China Monetary Policy Report
Quarter Two, 2010

(August 5, 2010)

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

Executive Summary

In the first half of 2010 the Chinese economy generally performed well and was proceeding in the direction intended by the macroeconomic management policies. Consumption picked up rapidly; investment growth moderated but remained high; foreign trade experienced a fast rebound; the contributions of consumption, investment, and exports to economic development were more balanced; both industrial output and corporate profits went up by a large margin and the Consumer Price Index (CPI) edged up slightly. In the first half of the year, China's Gross Domestic Product (GDP) stood at 17.3 trillion yuan, up 11.1 percent year on year. The Consumer Price Index (CPI) rose year on year by 2.6 percent.

In accordance with the overall arrangements of the CPC Central Committee and the State Council, the People's Bank of China (PBC) continued a relatively loose monetary policy, maintained the consistency and stability of its policies, and made policies better targeted and more flexible in response to new developments. It deployed a mix of measures to strengthen liquidity management in the banking system and to guide financial institutions to properly manage the aggregate, pace, and structure of credit provision. The PBC further promoted the RMB exchange rate regime reform, improved foreign exchange administration, and pressed ahead steadily with the reform of financial enterprises, so as to contribute to the stable and healthy development of the economy. With the combined effects of various measures, the growth of money and credit gradually returned from the high level reached in 2009 to the general trend rate, liquidity in the banking system remained generally abundant, the flexibility of the RMB exchange rate was further strengthened, and the financial sector performed in a sound manner.

At the end of June 2010, broad money supply M2 recorded RMB 67.4 trillion yuan, up 18.5 percent from the same period of the last year, a deceleration of 4.0 percentage points. Narrow money supply M1 stood at RMB 24.1 trillion yuan, up 24.6 percent from the same period of the last year, a deceleration of 5.3 percentage points from the end of the last quarter. Deposits at financial institutions grew at a slower pace, with RMB and foreign currency deposits at financial institutions increasing by 18.6 percent year on year, down 3.1 percentage points from the end of the last quarter. Growth of lending by financial institutions moderated and loan extensions were more balanced. By end-June, RMB loans had grown 18.2 percent year on year, a deceleration of 3.6 percentage points from the end of the last quarter, or an increase of RMB 4.6 trillion yuan, representing a deceleration of RMB 2.7 trillion yuan. Lending rates offered by financial institutions went up slightly, with the weighted average lending rate for non-financial enterprises and other sectors standing at 5.57 percent in June, up 0.32 percentage points from the beginning of the year. After the PBC decided to proceed further with the reform of the RMB exchange rate regime on June 19, the largest daily appreciation of the RMB against the US dollar posted 122 basis points (or 0.18 percent). By the end of June the central parity of the RMB against the US dollar registered RMB 6.7909 yuan.

Going forward, the economy is expected to grow in a more stable and sustainable way on the basis of the recent rapid rebound. To boost economic growth, the central government has launched a series of new measures, which will step up adjustments in the economic structure and nurture new growth points. However, given the still-complicated and serious conditions at home and abroad, as well as the many uncertainties regarding economic development, macroeconomic management is facing a dilemma. The basis for a global recovery is still fragile and the international financial environment has not yet stabilized. Meanwhile, domestic private investment and endogenous drivers for growth need to be further enhanced, household consumption should be boosted, optimization of income distribution and adjustments of the economic structure are facing difficulties, the tasks of energy-savings and emission- reductions remain arduous, the risks in the fiscal and financial sector call for attention, movements in the price level is not clear, and management of inflation expectations needs to be strengthened.

The PBC will continue to follow the scientific outlook on development and implement the relatively easy monetary policy in line with the overall arrangements of the State Council. It will properly manage the intensity, pace, and focus of the policies and make policies better targeted and more flexible while also maintaining policy consistency and stability. Efforts will be made to strike a balance among supporting sound and relatively rapid development, restructuring the economy, and managing inflationary expectations. The PBC will employ a variety of policy tools to enhance liquidity management so as to maintain proper growth of money and credit, strengthen the sustainability of financial support to economic development, and make sure that the financial system performs in a sound manner. Moreover, the PBC will advance the market-based interest rate reform and the reform of the RMB exchange rate regime to promote the healthy development of the financial market. In addition, it will enhance the role of the market in allocating resources, improve policy coordination, optimize the policy mix, and facilitate systemic reform and economic structural adjustments to contribute to a shift in the growth model and to provide an internal impetus for economic development.

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Part 1 Monetary and Credit Performance

In the first half of 2010 the trend in the growth of money and credit turned to normal from the high in 2009. The first half of 2010 also witnessed adequate liquidity in the banking system, stronger flexibility of the RMB exchange rate, and sound financial performance.

I. The growth of money supply slowed down

At end-June 2010, outstanding M2 registered 67.4 trillion yuan, up 18.5 percent year on year, a deceleration of 9.2 percentage points over the end of 2009. Outstanding M1 stood at 24.1 trillion yuan, an increase of 24.6 percent year on year, a deceleration of 7.8 percentage points. Outstanding M0 totaled 3.9 trillion yuan, up 15.7 percent year on year, an acceleration of 3.9 percentage points over the end of the previous year. Net cash injections reached 65.8 billion yuan, 123.6 billion yuan more year on year.

Aggregate money growth gradually slowed down, as M2 and M1 declined by 4.0 percentage points and 5.3 percentage points respectively over the end of Q1 2010. Under the monetary policy mix, money growth has been in line with the macroeconomic goals, providing a money and financial environment facilitating stable economic development. M1 growth exceeded that of M2 for 10 consecutive months, indicating adequate liquidity.

II. Deposit growth slowed down

At end-June, outstanding loans in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, including hereafter) totaled 68.9 trillion yuan, up 18.6 percent year on year, 9.1 percentage points and 3.1 percentage points less than end-2009 and end-Q1 2010 respectively. Outstanding loans increased 7.7 trillion yuan over the beginning of the year, a deceleration of 2.4 trillion yuan year on year. Outstanding RMB deposits registered 67.4 trillion yuan, up 19.0 percent year on year, 9.2 percentage points and 3.1 percentage points less than end-2009 and end-Q1 2010 respectively, and up 7.6 trillion yuan over the beginning of the year, a deceleration of 2.3 trillion yuan year on year. Outstanding foreign currency deposits registered US$212.7 billion, up 2.2 percent year on year and an increase of US$ 4 billion over the beginning of 2010, a deceleration of US$11.3 billion.

Household deposits were stable while the deposits of non-financial enterprises registered a significant decline. The share of demand deposits rose. At end-June, outstanding household deposits at financial institutions totaled 29.2 trillion yuan, up 15.2 percent year on year, an acceleration of 0.1 percentage points and an increase of 2.8 trillion yuan over the beginning of the year, a deceleration of 415.2 billion yuan, which may be partly attributed to diversion to wealth management products and other investment products. Outstanding RMB deposits of non-financial institutions reached 28.1 trillion yuan, up 19.5 percent year on year, a deceleration of 7.1 percentage points over the growth in Q1. They rose 2.9 trillion yuan over the beginning of the year, a major deceleration of 2.7 trillion yuan, which can be partly attributed to last year's high base. Demand deposits accounted for 45 percent and 52 percent respectively of new household deposits and deposits of non-financial enterprises, up 10 percentage points and 6 percentage points respectively year on year. At end-June, outstanding fiscal deposits registered 3.2 trillion yuan, up 28.9 percent year on year and up 970.7 billion yuan over the beginning of the year, an acceleration of 282.6 billion yuan year on year.

III. Loan growth of financial institutions stabilized

At end-June, outstanding loans in domestic and foreign currencies of all financial institutions reached 47.4 trillion yuan, up 19.2 percent year on year, 13.8 percentage points and 4.9 percentage points lower thanend-2009 and end-Q1 2010 respectively. Outstanding loans grew 4.8 trillion yuan over the beginning of the year, a deceleration of 2.9 trillion yuan year on year. The major share of medium- and long-term loans in domestic and foreign currencies went to the infrastructure sector (transportation, warehousing, and postal services, the production and supply of electricity, gas, and water, and management of water conservation, the environment, and public utilities), the real estate sector, and the manufacturing sector. In the first half of the year, medium- and long-term loans extended by major financial institutions (including the China Development Bank and policy banks, state-owned commercial banks, shareholding commercial banks, postal savings banks, and urban commercial banks) to the three sectors registered 1.03 trillion yuan, 448.8 billion yuan, and 313.3 billion yuan, accounting for 43.4 percent, 18.8 percent, and 13.1 percent respectively in new medium- and long-term loans for all industries. The growth in loans extended to the agricultural sector and the rural areas remained higher than other loans during the same period. At end-June, outstanding loans extended to the rural areas by major financial institutions and rural cooperative financial institutions, urban credit unions, and rural banks and financial companies stood at 8.8 trillion yuan, up 31.3 percent year on year, 12.1 percentage points higher than the average loan growth in other sectors. Outstanding loans to the agricultural, forestry, animal husbandry, and fishery industries totaled 2.2 trillion yuan, up 22.0 percent year on year, 2.8 percentage points higher than the average loan growth in other sectors.

The growth of RMB loans gradually slowed down. At end-June, the growth of RMB loans stood at 18.2 percent, 13.5 percentage points and 3.6 percentage points slower from end-2009 and end-Q1 2010 respectively, and RMB loans totaled 4.6 trillion yuan more than that at the beginning of 2010, 2.7 trillion yuan less compared with the growth during the same period of the previous year. Credit extensions followed a stable trend from month to month. Beginning in February 2010, monthly credit extensions remained at around 650 billion yuan. Credit generally grew in line with the aims of macroeconomic management. Loans extended by Chinese-funded large banks and small- and medium-sized banks operating nationwide and locally grew slower compared with the growth during the same period of the last year. Broken down by sectors, household loans maintained fairly rapid growth whereas growth of non-financial enterprise loans and other sectors declined significantly. At end-June, household loans grew 49.3 percent year on year, up 6.0 percentage points over the end of 2009, 2.2 percentage points slower compared with Q1-2010, and 1.7 trillion yuan more than at the beginning of the year, an acceleration of 682.9 billion yuan year on year. Residential mortgage loans accounted for 50 percent of the total household loans, registering a remarkable increase of 870.3 billion yuan over the beginning of the year. In recent months, however, the growth of residential mortgage loans slowed down as a result of the further implementation of real estate control measures and the marked fall in the volume of real estate transactions. In June 2010, residential mortgage loans only accounted for 33 percent of total household loans. Loans to non-financial enterprises and other sectors rose 11.3 percent year on year, growing 2.9 trillion yuan over the beginning of this year, a deceleration of 3.4 trillion yuan year on year. Among this total, medium- and long-term loans went up 2.7 trillion yuan over the beginning of the year, a deceleration of 426.2 billion yuan. Bill financing dropped 652.4 billion yuan from the beginning of the year, a deceleration of 2.4 trillion yuan, falling only 28.1 billion yuan over end-Q1 2010. Recently, bill issuances remained at a fairly high level, as have the bill discount rate. Bill financing continued to serve as a pool for commercial banks to adjust their asset structures. Credit support for SMEs was reinforced. In the first half of the year, new loans extended by banking institutions to SMEs stood at 1.9 trillion yuan, and by end-June 2010 outstanding bank loans for SMEs had risen 19.2 percent year on year. Among this total, new loans for small enterprises registered 866.8 billion yuan in the first half of the year, and outstanding loans for small enterprises increased 23.9 percent year on year, 7.7 percentage points and 11.4 percentage points more than that for medium and large enterprises respectively.

