 0.27 percentage points from 3.33 percent to 3.60 percent; the one-year benchmark lending rate was raised by 0.18 percentage points from 6.84 percent to 7.02 percent; and the deposit and lending rates of other maturities were adjusted accordingly. The interest rate of housing provident funds was also raised by 0.09 percent.

On August 29, the PBC purchased from domestic commercial banks the first issue of special treasury bonds worth 600 billion yuan.

On September 3, the National Association of Financial Market Institutional Investors (NAFMII) was established, composed of participants in the inter-bank bond market, funding market, bills market, foreign exchange market, and gold market.

On September 4, the PBC decided at the 10th meeting of its RCCs Pilot Reform Special Central Bank Bills Issuance, Redemption, and Performance Review Committee to redeem special central bank bills totaling 23.7 billion yuan for 330 rural cooperative financial institutions in 19 provinces and municipalities including Jiangsu.

On September 5, the PBC adjusted the composition of financial institutions eligible to apply for the differentiated reserve requirement ratio, so as to continuously use the differentiated reserve requirement ratio as an effective policy to provide positive incentives and discipline for financial institutions.

On September 6, the PBC announced it would raise the RMB reserve requirement ratio of depository financial institutions, effective September 25, 2007, by 0.5 percentage points to 12.5 percent.

On September 15, the PBC decided to raise the benchmark deposit and lending rates of financial institutions. The one-year benchmark deposit rate was raised by 0.27 percentage points from 3.60 percent to 3.87 percent; the one-year benchmark lending rate was raised by 0.27 percentage points from 7.02 percent to 7.29 percent; and the deposit and lending rates of other maturities were adjusted accordingly. The interest rate of housing provident funds was also raised by 0.18 percent.

On September 24, the PBC held a conference to analyze the current economic and financial situations. During the conference, potential risks of the economy growing at a relatively rapid pace to overheating were thoroughly studied, so as to deeply understand the great significance of money and credit management to maintain the stable and sustainable growth of the economy. Financial institutions were encouraged to uphold a correct perception of market shares, consciously control the pace of loan extensions in line with the needs of the real economy, improve credit services, forcefully explore intermediary businesses, and work hard to achieve stable and sustainable business development.

On September 27, the PBC and the China Banking Regulatory Commission jointly issued the *Notice on Strengthening Commercial Property Credit Management* (PBC Document [2007] No. 359), with a focus on adjusting and clarifying credit policies for real estate development and housing consumption.

On September 27, the Monetary Policy Committee of the PBC held its third quarterly meeting of 2007.

On September 29, the PBC issued the *Administrative Rules on the Forward Rate* Agreement (PBC Announcement [2007] No. 20), introducing forward rate agreement business in the market.

Appendix 2: Monetary Policies of the Central Banks of the Major Economies in the First Three Quarters of 2007

The U.S. Federal Reserve

At its several regular meetings in the first half of 2007, the Federal Open Market Committee (FOMC) decided to leave unchanged the target of the federal funds rate at 5.25 percent. According to the FOMC, although the real estate market continued to adjust, the American economy maintained moderate growth during the first half of 2007 and will continue to maintain this trend in coming seasons. Readings on core inflation improved modestly, but inflation pressures still remained. Meanwhile, the high level of resource utilization has the potential of sustaining these pressures. Under these conditions, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. In this context, the Federal Reserve judges that future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

The FOMC decided to cut the discount rate by 50 basis points respectively on August 17 and September 18 to 5.25 percent, and to cut the target of the federal funds rate by 50 basis points to 4.75 percent. The Committee judged that the credit crunch may result in a further worsening in the real estate market and may spill over into a number of other macro-economic areas, so the aim of the rate cut is to forestall the negative impact of financial market turmoil on the macroeconomy and also to promote the healthy and sustainable development of the economy. According to the Fed, financial market development adds uncertainty to the economic outlook, and the Committee will continue to assess the effects on the economic prospects from financial and other developments and will act as needed to foster price stability and sustainable economic growth.

The European Central Bank (ECB)

On March 8 and June 6, the ECB Governing Council increased by 25 basis points the interest rate on deposit facilities, the main refinancing operations minimum bid rate, and the interest rate on marginal lending facilities to 3 percent, 4 percent, and 5 percent respectively. In the ECB's opinion, this decision was taken in view of the prevailing upside risks to price stability over the medium term. Therefore, looking ahead, it is warranted to act in a firm and timely manner to ensure price stability over the medium term. The Governing Council will closely monitor developments to ensure that risks to price stability over the medium term do not materialize. As the upside risks to price stability over the medium term remain and the underlying rate of money and credit expansion remains vigorous, monetary policy stands ready to counter upside risks to price stability.

The Bank of Japan

On February 21, the Bank of Japan decided to raise the unsecured overnight call rate by 25 basis points to 0.5 percent. In the opinion of the Bank of Japan, the increase in the policy rate will also contribute to maintaining a lax monetary environment, ensuring price stability in the medium and long terms, and promoting sustainable growth. The Bank of Japan reported it will adjust the level of the policy interest rate gradually in light of developments in economic activities and prices. At the following regularly scheduled meetings, the Bank of Japan decided to leave the unsecured overnight call rate unchanged at 0.5 percent.

The Bank of England

On January 11, May 10, and July 5, the Monetary Policy Committee of the Bank of England decided to raise the official bank rate by 25 basis points to 5.75 percent due to the steady growth of output, the rapid growth of broad money and credit, and the continued strong growth of the international economy. In the opinion of the Committee, the risks in the inflation outlook over the medium term consequently remain tilted to the upside. Against this background, the Committee judges that a further increase in the bank rate of 0.25 basis points is necessary to bring the CPI rate back to the target of 2 percent in the medium term. At the scheduled meetings on August 2 and September 6, the Monetary Policy Committee of the Bank of England decided to leave the benchmark rate unchanged at 5.75 percent.