Table 1: RMB loans of financial institutions in the first half of 2010

Unit: 100 million yuan

	First Half of 2010	
	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	24282	-17180
Chinese-funded Small and Medium Banks Operating Nationwide②	12649	-8955
Chinese-funded Small and Medium Local Banks③	2801	-1713

Rural Cooperative Financial Institutions④	7602	143
Foreign-funded Financial Institutions	775	1101

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

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

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

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

Source: The People's Bank of China

At end-June, outstanding foreign-currency loans of financial institutions registered US$411.7 billion, up 39.4 percent year on year, and US$32.3 billion more than that at the beginning of the year, a deceleration of US$19.4 billion. Among this total, trade financing support for imports and exports increased by US$12.2 billion, accounting for 38 percent of the total new foreign-currency loans. In Q2, new foreign-currency loans totaled merely US$3 billion, representing slower growth partly as a result of the small increase in foreign-currency deposits and the limited foreign-currency position at the commercial banks.

Box 1. Reinforce the capital requirement and enhance the efficiency of commercial banks in capital operations

After the launching of the shareholding reform of commercial banks in 2003, commercial banks in China have improved capital management and enhanced awareness of capital discipline, and have established a capital discipline mechanism that has facilitated the sound development of the banking industry and helped provide more efficient financial support for economic growth. At end-2009, the weighted average capital adequacy ratio of commercial banks in China stood at 11.4 percent. All 239 commercial banks met the capital adequacy requirement.

The goal of capital management is to put the role of the capital discipline mechanism into full play, so that capital will grow along with the expansion of risk assets, thus making banks better prepared to face any risks. Currently, commercial banks in China are accelerating their development. A facilitating economic environment, a rapid rise in profits, and dependence on the interest spread for profits have driven commercial banks to expand the size of their assets, especially those with high risk weights, bringing down their capital adequacy ratio. Many banks, particularly the large commercial banks, still rely on state-owned shareholders and the government for replenishment of capital when there is a lack of capital adequacy as a result of credit expansion. The role of the capital discipline mechanism was not put into full play as the banks expanded their assets regardless of their capital adequacy and they resorted to state-owned shareholders and the government for capital increases when their asset expansion diluted and undermined the capital adequacy. This was misaligned with the long-term sustainable development of the banks. Moreover, intensive capital replenishment on the part of large financial institutions will have an impact on the capital market, making it more difficult to raise capital and it will increase financing costs. In brief, capital discipline awareness and measures, the capital discipline mechanism, and efficiency in running capital operations require further improvement.

In response to the international financial crisis, China has taken a series of policy measures to promote stable and fairly rapid growth of the economy in a timely manner during the past year. Implementation of the relatively loose monetary policy enabled rapid growth in bank credit and helped fuel development of the real economy. Alongside the rapid credit extensions, however, the size of bank assets went up and the capital adequacy ratio declined. To solve this problem, regulators introduced stronger requirements for both the quantity and the quality of capital. In addition, implementation of Basel II and the global trend to strengthen the regulatory capital requirement added to the necessity to reinforce the capital discipline mechanism, enhance the efficiency of capital operations, and improving the capital replenishment and discipline mechanisms of commercial banks in China.

Stronger capital discipline and more efficient use of capital facilitate sound operations of the banking system, help ease the replenishment pressures faced by commercial banks, adjust the financing structure, and prevent systemic risks in the financial sector, thus promoting sustainable, sound, and healthy development of the Chinese economy. At present, continued efforts should be made to improve the capital regulatory system based on the specifics of the Chinese banking system and in line with the concepts and approaches for capital regulation proposed by international organizations such as the Basel Committee on Banking Supervision (BCBS) since the outbreak of the international financial crisis. While improving the capital replenishment mechanism and strengthening core capital and the internal capital accumulation capability of commercial banks, efforts should be made to strengthen awareness of capital discipline and to establish a long-term and effective capital discipline system so that commercial banks will handle capital in a more efficient manner. First, the total amount and pace of credit extensions should be well managed so that credit will grow based on the needs of economic development. Efforts should be made to establish and improve the macro-prudential framework to enable counter-cyclical adjustments, to guide the stable growth of money and credit, and to enhance the banks' capability to handle cyclical volatilities. Second, appropriate financial innovations should be guided and encouraged to improve the banks' active management of assets and liabilities. Banks will be encouraged to adjust the asset structure based on their resilience to risks, to enhance the share of fee-based businesses and other non-capital intensive businesses and items, to transform their profit-making patterns, to make more efficient use of capital, and to enhance competitiveness by adopting cost-effective operations. Third, continued efforts should be made to improve the internal capital management of commercial banks, to improve the internal capital adequacy assessment procedure, to put in place a strictly-implemented capital discipline system that limits excessive asset expansions so as to strike a balance between risk management, profitability, and capital adequacy. Fourth, development of the financial market should be accelerated to enhance the share of direct financing, adjust the financing structure, and ease the capital needs of the banking sector.

IV. Liquidity in the banking sector was adequate

At end-June, outstanding base money registered 15.4 trillion yuan, up 24.5 percent year on year and an increase of 1.0 trillion yuan over the beginning of the year. At end-June, the money multiplier was 4.37, basically flat with that in Q1 2010 and 0.22 smaller compared with that in Q2 2009, indicating less of an increase in money supply in response to one unit of growth in the monetary base. At end-June, excess reserves of financial institutions stood at 1.82 percent, and those of Chinese-funded large banks, Chinese-funded medium banks, Chinese-funded small banks, and rural credit cooperatives registered 1.39 percent, 1.79 percent, 2.68 percent, and 4.27 percent respectively.

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

Lending rates offered to non-financial enterprises and other sectors increased slightly. At end-June, the weighted average lending rate reached 5.57 percent, up 0.32 percentage points over the beginning of the year. The weighted average interest rate for general lending registered 5.99 percent, up 0.11 percentage points over the beginning of 2010, and the weighted average bill financing rate posted 3.77 percent, up 1.03 percentage points over the beginning of the year. The weighted average residential mortgage rate rose by a small margin of 0.53 percentage points over the beginning of 2010 to 4.95 percent at end-June.

Loans with interest rates lower than the benchmark accounted for a smaller share of the total. In June, the share of general loans of financial enterprises and other sectors with interest rates lower than the benchmark stood at 27.72 percent, down 5.47 percentage points from the beginning of 2010. Loans with interest rates flat with or higher than the benchmark accounted for 30.89 percent and 41.39 percent respectively of the total, up 0.63 percentage points and 4.84 percentage points compared with the beginning of this year.

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

Unit：%

	Lower than the benchmark	At the benchmark	Higher than the benchmark					
	[0.9，1]	1	Sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2
January	35.38	31.18	33.44	11.92	8.74	4.42	5.71	2.65
February	32.64	31.95	35.41	12.77	9.21	4.31	6.09	3.03
March	30.05	28.91	41.04	13.12	10.91	5.45	7.11	4.45
April	26.22	31.18	42.60	13.83	11.66	5.89	7.47	3.75
May	26.56	29.55	43.89	14.92	11.88	5.77	7.62	3.70
June	27.72	30.89	41.39	14.44	11.63	5.34	6.80	3.18

Source: The People's Bank of China

Due to the heightened foreign-currency financing needs of domestic enterprises and the higher interest rates on the international market, such as the overseas US dollar Libor, foreign currency deposits and lending rates in China increased. In June, the weighted average 3-month and 3-6 month US dollar lending rate stood at 2.39 percent and 2.81 percent respectively, up 0.80 and 1.15 percentage points over the beginning of the year. The weighted average interest rates of US dollar demand deposits and large-value US dollar deposits with a maturity of less than 3 months posted 0.21 percent and 1.76 percent respectively, increases of 0.04 and 1.30 percentage points compared with the beginning of the year.

Table 3: The average interest rate for large-value deposits and loans denominated in US dollars in the first half of 2010

Unit：%

	Large-value deposits						Loans				
	Demand Deposits	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year
January	0.12	0.62	0.88	1.07	1.88	2.96	1.55	1.91	2.07	2.09	3.04
February	0.15	0.70	0.85	1.50	1.65	1.75	1.68	1.88	1.90	2.16	2.79

March	0.15	0.76	0.81	1.34	2.32	0.82	1.69	1.82	2.03	2.32	2.87
April	0.15	0.92	0.87	1.69	1.99	3.83	1.94	2.12	2.14	2.53	2.50
May	0.16	1.41	1.65	1.72	3.09	2.82	2.39	2.88	2.63	2.96	3.02
June	0.21	1.76	1.44	2.32	1.60	3.94	2.39	2.81	2.88	3.10	3.33

Source: The People's Bank of China.

VI. The flexibility of the RMB exchange rate rose significantly

From the beginning of 2010 to June 19 of this year, the RMB exchange rate remained basically stable within a range of 6.81 to 6.85 yuan. Since the furthering of the RMB exchange rate reform on June 19, 2010, the RMB exchange rate has moved in both directions and has appreciated slightly with much stronger flexibility. At end-June, the central parity of the RMB against the US dollar was 6.7909 yuan per US dollar, up 373 basis points or 0.55 percent over end-2009. The central parity of the RMB against the euro registered 8.2710 yuan per euro, an appreciation of 18.45 percent from end-2009, and the central parity of the RMB against the Japanese yen stood at 7.6686 yuan per 100 Japanese yen, a depreciation of 3.79 percent from end-2009. From the reform of the RMB exchange rate in July 2005 to end-June 2010, the RMB has appreciated 21.88 percent against the US dollar, 21.07 percent against the euro, and has depreciated 4.73 percent against the Japanese yen. According to the estimation of the BIS, the nominal effective RMB exchange rate appreciated 18.5 percent and the real effective exchange rate appreciated 21.5 percent.

In the first half of the year, the central parity of the RMB against the US dollar peaked at 6.7890 yuan per dollar and reached a trough of 6.8284 yuan per dollar. Among the 118 trading days, the inter-bank foreign exchange market saw an appreciation on 59 days, flat movement on 6 days, and a depreciation on 53 days. Since the furthering of the RMB exchange rate reform on June 19 to the end of June, the largest appreciation in a single day was 295 basis points (or 0.43 percent) whereas the largest depreciation in a single day was 122 basis points (or 0.18 percent).

Part 2 Monetary Policy Conduct

In line with the overall arrangements of the State Council, the PBC continued to implement a moderately easy monetary policy in the first half of 2010. While policies remained consistent and stable, they also became better targeted and more flexible in response to new developments so as to support steady and healthy economic development. Specifically, the PBC strengthened liquidity management in the banking system and guided financial institutions to properly manage the aggregate, pace, and structure of credit provisions. It continued to overhaul financial enterprises, further reform the RMB exchange rate regime, and improve foreign exchange administration.

I. Open market operations were conducted in a flexible manner

Closely monitoring and analyzing global and domestic economic and financial developments as well as liquidity movements in the banking system, and in line with its relatively easy monetary policy stance, the PBC conducted open market operations in a flexible manner during the second quarter of 2010, which helped maintain liquidity in the banking system at a reasonably adequate level and stabilize market expectations. First, the PBC properly managed the size and pace of open market operations to deal with the heightened liquidity volatility in the banking system, which came about as a result of a number of factors, including the worsening of the European sovereign debt crisis since the second quarter, the mid-year supervisory examination of financial institutions, and a series of IPOs. These operations have stabilized liquidity in the banking system to a reasonably adequate level. In the first six months, the PBC issued 2.6 trillion yuan of central bank bills and conducted 1.5 trillion yuan of repurchase operations on a cumulative basis. Outstanding central bank bills stood at 4.4 trillion yuan at end-June. Second, the PBC continued to improve the mix of tools employed in open market operations in an effort to flexibly manage the liquidity in the banking system. In early April, it reintroduced 3-year central bank bills to supplement the tools with a maturity less than 1 year, and conducted short-term repurchase operations in addition to central bank bill issuances. Third, the PBC duly increased the flexibility of interest rates of open market operations in line with market movements. Although the interest rate of short-term operations moved upward, the interest rate for 3-year central bank bill issuances edged down in response to market changes. This helped improve the maturity structure of open market interest rates, guide market expectations, and improve liquidity management. On June 30, the interest rates of 3-month and 1-year central bank bills stood at 1.5704 percent and 2.0929 percent, up 24 basis points and 33 basis points from end-2009 respectively; the interest rate for 3-year central bank bills posted 2.68 percent, down 7 basis points cumulatively since they were resumed. Fourth, the PBC duly conducted state treasury cash management operations in an effort to accommodate fiscal policy, support monetary policy, and raise returns on state treasury funds. In the first half of 2010, the PBC deposited 200 billion yuan of state treasury funds in commercial banks in 6 separate operations, including 80 billion yuan in 3-month deposits, 90 billion in 6-month deposits, and 30 billion in 9-month deposits. This helped maintain the consistency of operations and satisfied the financing needs of some small- and medium-sized financial institutions.

II. The reserve requirement ratio was raised with proper timing

In an effort to enhance liquidity management, guide proper money and credit growth, and manage inflationary expectations, the PBC raised the reserve requirement ratio for RMB deposits in depository financial institutions on January 18, February 25, and May 10, by an increment of 0.5 percentage points. The reserve requirement ratio for rural credit cooperatives and other small financial institutions remained unchanged so as to support agriculture, rural areas, and farmers, and county-level development. These properly timed moves helped sterilize part of the excess liquidity in the banking system. After these moves, there was still sufficient liquidity available in the market to support proper money and credit growth and economic development.

III. Window guidance and credit policy guidance were strengthened

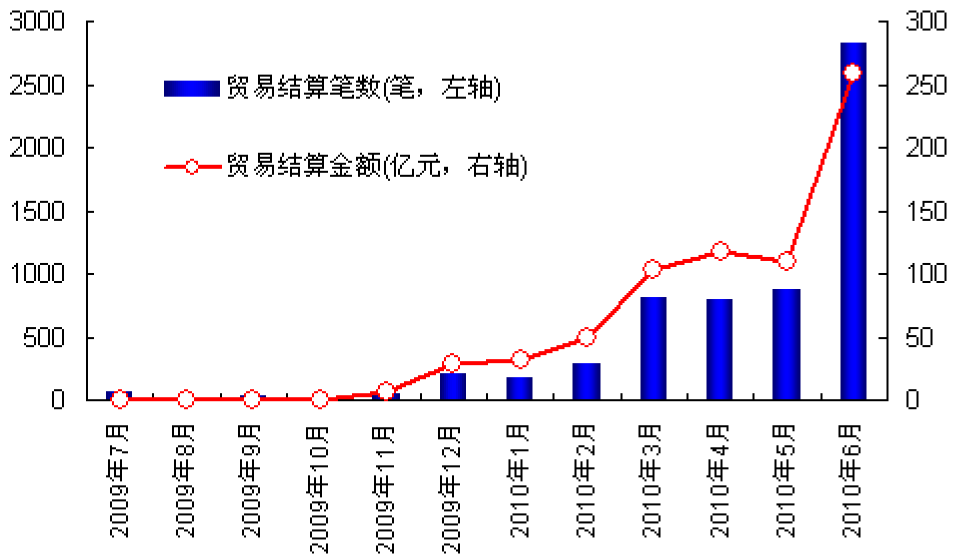
The PBC continued to improve window guidance on financial institutions in the first half of 2010. It encouraged financial institutions to properly manage the pace of credit provisions and improve the credit management system, fully leveraging the role of credit policy to support economic and social development. First, following the requirement to make differentiated credit policies, the PBC guided financial institutions to increase lending to key industries and projects under construction, to support companies' efforts for energy savings, emission reductions, technological upgrading, and elimination of inefficient capacity, and to improve financial services to small enterprises. It encouraged financial institutions to support the development of the culture industry, outsourcing services, logistics, and other emerging industries of strategic importance, improve financial services closely related to the people's livelihood, including ensuring credit support to earthquake relief efforts, programs to encourage university graduates to work in civil service positions at the grass-roots levels, to encourage employment, and to support students facing financial difficulties, poverty reduction, and regional development programs. In the meantime, the PBC strengthened management of lending activities for local government financing platforms, cut back lending to high energy-consuming and polluting industries and industries with an overcapacity. It also guided financial institutions to concretely implement differentiated mortgage policies. Second, the PBC encouraged innovation in rural financial products and services across the country so as to improve rural financial services. It took measures to adjust and optimize the credit structure and increased the agro-linked credit supply. Third, the PBC encouraged financial institutions to update their evaluation systems and properly pace credit extensions to avoid sharp lending fluctuations between months and quarters.

IV. The pilot program for RMB settlement of cross-border trade transactions made new progress

In the second quarter of 2010, RMB settlement of cross-border trade reached 48.66 billion yuan, expanding 1.65 times quarter on quarter. At end-June total RMB settlement reached 70.60 billion yuan since the program was launched, including 6.53 billion yuan of goods exports, 56.39 billion yuan of goods imports, and 7.68 billion yuan in services trade and other items under the current account. Agent banks in the mainland opened 284 inter-bank RMB transfer accounts for overseas participating banks, with a total balance of 7.73 billion yuan. Most overseas RMB settlements took place in Hong Kong and Singapore, which together accounted for 87 percent of the total RMB payments and receipts business.

To meet the growing need for RMB settlement in cross-border trade, on June 22, 2010, the PBC, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the China Banking Regulatory Commission (CBRC) issued a joint notice on expanding the pilot program. According to the *Notice on Issues Regarding Expanding the Pilot Program for RMB Settlement of Cross-border Trade Transactions*, the pilot program was expanded to allow more regions in China to settle trade of goods and other items under the current account with overseas companies throughout the world.

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



Number of transactions (Left)
Volume of transactions (Right, 100 million yuan)

Source: People's Bank of China

Box 2 The pilot program for RMB settlement of cross-border trade was expanded

Since the pilot program for RMB settlement of cross-border trade was initiated in July 2009, RMB settlement and clearing have been conducted smoothly, and policies for tax rebates and exemptions for exports and for declaration of imports and exports have been clearly defined and supported by easy operational procedures. The pilot program was positively received, and there have been growing calls among companies that the program be expanded.

In response to these calls and to promote the role of RMB settlement of cross-border trade, with the approval of the State Council, the PBC, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the CBRC jointly issued the *Notice on Issues regarding Expanding the Pilot Program for RMB Settlement of Cross-border Trade Transactions*. The *Notice* expanded the pilot program in the following 6 ways. First, the pilot program was expanded to cover overseas enterprises from all other countries and regions in addition to Hong Kong, Macao, and the ASEAN countries. Second, another 18 provinces (autonomous regions and municipalities) were added to the list of regions covered by the pilot program, including Beijing, Tianjin, Inner Mongolia, Liaoning, Jilin, Heilongjiang, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangxi, Hainan, Chongqing, Sichuan, Yunnan, Tibet, and Xinjiang. Third, the pilot program was implemented in all cities in Guangdong in addition to the 4 original cities, and covered more goods exporters in Shanghai and Guangdong. Fourth, licensed importers and exporters in all regions covered by the pilot program were allowed to make RMB settlements for goods imports, cross-border services trade, and other current account items in accordance with the provisions of the *Administrative Measures for the Pilot Program for RMB Settlement of Cross-border Trade* (the *Measures*, Document No. 10 [2009], the PBC, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the CBRC). Fifth, a management system for companies under the pilot program was applied for RMB settlement of goods exports in 16 provinces, i.e., Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Chongqing, Sichuan, and Yunnan. Sixth, licensed importers and exporters in 8 border provinces (Inner Mongolia, Liaoning, Jilin, Heilongjiang, Guangxi, Yunnan, Tibet, and Xinjiang) were allowed to settle in RMB goods exports in general trade and small value border trade with neighboring countries at prescribed ports following the provisions of the *Measures*. Export tax rebates or exemptions in this process are conducted in line with the *Notice on Export Rebates or Exemptions for RMB Settled Goods Exports in General Trade and Small-Value Border Trade in Border Regions* (Document No. 26 [2010], the Ministry of Finance and the State Administration of Taxation).

The pilot program was expanded in response to calls from domestic and overseas markets. It provides another source for overseas RMB supplies, satisfies the needs of companies to diversify overseas businesses, facilitates trade and investment, and greatly supports the “going-global” initiative. The move also will help strengthen economic and trade ties with neighboring countries and regions, especially the developing countries.

V. The RMB exchange rate regime was improved

The RMB exchange rate remained at a generally stable level from early 2010 to mid-June in order to deal with the impact of the global financial crisis. In view of the domestic and global economic and financial situations and China's BOP position, on June 19, 2010 the PBC decided to further reform the RMB exchange rate regime and improve its flexibility. Since then, the RMB has appreciated by a small margin as it has moved in both directions with markedly greater flexibility.

Box 3 China further reformed the RMB exchange rate regime

Based on a review of the economic and financial conditions both at home and abroad as well as China's BOP position, on June 19, 2010 the PBC announced it would further reform the RMB exchange rate regime to make it more flexible.

1. The RMB exchange rate regime reform in 2005 produced the desired results.
On July 21, 2005, China began the RMB exchange rate regime reform and moved to a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Since then, the reform has been promoted steadily. It supports the development of the real economy, creates favorable conditions for macroeconomic management, and plays an important role in China's efforts to respond to domestic and global developments. In general, it has produced the intended results.

In 2008, the floating range of the RMB exchange rate was narrowed to address the adverse impact of the global financial crisis. This served the economic interests of China and contributed to its rapid economic stabilization and recovery. Although many currencies depreciated sharply against the US dollar during the worst of the crisis, the RMB exchange rate remained basically stable. This policy commitment has been important in mitigating the shocks of the financial crisis and has contributed greatly to the Asian and global recovery.

2. Key aspects in further reforming the RMB exchange rate regime.
The managed floating exchange rate regime is China's established policy. It needs to be further reformed on the basis of the reform in 2005 to enhance exchange rate-flexibility against the backdrop of a recovering global economy and a strengthened recovery in China and driven by the urgent need to restructure the economy and shift the development pattern.

In doing so, the PBC will focus on reflecting the role of market supply and demand with reference to a basket of currencies. The RMB exchange rate will float within the floating bands previously announced in the inter-bank foreign exchange market to help keep the RMB exchange rate basically stable at an adaptive and equilibrium level, to promote a balanced BOP account, and to maintain economic and financial stability.

The basis for large fluctuations in the RMB exchange rate does not exist. China's external trade is becoming more balanced. In 2009, the current account surplus dropped 32 percent year on year, and its share in GDP shrank significantly from 9.6 percent in 2008 to 6 percent in 2009. This development continued in 2010. In the first 3 months of 2010, China's current account surplus was reduced year on year by 32 percent to 53.6 billion US dollars, making up 4.5 percent of GDP and indicating a more balanced BOP account.

3 Further reform of the RMB exchange rate serves China's fundamental interests.

The decision to further reform the managed floating exchange rate regime was made in light of China's specific circumstances and development strategy. It is consistent with the reform to improve the socialist market system and it is in China's long-term and fundamental interests. An improved managed floating exchange rate regime will support economic restructuring and promote comprehensive, balanced, and sustainable development. It will help fight inflation and asset bubbles and will make macroeconomic management more proactive and effective. Moreover, it will secure strategic opportunities and a trade environment that support China's economic development.

Further reforming the RMB exchange rate will have more positive impacts than the negative impacts on imports, exports, and employment. As the floating exchange rate regime is widely adopted under the current international monetary system, exchange rate fluctuations is a challenge that importers and exporters have to deal with. As the Chinese economy becomes more market-based, Chinese enterprises are increasingly resilient to adapt to market changes. This has been demonstrated in the rapid expansion of the export industries from the exchange rate regime reform in 2005 until 2008, when the global financial situation began to deteriorate. A floating exchange rate is also advantageous in that it cuts import costs and improves trade, facilitating effort by enterprises to introduce technology and equipment and to purchase raw materials and parts. It also helps improve the employment structure and increase employment. More jobs will be created in the export sector as the sector is upgraded from simple processing to deep and intensive processing, extending the industrial chain and improving the division of labor; the service sector will be able to employ more as it benefits from an optimized allocation of resources between tradable and non-tradable sectors.

Going forward, it is necessary to create favorable conditions to guide enterprises to carry out structural adjustments and to encourage banks to help enterprises to manage exchange rate risks. Moreover, the PBC will closely monitor the flows of short-term speculative capital and enhance management in this area to mitigate the shocks of massive hot money inflows on the financial system.

4 The foreign exchange market was stable and RMB exchange-rate flexibility increased after the furthering of the reform.

The interbank foreign exchange market remained stable and the RMB exchange rate became more flexible after last month's announcement by the PBC to further reform the RMB exchange rate. First, the RMB appreciated slightly, reflecting the fundamental role of market supply and demand. As of July 21, the central parity of the RMB against the US dollar posted 6.7802 yuan per dollar, up 473 basis points or 0.70 percent from the level on June 18, one day before the reform began, and representing an appreciation of 0.71 percent from end-2009. Second, the role of the currency basket grew stronger, which was reflected in the RMB exchange rate movements. Measured against the US dollar, the central parity of the RMB exchange rate moved in unison with the dollar exchange rate against other major currencies on all trading days with the one exception of June 21, when the exchange rate closed at the same level as on the previous day. Third, the RMB exchange rate moved in both directions. Following the reform in June, the central parity of the RMB against the US dollar leveled on one trading day, strengthened on 14 days, and weakened on 8 days, while, compared with the central parity, the closing rate gained on 14 trading days and lost on 9 days. Fourth, the RMB exchange rate became noticeably more flexible. Intra-day exchange rate fluctuations in the interbank foreign exchange market varied from 34 to 329 basis points, averaging 101 basis points, which is 1.3 times the average of 77 basis points in the period from 2005, when the previous round of reform began, to July 2008. Fifth, the reform was well received by enterprises and individuals and did not cause any unusual changes in foreign exchange sales and purchases at the banks. Sixth, in response enterprises began to employ tools to hedge foreign exchange risks, which led to the growth of forward foreign exchange sales and purchases at banks.

VI. The reform of financial institutions continued

Reform of the large commercial banks saw further progress. The Agricultural Bank of China (ABC) went public in both Shanghai and Hong Kong on July 15 and 16, marking the completion of the reform of large commercial banks. The ABC's dual listing raised 68.5 billion yuan from its 25.6 billion A-shares and 93.5 billion HK dollars from 29.2 billion H-shares after it exercised an over-allotment option in both listings. The ABC also explored ways to combine its agro-linked businesses and commercial operations. It continued a multi-divisional structural overhaul program and built a division dedicated to rural finance, which was launched on a trial basis in 8 provinces, including Sichuan, Chongqing, Hubei, Guangxi, Gansu, Jilin, Fujian, and Shandong. At the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB), and the Bank of Communications, the large four listed commercial banks, the governance structure was improved, contributing to stronger core competitiveness. As of end-March, the capital adequacy ratio at these four banks stood at 12.0 percent, 11.1 percent, 11.4 percent, and 11.7 percent respectively; the non-performing loan (NPL) ratio posted 1.35 percent, 1.30 percent, 1.35 percent, and 1.27 percent, whereas before-tax profits registered 54.1

billion yuan, 35.5 billion yuan, 45.7 billion yuan, and 13.5 billion yuan. The China Development Bank proceeded with its market-oriented reform to better support the major medium- and long-term economic development strategies.

Reforms tailored to policy financial institutions were advanced. The PBC continued to study and improve the reform plan for the Export and Import Bank of China and the draft amendment of the Articles of Association for the China Export and Credit Insurance Corporation, which will enhance their capacity as policy financial institutions to support foreign trade and investment. Moreover, the PBC stepped up work on studying the deepening of the internal reform at the China Agricultural Development Bank in preparation for an overall reform.

Meanwhile, major achievements were made in the reform of the rural credit cooperatives (RCCs). First, the financial position of the RCCs improved substantially. Based on the four-category loan classification, NPLs at RCCs totaled 358.1 billion yuan at end-June, accounting for 6.6 percent of their total lending, down 0.8 percentage points from end-2009. In contrast, total profits in the first six months of 2010 grew 35.3 percent to 39.5 billion yuan, an acceleration of 10.3 billion yuan year on year. Second, the RCCs stepped up support for agricultural development significantly. At end-June, total RCC lending was recorded 5.5 trillion yuan, and its share of the total lending by financial institutions went up from end-2009 by 0.5 percentage points to 12.2 percent. Among this total, agro-linked loans amounted to 3.7 trillion yuan, up 569.1 billion yuan from end-2009, and lending to rural households increased by 305.6 billion yuan from end-2009 to 1.9 trillion yuan. Third, reform of the RCC property rights system made progress. As of end-June, a total of 2,023 RCCs, 55 rural commercial banks, and 205 rural cooperative banks had been established, all with legal person status at the county (city) level.

VII. Reform of the foreign exchange administration system was deepened

In the first half of 2010, the foreign exchange administration authority implemented the overall arrangements of the State Council and the policy package designed to address the global financial crisis. This prevented risks from cross-border capital flows and thus contributed to the sound and rapid economic development.

Trade and investment was greatly facilitated in support of the external sector. This included efforts to launch the pilot reform of the verification and write-off system for import payments in foreign exchange in 7 provinces (municipalities), moving from on-site case-by-case verification to off-site aggregate verification and shifting the focus of supervision from transactions to companies; delegation of approval authority for 10 capital and financial account items and simplification of the documents required for such approval; allowing individual customers to purchase and sell foreign exchange through e-banking at the Bank of China, the China Merchants Bank, and the Industrial and Commercial Bank of China on a pilot basis; and, while controlling the level of aggregate external debt, allowing Chinese companies to borrow short-term external debt within the regional short-term debt quota and authorizing the regional foreign exchange administration authorities to set such quotas in line with the short-term external debt limit for Chinese companies within their respective jurisdictions.

Monitoring and early warning for cross-border capital flows were strengthened, and efforts were stepped up, including special campaigns to deal with hot money inflows and actions against underground banking and other foreign-exchange-related irregularities, to crack down on hot money and other forms of illegal fund flows. The use of foreign exchange for direct overseas investments by mainland banks was put under better management, and statistics on direct overseas investments were improved. In addition, a set of indicators to monitor both surplus and deficit risks was established, improving the monitoring and early warning system for BOP risks.

Part 3 Financial Market Analysis

In the first half of 2010, performance of China's financial market continued to be sound and in general market liquidity was adequate. The money market traded briskly and interest rates fluctuated upward. Indices on the bond market went up slightly and bond issuances grew significantly. Stock indices fluctuated downward whereas financing on the stock markets rose substantially.

In the first half of 2010, aggregate financing by the domestic non-financial sector (including the household, corporate, and public sectors) stood at 6.0 trillion yuan, down 32.3 percent year on year. Loans dominated the financing structure but their share of total financing declined compared with their share in the previous year. The share of financing through stocks rose notably, and enterprise bond financing continued to increase by a large amount. Therefore, direct financing played a more important role.

Table 4: Financing by domestic non-financial sectors in the first half of 2010

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	First half of 2010	First half of 2009	First half of 2010	First half of 2009
Financing by domestic non-financial sectors	60156	88915	100.0	100.0
Bank loans(1)	48358	77230	80.4	86.9
Equities(2)	2548	919	4.2	1.0
Government securities (3)	3275	4902	5.4	5.5
Enterprise bonds(4)	5975	5864	9.9	6.6

Notes: 1. Bank loans include domestic currency loans and foreign currency loans.

2. Equity financing includes convertible bond financing and excludes financing by financial institutions on the stock markets.

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

4. Enterprise bonds include enterprise bonds, corporate bonds, bonds with detachable warrants, collective bills, short-term financing bills, and medium-term notes.

Source: The People's Bank of China

I. Financial market analysis

1. The money market traded briskly and interest rates fluctuated upward

In the first half of 2010, repo transactions on the money market increased steadily and inter-bank borrowing rose remarkably. The turnover of bond repos totaled 38.4 trillion yuan, with an average daily turnover of 314.6 billion yuan, up 7.7 percent year on year. The turnover of inter-bank borrowing reached 11.1 trillion yuan, with an average daily turnover of 91.4 billion yuan, an increase of 40.6 percent year on year. Overnight products dominated bond repo and inter-bank borrowing transactions, accounting for 79.3 percent and 87.7 percent in their respective turnovers. The total turnover of government securities repos on the stock exchanges soared 100.2 percent to 2.6 trillion yuan.

The financing structure on the money market showed the following characteristics. First, the structure of the funding supply changed. As the commercial banks strengthened their balance-sheet management in response to the changing economic and financial situations, the policies for macro-economic management, and regulatory requirements, net lending of state-owned commercial banks declined substantially whereas other commercial banks became net borrowers in the first half of 2010, after being net lenders in the same period of the last year. Net lending of the state-owned commercial banks registered 10 trillion yuan, down 6.4 trillion yuan year on year. Net borrowing of other commercial banks registered 4.1 trillion yuan, 4.3 trillion yuan more than during the same period of the last year. Second, non-banking financial institutions in general showed a lower demand for funds. Facing the many uncertainties with respect to domestic and international economic prospects and the heightened fluctuations on the domestic stock market, they traded more cautiously and their funding demand declined substantially from the previous year. Net borrowing by securities and fund management companies saw a year-on-year decline of 29.9 percent and 95.8 percent respectively in the first half of 2010. In addition, with their own funding sources and balance sheets improved, net borrowing of foreign financial institutions posted a year-on-year decline of 32.6 percent.

Table 5: Fund flows among financial institutions in the first half of 2010

Unit: 100 million yuan

	Repo		Inter-bank borrowing	
	First half of 2010	First half of 2009	First half of 2010	First half of 2009
State-owned commercial banks	-91317	-151343	-8552	-12349
Other commercial banks	39996	-4529	916	2714
Other financial institutions (1)	37888	138777	6347	4888
Of which：Securities and fund management companies	37314	53068	642	1103
Insurance companies	908	21500	——	——
Foreign-funded financial institutions	13434	17095	1290	4746

Note: (1)"Other financial institutions" include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, fund management companies, and so forth. (2) A negative sign indicates net lending; a positive sign indicates net borrowing.
Source: The People's Bank of China

Interest on the money market fluctuated upward. In the first four months of 2010 to April, due to the diminishing impacts of the Spring Festival, the weighted average interest rate of bond-pledged repo and inter-bank borrowing declined steadily after hitting a high of 1.55 percent and 1.52 percent respectively in February. Since mid-May, affected by various factors, such as the increased risk aversion caused by the European sovereign debt crisis, the impending review by the regulatory authority of the deposit-to-lending ratio and other indicators, and additional capital raising by large commercial banks, market liquidity fluctuated and interest rates on the money market moved upward. In June, the monthly weighted average interest rate of bond-pledged repo and inter-bank borrowing was 2.38 percent and 2.31 percent respectively, up 67 and 64 basis points from May, and up 112 and 106 basis points from the same period of the last year. At end-June, the overnight and 7-day Shibor stood at 2.27 percent and 2.62 percent respectively, an increase of 112 and 105 basis points over end-2009. The 3-month and 1-year Shibor registered 2.63 percent and 2.62 percent, up 80 and 37 basis points respectively from the beginning of the year.

Trading in interest rate swaps grew rapidly whereas the forward interest rate market traded sluggishly. In the first half of 2010, a total of 4,262 transactions in RMB interest rate swaps was conducted, with an aggregate nominal principal of 485.63 billion yuan, up 160 percent year on year. In particular, trading of interest rate swaps with a maturity of less than 1 year was the most buoyant, with an aggregate nominal principal of 256.76 billion yuan, accounting for 52.9 percent of the total turnover. There were 644 bond forward transactions with a total turnover of 235.55 billion yuan, down 17.6 percent year on year. In particular, bond forward products with a maturity of less than fourteen days accounted for 90 percent of the total turnover. Interest rate forward products traded sluggishly, and there was only one transaction conducted in May and June respectively, with a total nominal principal of 500 million yuan. The Shibor played a more important role in pricing interest rate derivatives and the turnover of the Shibor-based interest rate swaps posted 140.1 billion yuan in the first half of 2010, accounting for 29 percent of the total turnover of the interest rate swaps. All the interest rate forward agreements were based on the Shibor.

Table 6: Transactions of interest rate derivatives

	Bond forwards	Interest rate swaps	Forward rate agreements

	Transactions	Volume (100 million yuan)	Transactions	Volume of nominal principal (100 million yuan)	Transactions	Volume of nominal principal （100 million yuan）
2006	398	664.5	103	355.7	—	—
2007	1238	2518.1	1978	2186.9	14	10.5
2008	1327	5005.5	4040	4121.5	137	113.6
2009	1599	6556.4	4044	4616.4	27	60.0
Q1 2010	552	1951.4	1872	2098.1	0	0
Q2 2010	92	404.2	2390	2758.2	2	5.0

Source: China Foreign Exchange Trade System

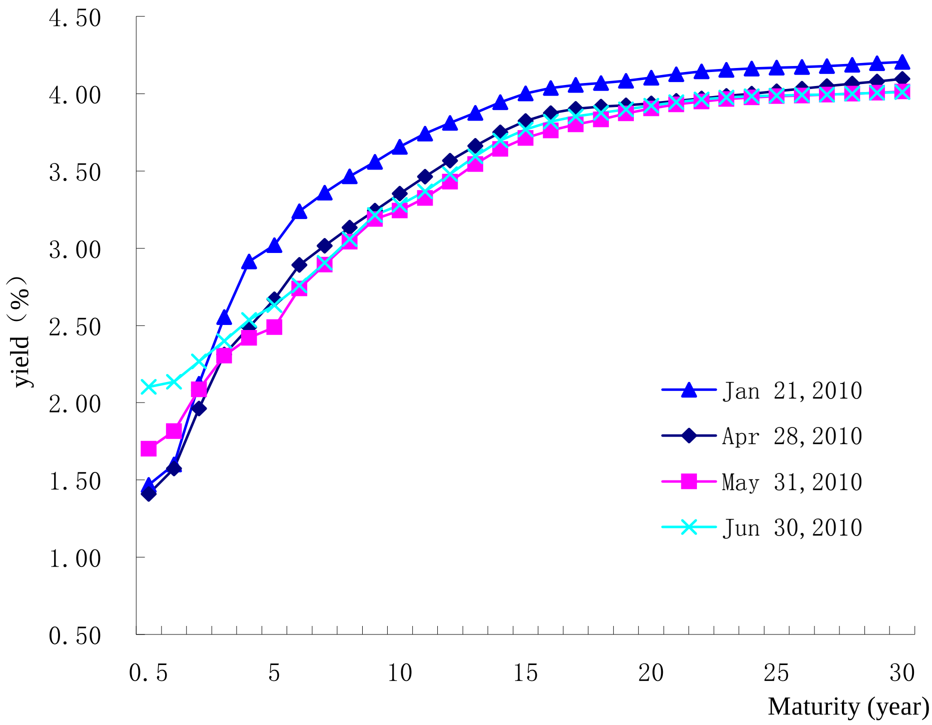
2. Indices on the bond market went up slightly and bond issuances grew steadily

Spot trading on the inter-bank bond market was stable. In the first half of 2010, the turnover of spot bond trading on the inter-bank bond market totaled 24.5 trillion yuan, with a daily average turnover of 200.6 billion yuan, up 12.8 percent year on year. All categories of financial institutions were net bond buyers, except for other commercial banks whose net bond sales posted 689.8 billion yuan. In particular, bond purchases by state-owned commercial banks totaled 572.2 billion yuan. Bond purchases by other financial institutions and foreign-funded financial institutions stood at 67.6 billion yuan and 50 billion yuan respectively. The turnover of spot government securities trading on the exchanges posted 97 billion yuan, down 13.7 billion yuan year on year.

Bond indices on the inter-bank bond market rose slightly. In the first half of 2010, bond indices on both the inter-bank market and the stock exchanges went up noticeably. The index of total returns on the inter-bank bond market rose 3.5 percent from 130.2 points at the beginning of 2010 to 134.7 points at end-June. The index of government securities on the stock exchanges rose 2.8 percent, from 122.3 points at the beginning of 2010 to 125.7 points at end-June.

The yield curve of government securities flattened. As fund availability was gradually reduced and interest rates on the money market continued to rise in May and June the yields of short-term government securities increased rapidly, whereas the yields of medium- and long-term government securities generally declined due to the strong demand by financial institutions and the changed market expectations. The yield curve of government securities flattened. For example, in late June, the yield of 6-month and 1-year government securities increased 70 basis points and 64 basis points respectively from end-2009, whereas the yield of 3-year, 5-year, 7-year, and 10-year government securities declined 3 basis points, 37 basis points, 39 basis points, and 37 basis points respectively.

Figure 2. Yield curve of government securities on the inter-bank market in the first half of 2010



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

Bond issuances grew steadily. In the first half of 2010, a total of 2.3 trillion yuan of bonds (excluding central bank bills) was issued on the primary bond market, up 9.9 percent year on year. In particular, bonds issued by policy banks and short-term financing bills grew significantly, by 68.1 percent and 136.0 percent respectively. At end-June, outstanding bonds deposited with the China Government Securities Depository Trust and Clearing Co. Ltd. totaled 17.9 trillion yuan, up 13 percent year on year.

Bond issuance rates showed some fluctuations. In Q1 2010, affected by the abundant market liquidity and the strong demand for bond investments, bond issuance rates declined gradually. Since April 2010, as bond supplies increased and fund availability was reduced to some extent, bond issuance rates have generally been on the rise. For example, the interest rate of 10-year book-entry government securities issued in June 2010 was 3.41 percent, 5 basis points and 16 basis points higher than in March 2010 and May 2010 respectively. The interest rate of 7-year bonds issued by policy banks fluctuated between 3.2 percent and 4.0 percent. The issuance rate of 1-year short-term financing bills fluctuated between 2.5 percent and 4.5 percent.

Table 7: Issuance of bonds in the first half of 2010

Type of bonds	Total volume (100 million yuan)	Year-on-year growth (%)
Government securities (1)	8296	-4.4
Of which: municipal bonds	438	-73.6
Financial bonds and policy financial bonds issued by the China Development Bank	5390	68.1
Bank subordinated bonds and hybrid capital bonds	1009	-4.5
Bank ordinary bonds	20	—
Enterprise bonds (2)	8175	6.3
Of which: short-term financing bills	3536	136.0
medium-term notes	2890	-33.7
corporate bonds	344	—
Asset-backed securities	0	—

Note: (1) Including municipal bonds. (2) Including enterprise bonds, corporate bonds, SME collective bills, short-term financing bills, and medium-term notes.

Source: The People's Bank of China

The Shibor played a greater role in bond pricing. In the first half of 2010, 10 floating-rate bonds were issued on the inter-bank bond market based on the Shibor, with a total issuance volume of 17.3 billion yuan. In addition, 71 enterprise bonds were issued based on the Shibor, with a total issuance volume of 140.4 billion yuan; 79 fixed-rate short-term financing bills were issued based on the Shibor, with a total issuance volume of 157.1 billion yuan, accounting for 45 percent of the total volume of fixed-rate short-term financing bills.

3. Bill financing gradually stabilized

The decline in outstanding bill financing moderated, and transactions on the bill market remained buoyant. In the first half of 2010, commercial drafts issued by enterprises totaled 5.5 trillion yuan, an increase of 1.6 percent year on year. Cumulative discounted bills declined 4.6 percent to 12.1 trillion yuan. Rediscounted bills totaled 62.74 billion yuan, 61.35 billion yuan more than during the same period of the last year. At end-June, the total value of outstanding commercial drafts declined 6.3 percent to 4.7 trillion yuan; outstanding discounted bills registered 1.7 trillion yuan, down 52.3 percent year on year; and outstanding rediscounted bills registered 47.31 billion yuan, 46.42 billion yuan more than during the same period of the last year. At end-June, outstanding bill acceptances were 276.8 billion yuan more than at end-March. The decline in the outstanding value of bill financing moderated, 28.1 billion yuan lower than that at end-March, and accounted for 3.9 percent of the total outstanding loans, down 5.7 percentage points year on year.

Bill market interest rates declined slightly from the previous quarter, although the overall level was still higher than in the previous year. Since the bill business is highly liquid, its expansion and contraction have an increasingly important impact on money and credit aggregates and their structures. Since April, with the growth of money and credit aggregates slowing down, financial institutions have been more inclined to hold bills, and the scale of bill financing has been stabilized. As a result, bill market interest rates declined slightly from the first quarter, although they still remained at an elevated level.

4. Stock indices fluctuated downward whereas the volume of financing on the stock markets surged

The turnover on the stock markets increased slightly. In the first half of 2010, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 22.6 trillion yuan, 456.3 trillion yuan more than during the same period of the last year, and the daily turnover rose 2.1 percent year on year to 191.9 billion yuan. At end-June 2010, market capitalization declined 16.2 percent year on year to 12.7 trillion yuan.

The stock indices went down amid fluctuations. After the large volatilities in the first quarter, the Shanghai Stock Exchange Composite Index showed a rapid downward movement. At end-June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index had dropped 26.8 percent and 21.3 percent respectively from end-2009 to close at 2398 points and 945 points. The average P/E ratios on the A-share markets in Shanghai and Shenzhen posted 18 times and 32 times, down from 29 times and 47 times at end-2009.

Funds raised on the stock market increased remarkably. In the first half of 2010, a total of 402.9 billion yuan was raised by non-financial enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, secondary offerings, rights issuances, stock vesting, and convertible bond issuances, a surge of 311 billion yuan or 338.4 percent year on year. Among this total, 350.7 billion yuan was raised through IPOs and rights issuances on the A-share market, up 262.8 billion yuan, or 299.0 percent, over that in the first half of 2009.

5. Total assets in the insurance industry continued fairly rapid growth

Premium income increased significantly. In the first half of 2010, aggregate insurance premiums grew 33.6 percent year on year to 799.9 billion yuan, an acceleration of 27.0 percentage points from the same period of the last year. In particular, premium income from life insurance grew 33.7 percent, an acceleration of 17.1 percentage points from the same period of the last year. Premium income from property insurance rose 33.5 percent, an acceleration of 17.1 percentage points. Total compensation and claim payments declined 13.5 billion yuan over the same period of the last year to 147.3 billion yuan.

The total assets of the insurance industry continued fairly rapid growth, and more money was allocated to investment-type assets. At end-June, the total assets of the insurance industry totaled 4.5 trillion yuan, an increase of 22 percent year on year. Among this total, investment-type assets grew 24.4 percent year on year, an acceleration of 8.5 percentage points. Bank deposits were up 21.6 percent, a deceleration of 28.1 percentage points.

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

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-June 2010	End-June 2009	End-June 2010	End-June 2009
Total assets	45235	37072	100.0	100.0
Of which: bank deposits	12700	10445	28.1	28.2
Investment	28954	23280	64.0	62.8

Source: China Insurance Regulatory Commission

6. The foreign exchange market operated soundly

The foreign exchange spot market operated soundly. The volume of swap transactions continued to rise and the volume of forward transactions increased by a large margin. In the first half of 2010, the turnover of spot RMB foreign exchange swaps continued its stable growth and was concentrated in OTC transactions. The total turnover of RMB foreign exchange swaps registered 630.6 billion yuan and the daily turnover soared 118.4 percent year on year. Among this total, swaps accounted for 59.5 percent, 3.8 percentage points less than that during the same period of the last year. The turnover on the RMB foreign exchange forward market totaled US$5.49 billion, and the daily average turnover rose 72.0 percent from the same period of the last year. The turnover of 8 foreign currency pairs amounted to US$28.2 billion, and their daily average turnover increased 58.7 percent year on year. The USD/HKD and EUR/USD currency pairs accounted for 82.7 percent of the total.

The foreign exchange market continued to develop, and participants on the foreign exchange market increased further. Eleven new members on the spot market, two market makers, and six non-banking financial institutions and non-financial enterprises began to trade on the foreign exchange market. In addition, adjustments to the comprehensive foreign exchange position for sales and surrenders of foreign exchange gave the commercial banks more flexibility and self-initiative to use their foreign exchange.

7. Trading on the gold market increased rapidly

In the first half of 2010, the turnover of precious metals totaled 891.51 billion yuan, up 111.3 percent year on year. In particular, a total of 317.45 tons of gold was traded, up 58.7 percent year on year, and the total turnover rose 100.0 percent year on year to 807.35 billion yuan. The trading volume of silver surged 418.5 percent over the same period of the last year to 18,000 tons and its turnover soared 612.7 percent year on year to 74.05 billion yuan. The trading volume of platinum declined 9.4 percent year on year to 27.9 tons and its turnover rose 27.5 percent year on year to 10.12 billion yuan.

In the first half of 2010, movement of the price of gold on the Shanghai Gold Exchange was consistent with that on international gold markets. In general, the domestic price of gold had been on the rise, and the price gap between the domestic and international markets widened. The price of gold reached a peak of 275.99 yuan per gram and a trough of 233.10 yuan per gram in the first half of 2010. At end-June, it closed at 271.33 yuan per gram, up 12.51 percent over the beginning of the year.

II. Financial market institutional building

1. Improvements in institutional arrangements for the securities market

Supervision over securities brokerage was strengthened. On April 1 2010, the China Securities Regulatory Commission (CSRC) issued the *Administrative Rules on Strengthening Management of Securities Brokerage*. The *Rules* require that securities companies put in place a sound and centralized management mechanism over the securities brokerage business, prevent conflicts of interest between securities companies and clients, earnestly honor their obligations against money laundering, and protect the legitimate rights and interests of their clients.

Participation by institutional investors in securities index futures trading was regulated. On April 21 2010, the CSRC issued the *Guidelines on the Participation in Stock Index Futures Trading by Securities Companies* and the *Guidelines on Participation of Securities Investment Funds in Stock Index Futures Trading*. These two *Guidelines* require that proprietary trading of securities companies and trading of securities investment funds should be for the sole purpose of hedging risks, and risk management and the internal control system should be strengthened.

2. Strengthening the basic institutional arrangements on the insurance market

Supervision over insurance companies was strengthened. In order to maintain the sound operation of insurance companies, protect the legitimate rights and interests of the investors and the insured, and strengthen supervision over the equity of insurance companies, in May 2010 the China Insurance Regulatory Commission (CIRC) issued the *Rules on Management over the Equity of Insurance Companies* to raise the threshold for equity investment in insurance companies, strengthen supervision over major shareholders, regulate investment and shareholding behavior, strengthen the responsibilities of shareholders, regulate the transfer of equity, and further relax the upper limits on shareholding by individual shareholders.

Efforts were made to enhance the transparency of insurance companies. In May 2010, the CIRC issued the *Administrative Measures on Information Disclosures by Insurance Companies*, urging insurance companies to disclose their operational information to the general public, including basic information, financial accounting, risk management, insurance product management, solvency, significant related-party transactions, and major events, further regulating the insurance companies' information disclosure behavior and protecting the legitimate rights and interests of the policyholders, the insured, and beneficiaries.

Supervision over the reinsurance business was strengthened. In order to implement the *PRC Insurance Law (Amended)* and strengthen supervision over the reinsurance business, in May 2010 the CIRC released the amended *Provisions on the Administration of the Reinsurance Business* to further regulate control of risk concentration, reserve evaluation of the life insurance business, and information disclosure of the reinsurance business, and so forth.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

Since 2010, the global recovery has evolved moderately, but the sovereign debt crisis in some EU countries and the risks accumulating in the financial sector have added uncertainties to the outlook for the world economy. The unemployment rate of the major advanced economies remained high and global activity was recovering at varying speeds across the different economies and areas. The US and Japanese economies picked up continuously whereas recovery in the euro area lost momentum somewhat. The emerging market economies experienced a generally rapid but divergent rebound, with Asia and Latin America growing faster than the EU emerging market economies. Due to the EU sovereign crisis, turmoil hit the global financial markets and the exchange rates between the major currencies fluctuated within an enlarged band.

1. Economic developments in the major economies

The US economy continued its moderate recovery. In Q2 2010, the seasonally adjusted annualized GDP registered 2.4 percent, lower than the expected 2.5 percent. But the GDP for Q1 was revised up from 2.7 percent to 3.7 percent. The employment rate and work-week for April and May all edged up but the unemployment rate remained high, with the seasonally adjusted monthly figures for the three months of Q2 standing at 9.9 percent, 9.7 percent, and 9.5 percent respectively. The total trade volume increased gradually and the trade deficit gained month by month, reaching USD 40.3 billion and USD 42.3 billion respectively for April and May, up by USD 11.8 billion and USD 17.4 billion compared with the same period of the last year. The federal fiscal deficit continued to grow, reaching USD 82.69 billion, USD 135.9

billion, and USD 68.4 billion respectively for the three months in Q2, down by USD 17.85 billion compared with Q2 of the last year. Due to the plunge in oil prices, the CPI for the three months of Q2 grew by 2.2 percent, 2.0 percent, and 1.1 percent year on year, but were down by 0.1 percent, 0.2 percent, and 0.1 percent month on month.

The recovery momentum weakened in the euro area. In Q1 2010, the GDP edged up by 0.2 percent month on month, higher than the 0.1 percent in Q4 of 2009, showing a trend of a moderate increase. However, in June the Composite PMI for the euro area dropped to a four-month low of 55.6. Though several countries in the area were hit by the sovereign debt crisis, the economy was supported by the improvement in exports boosted by the global recovery, a proper monetary stance, and measures aimed at stabilizing the financial market. Trade continued to pick up, with imports and exports for the first five months increasing by 15 percent and 16 percent year on year respectively, leading to a deficit of EUR 6.8 billion, slightly lower than that during the same period of the last year. The growth in prices was moderate, with the year-on-year HICP for the three months in Q2 edging up by 1.5 percent, 1.6 percent, and 1.4 percent respectively. Employment conditions remained gloomy and the seasonally adjusted unemployment rates for the three months of Q2 all remained at 10 percent, unchanged from March.

The Japanese economy showed signs of turning around. Promoted by consumption and exports, the real GDP growth after the seasonal adjustment registered 5.0 percent in Q1. The employment situation continued to be serious. Unemployment rates were recorded at 5.1 percent, 5.2 percent, and 5.3 percent for the three months of Q2. Foreign trade continued to rebound, with imports and exports soaring by 23.3 percent and 37.9 percent year on year for the first half of the year and the trade surplus standing at 3.395 trillion yen. Private consumption maintained an upward momentum. Price levels slid further but at a slower pace. The CPI for the three months of Q2 declined by 1.2 percent, 0.9 percent, and 0.7 percent respectively.

The emerging market economies continued to recover but at varying speeds. Due to the improvements in consumption and exports, the emerging Asian market economies experienced a robust rebound. In Q1, GDP in India rose by 8.6 percent compared with the last year, a record high since Q4 of 2007. Boosted by the strengthening domestic demand and the steady pick-up in the commodity market, the recovery of the major economies in Latin America was proceeding more rapidly than the world average. Growth in Argentina was stronger than expected, with the month-on-month GDP for Q1 back to the pre-crisis level of 6.8 percent. Economic conditions in Russia also brightened, reflected in the rising household consumption and the 2.9 percent year-on-year GDP growth rate for Q1 of 2010. However the rebound has yet to be confirmed. Recovery of the European emerging market economies, especially those in east and south Europe, have been held back by fiscal austerity measures and deleveraging by financial institutions.

2. Global financial market developments

In the first half of the year, the exchange rates of the major currencies fluctuated within broad bands. Exchange rate developments can be divided into three stages: From the beginning of the year to mid-April, the euro tumbled all the way down due to concerns about the sustainability of the EU countries' sovereign debt, the yen headed down from a high level, and the currencies of the other major economies mostly gained against US dollar as their economic conditions picked up. From mid-April to early June, the European debt crisis deteriorated across the board, leading to rising market risk aversion. Although the other currencies fell sharply, the US dollar bucked the trend and it alone appreciated, which had also been observed during the global financial crisis. On June 7, the exchange rate of the euro to the US dollar touched the bottom of 1.1875 US dollar per euro, a record low for four years. Since June, against the backdrop that the spread of the European sovereign crisis had been gradually restrained, the retreat of the euro was moderated and later turned into a marginal gain. The Japanese yen and the British sterling appreciated dramatically against the US dollar. At end-June, the exchange rate of the euro against the US dollar closed at 1.2238 dollar per euro, down 9.4 percent compared with the last quarter and down 14.5 percent from the end of the last year; that of the Japanese yen against the US dollar closed at 88.43 yen per dollar, up 5.7 percent compared with the last quarter and up 5.2 percent from the end of the last year. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, appreciated cumulatively by 2.6 percent throughout the first half of the year.

Driven by the demand for safe havens, the yields of government securities of the major countries fluctuated downward. Since Q2, market concerns about the worsening European sovereign crisis and the still-uncertain global outlook grew. As a result, demand for risk aversion increased and capital fled into the government securities market, which was relatively safe. On June 30, the yields of 10-year treasury bonds in the United States, euro area, and Japan closed at 2.941 percent, 2.575 percent, and 1.090 percent respectively, down 0.89, 0.52, and 0.323 percentage points from the end of the last quarter, and down 0.852, 0.806, and 0.201 percentage points from the end of the last year. US treasury prices were pushed up whereas yields declined by investors' heavy buying of treasuries due to their risk aversion. On June 30, 10-year yields once plunged to 2.924 percent, a record low since April 2009; and 30-year treasuries traded as low as 3.892 percent, the lowest level since October 2009.

Influenced by factors such as the European sovereign crisis, the major market interest rates fluctuated upward. On June 30, the 1-year US dollar Libor traded at 1.17 percent, up 0.19 percentage points from the beginning of the year. Since Q2, the Euribor had been rising. On June 30, the 1-year Euribor reached 1.306 percent, 0.058 percentage points higher than at the beginning of the year.

The major stock indices moved downward amid fluctuations and they all registered a decrease of more than 10 percent. Expectations about the exit of the stimulus policies and the shadow of the European sovereign crisis added to market concerns about the uncertainties facing a global recovery. In Q2, the major stock markets experienced a large correction and there were several freefalls at the beginning of May and at the end of June. On May 6, the Dow Jones Industrial Average plummeted 997 points, or 9.1 percent, due to market panic and rumors about a trader's lapses. On June 30, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 9774, 2109, 2573, and 9383 respectively, down 9.98 percent, 12.1 percent, 12.2 percent, and 15.4 percent from the end of the last quarter and down 6.3 percent, 7.0 percent, 13.2 percent, and 24.1 percent from the end of the last year, near the bottom since 2010.

3. Housing market developments in the major economies

Short-term data for the US housing market showed a mixed picture. In April, the sale of existing homes rocketed to 5.79 million after the seasonal adjustments, the highest level since November. In May, the sale of existing homes registered 5.66 million, a year-on-year increase of 19.2 percent. The vacancy rate of office buildings in Q2 was 17.4 percent, reflecting a 17-year low in the demand for office buildings. Since the preferential policy for first-time homebuyers was soon to terminate, the start of new home construction dropped by 5 percent month on month, a record low since 2010. The US preferential policy for first-time homebuyers provided a strong stimulus for the sale of existing homes, but the development of the housing market in the latter half of the year mainly will depend on macroeconomic conditions, especially the performance of the labor market.

The European housing market was tepid. In Q2, housing prices in Britain declined marginally. The seasonally adjusted month-on-month Halifax Index for the three months of Q2 dropped by 0.13 percent, 0.55 percent, and 0.65 percent respectively. Housing prices in France showed signs of stabilization. Meanwhile, the residential housing market in Germany continued to be stable, with the vacancy rate of office buildings edging up slightly and rent being flat.

Japanese housing remained sluggish. Though the Japanese government began to implement a preferential tax for energy-saving houses, the start of new home construction fell to a historic low range. After squeezing up by 0.6 percent year on year in April, the start of new home construction declined by 4.6 percent compared with the same period of the last year, which was below market expectations. In May, construction orders received by the top 50 construction companies in Japan rose by 9.2 percent year on year, a contrast with that in April, which were down by 25 percent year on year.

4. The monetary policies of the major economies

The central banks of the major economies continued to implement accommodative monetary policies. In order to support economic growth, the central banks of the major economies kept the policy rates unchanged at a low level throughout Q2. The

US Fed, ECB, Bank of England, and Bank of Japan kept the benchmark rates at 0-0.25 percent, 1 percent, 0.5 percent, and 0.1 percent respectively. On May 10, the ECB decided on several measures to address the serious tensions in the financial markets, including intervention in public and private debt securities in the euro area, adoption of a fixed-rate tender procedure with a full allotment in the regular 3-month and 6-month longer-term refinancing operations, and reactivation of the temporary liquidity swap lines with the Federal Reserve.

More and more central banks of the emerging market and advanced economies decided to raise their benchmark rates. To cool the overheated growth, ease inflationary pressures, and contain asset bubbles, emerging market economies such as Brazil, India, Malaysia, Peru, South Korea, and Thailand raised their interest rates. On June 1 and July 20, the Bank of Canada twice raised its target for the overnight rate by one quarter to 0.75 percent, becoming the first G7 country to raise its target rates since the outbreak of the crisis. Decisions by several economies to raise benchmark rates revealed confidence in the economic outlook and worries about future inflation.

However, several central banks announced that they would lower their benchmark rates. Since Q2, several economies have cut their interest rates. On April 30 and June 1, the Central Bank of the Russian Federation lowered its refinancing rate by 25 percentage points respectively to 7.75 percent, in order to support domestic demand. On May 5 and June 23, Sedlabanki Bank of Iceland cut its interest rates twice by 50 basis points respectively to 8.0 percent. The differences in these policy stances reflected the complexity and unsynchronized nature of the global recovery.

Table 9 Monetary Policies of Several Economies since 2010

Central Bank	Target Interest Rate at End-July 2010	Policy Measures since 2010
US Federal Reserve	Federal funds rate 0-0.25%	On June 14, June 28, and July 12, the Fed conducted three auctions through its Term Deposit Facility, offering \$1.15 billion in 14-day term deposits, \$2.12 billion in 28-day term deposits, and \$2.12 billion in 84-day term deposits respectively. This was the first time the Fed tried to drain liquidity from the banking system using this kind of tool.
European Central Bank	Main refinancing operations rate 1%	On May 10, the ECB decided on several measures to ease tension in the markets, including interventions in the euro area public

		and private debt securities, adopting a fixed-rate tender procedure with a full allotment in the regular 3-month and 6-month longer-term refinancing operations, and to reactivate the temporary liquidity swap lines with the Federal Reserve.
Bank of Japan	Uncollateralized overnight call rate 0.1%	On May 21, the Bank of Japan introduced a fund-provisioning measure to support strengthening the foundation for economic growth. On June 15, the BOJ announced details for the fund provisioning, which would provide loans of up to 3 trillion yen to the banking sector.
Bank of England	Bank rate 0.5%	The Bank of England voted to keep the stock of asset purchases under the “quantitative easing” monetary policy unchanged at ₤200 billion.
Reserve Bank of Australia	Cash rate 4.5%	On March 2, April 6, and May 4, the Reserve Bank of Australia raised the cash rate three times by 25 basis points each time to 4.5 percent.
Bank Negara Malaysia	Overnight policy rate 2.75%	On March 5, May 13, and July 8, the Bank Negara Malaysia raised the overnight policy rate three times by 25 basis points each time to 2.75 percent.
Reserve Bank of India	Repo rate 5.75%	On March 19, April 20, July 2, and July 27, the RBI increased the repo rate four times by 25 basis points each time to 5.75 percent.
Banco Central do Brasil	TBC/SELIC rate targets 10.75%	On April 29 and June 10, the Banco Central do Brasil raised the target rate twice by 75 basis points each time and on June 21 it raised it again by 50 basis points to 10.75 percent.
Norges Bank	Key policy rate 2%	On May 5, the Norges Bank raised the key policy rate by 0.25 percentage point to percent.
Banco Central de Reserva del	Reference interest rate 2%	In May, June, and July, the Banco Central de Reserva del Peru raised the reference interest rate

Peru		three times by 0.25 percentage points each time to 2 percent.
Bank of Canada	Overnight rate 0.75%	On June 1 and July 20, the Bank of Canada raised its target for the overnight rate by one quarter twice to 0.75 percent, becoming the first G7 country to exit from the accommodative policy measures.
Reserve Bank of New Zealand	Official cash rate 3%	On June 10 and July 29, the Reserve Bank raised the official cash rate twice by 25 basis points each time to 3 percent.
Banco Central de Chile	Monetary policy interest rate 1.5%	On June 14 and July 15, the Banco Central de Chile raised the monetary policy interest rate twice by 50 basis points each time to 1.5 percent.
Sveriges Riks banks	Repo rate 0.5%	On July 1, the Riksbank decided to raise the repo rate by 0.25 percentage points to 0.5 percent.
Bank of Korea	Base Rate 2.25%	On July 9, the Bank of Korea decided to raise the Base Rate by 25 basis points to 2.25 percent, marking the first rate increase since the outbreak of the crisis.
Bank of Thailand	Overnight repo rate 1.5%	On July 14, the Bank of Thailand raised the policy interest rate by 25 basis points to 1.5 percent.
Central Bank of the Russian Federation	Refinancing rate to financial institutions 7.75%	On February 24, March 29, April 30, and June1, the Central Bank of the Russian Federation lowered its refinancing rate four times, by 25 basis points each time, to 7.75 percent.
Sedlabanki Bank of Iceland	Seven-day collateral lending rate 8.5%	On March 17, May 5, and June 23, the Bank cut the seven-day collateral lending rate twice by 50 basis points to 8.0 percent.

Source: Websites of the relevant central banks

5. World economic outlook

The IMF forecasted in July that the global recovery would continue but renewed financial turbulence and problems in the euro area could cloud the outlook. The IMF forecasted that world growth would rise to 4.6 percent, an upward revision of 0.4

percentage points from April's forecast, with the United States expected to grow at 3.3 percent, the euro area at 1.0 percent, Japan at 2.4 percent, and the emerging and developing economies averaging about 6.8 percent, up by 5.7 percentage points, 5.1 percentage points, 7.6 percentage points, and 4.3 percentage points compared with the real growth in 2009.

According to the IMF, the still-low levels of capacity utilization and moderate economic growth should generally contain global inflation pressures in 2010. Impacted by the sluggish demand and the fiscal consolidation measures, headline inflation in the advanced economies is expected to edge up from 0.1 percent in 2009 to 1.4 percent in 2010. In contrast, in the emerging and developing economies, inflation is expected to rise to 6.3 percent due to the strong economic growth.

Looking ahead, though the global recovery continues, downside risks should not be neglected given the unrestrained European sovereign crisis, the serious fiscal deficit in some economies, the high unemployment rate in the major economies, the return of trade protectionism, the price hike for commodities and the increased inflationary pressures, and the capital inflows witnessed in the emerging market economies.

II. Analysis of China's macroeconomic performance

In the first half of 2010, China's economy developed in the direction intended by macroeconomic management and generally performed well. Consumption grew rapidly, investment growth remained stable and high, external trade recovered quickly, the contribution of consumption, investment, and exports became more balanced in driving economic growth, industrial growth was generally rapid with corporate profits greatly enhanced, and the consumer price hike was modest. In the first half of the year, the Gross Domestic Product (GDP) registered 17.28 trillion yuan, up 11.1 percent year on year based on comparable prices, and a deceleration of 0.8 percentage points from the previous quarter; the CPI was 2.6 percent, up 0.4 percentage points from the previous quarter; the trade surplus posted US$55.3 billion, representing a decline of US$40.9 billion from the same period of the last year.

1. Consumption grew rapidly, investment growth remained stable and high, and foreign trade recovered rapidly

Supported by the income gains of the urban and rural residents, consumption grew rapidly. In the first half of the year, the per capita disposable income of urban households stood at 9,757 yuan, representing year-on-year growth of 10.2 percent and real growth of 7.5 percent on a price-adjusted basis. The per capita cash income of rural households posted 3,078 yuan, up 12.6 percent year on year, or 9.5 percent in real terms. In the first half of the year, retail sales totaled 7.27 trillion yuan, representing an increase of 18.2 percent year on year and an acceleration of 0.3 percentage points from the previous quarter. Price-adjusted real consumption growth was 15.3 percent, a deceleration of 0.1 percentage points from the previous quarter. Broken down by urban and rural areas, consumption in the urban areas grew faster than that in the rural areas, with the gap basically stable. In the first half of the year, retail sales in the urban areas registered 6.27 trillion yuan, up 18.6 percent, or 15.9 percent in real terms; whereas retail sales in the rural areas posted 1.00 trillion yuan, up 15.6 percent, or 12.2 percent in real terms. The survey of urban depositors in the second quarter showed that although the income sentiment indicator had dropped 5.5 percentage points to 49.5 percent, it was still 3.7 percentage points higher than that during the same period of the last year. The investment sentiment of depositors dropped, consumption sentiment was tepid, and preferences for saving deposits continued to rise.

Growth of fixed-asset investments stabilized at a high level, and growth of investment in the tertiary sector was high. In the first half of the year, fixed-asset investments totaled 11.42 trillion yuan, up 25.0 percent year on year, or 21.8 percent in real terms, representing a deceleration of 0.6 percentage points from the previous quarter. Broken down by urban and rural areas, completed fixed-asset investments in the urban areas stood at 9.80 trillion yuan, representing year-on-year growth of 25.5 percent and a deceleration of 0.9 percentage points from the previous quarter. Completed fixed-asset investments in the rural areas registered 1.61 trillion yuan, up 22.1 percent year on year and an acceleration of 1.1 percentage points from the previous quarter. Broken down by regions, urban fixed-asset investment growth in the eastern, central, and western regions registered 22.4 percent, 28.0 percent, and 27.3 percent respectively, with the central and western regions obviously outpacing the eastern region. Broken down by industries, urban fixed-asset investments in the primary, secondary, and tertiary industries grew 17.8 percent, 22.3 percent, and 28.4 percent respectively, and growth in the tertiary industry was much higher than that in the other two industries. In the first half of the year, the total planned investment in projects under construction in the urban areas registered 39.37 trillion yuan, up 27.0 percent year on year. A total of 299,311 projects were under construction, 24,052 more than during the same period of the last year.

External trade recovered rapidly, but the trade surplus declined. In the first half of the year, imports and exports totaled US$1354.9 billion, up 43.1 percent year on year, representing an acceleration of 66.5 percentage points from the same period of the last year but a deceleration of 1.0 percentage points from the previous quarter. In particular, exports posted US$705.1 billion, representing year-on-year growth of 35.2 percent and an acceleration of 57.0 percentage points and 6.5 percentage points from the same period of the last year and the previous quarter respectively; imports posted US$649.8 billion, up 52.7 percent year on year, an acceleration of 77.9 percentage points from the same period of the last year and a deceleration of 12.0 percentage points from the previous quarter. The trade surplus stood at US$55.3 billion, representing a decrease of US$40.9 billion from the same period of the last year. The improved export product mix boosted the continued trade recovery. Exports of mechanical and electronic products and high- and new-tech products grew by a large margin of 35.9 percent and 40.9 percent respectively in the first half of the year, both faster than the total export growth during the same period. The US, Japan, and the EU remained the major destinations for Chinese exports, but their share of exports declined, which shows that China's trade is becoming increasingly diversified. In the first half of the year, actually utilized foreign investment reached US$51.4 billion, up 19.4 percent and an acceleration of 11.8 percentage points from the previous quarter.

2. Agricultural production remained stable and in general industrial production grew rapidly

In the first half of the year, the added value of primary, secondary, and tertiary industry reached 1,336.7 billion, 8,583 billion, and 7,364.3 billion yuan respectively, up 3.6 percent, 13.2 percent, and 9.6 percent respectively. The share of the three industries in GDP was 7.7 percent, 49.7 percent, and 42.6 percent respectively.

Agricultural production remained stable, with output of summer crops on a par with that during the last year. The total output of the summer crop posted 123.1 million tons, down 0.3 percent from the previous year, but still the third largest harvest since the founding of the People's Republic. In the first half of the year, production of pork, beef, mutton, and poultry was up 3.5 percent year on year to 37.13 million tons, including pork output of 24.55 million tons, up 3.6 percent.

Industrial growth was generally fast, with corporate profits greatly improved. In the first half of the year, the added value of statistically large enterprises grew 17.6 percent year on year, representing an acceleration of 10.6 percentage points from the same period of the last year but a deceleration of 2.0 percentage points from the previous quarter. Production and sales of industrial products were well connected, and 97.6 percent of manufactured goods were sold, up 0.4 percentage point from the same period of the last year. As the domestic economy performed well, corporate profits increased notably. In the first five months, profits of statistically large enterprises reached 1,539.7 billion yuan, representing year-on-year growth of 81.6 percent and an acceleration of 104.5 percentage points from the same period of the last year. The rate of return on sales was 6.1 percent, an acceleration of 1.5 percentage points from the same period of the last year. The survey of 5,000 industrial enterprises in the second quarter conducted by the PBC showed that the corporate business index had registered growth for five successive quarters to reach 64.1 percent, close to the level at the beginning of 2008. Market demand continued to pick up, with the market demand index posting 59 percent, up 1.4 percentage points from the previous quarter, representing the fourth consecutive quarter in the positive zone. The profitability of the corporate sector continued to improve, with the profitability index at 57.5 percent, representing an acceleration of 1.1 and 6.7 percentage points from the previous quarter and the same period of the last year respectively

3. CPI growth was modest

The CPI rose modestly year on year. In the first half of the year, the CPI gained 2.6 percent year on year, an acceleration of 3.7 percentage points compared to the previous year, and the quarterly CPI was up 2.2 percent and 2.9 percent respectively year on year. Broken down by food and non-food items, significant food price increases were the major driver for the CPI hike. In the first half of the year, food prices increased by 5.5 percent, pushing up the CPI by 1.8 percentage points. The prices of non-food items grew 1.2 percent, driving the CPI up by 0.8 percentage points. Broken down by consumer goods and services, the prices of consumer goods grew faster than the prices of services, with the prices of consumer goods up 2.9 percent in the first half of the year, which shored up the CPI by 2.2 percentage points, and the prices of services up 1.5 percent, contributing 0.4 percentage points to CPI growth. In terms of the base period factor and the new price-rising factor, the base period factor and the new price-rising factor averaged 1.4 percent and 1.2 percent respectively in the first half of the year.

Prices of manufactured goods increased by a large margin. In the first half of the year, ex-factory producer prices of industrial products grew 6.0 percent year on year, an acceleration of 11.9 percentage points from the same period of the last year. Growth in the first and second quarters registered 5.2 percent and 6.8 percent respectively. The purchasing prices of raw materials, fuel, and power registered an average year-on-year increase of 10.8 percent, 19.5 percentage points higher than the previous year, with the quarterly increase posting 9.9 percent and 11.7 percent respectively. Producer prices of agricultural products (prices at which the products are sold) registered year-on-year growth of 8.4 percent, representing an acceleration of 15.0 percentage points compared to the previous year; the prices of agricultural capital goods grew 1.1 percent year on year, at a par with the level during the same period of the last year. The Corporate Goods Price Index (CGPI) monitored by the PBC gained 6.0 percent in the first half of the year, an acceleration of 12.6 percentage points from the same period of the last year, and an acceleration of 5.3 percent and 6.8 percent in the two quarters respectively. Among this increase, investment product prices and consumer product prices were up 6.6 percent and 4.5 percent respectively. The main reason for the hike in the CGPI at the current stage is the significant increase in the price of primary products. Broken down by categories within the basket of the CGPI, agricultural produce, mineral products and coal, and oil and electricity grew 10.3 percent, 15.3 percent, and 16.9 percent respectively in the first half of the year compared to that during the same period of the last year.

The import price hike decelerated marginally. In the second quarter, import prices climbed 19.4 percent, 19.2 percent, and 17.4 percent respectively in the three months, averaging 18.7 percent, an acceleration of 37.3 percentage points from the same period of the last year. Export prices grew by -0.7 percent, 2.2 percent, and 3.4 percent year on year respectively in the three months, averaging 1.6 percent, an acceleration of 8.6 percentage points. The deceleration of the year-on-year import price hike was mainly due to the falling commodity prices in the international market. In the second quarter, the average price of crude oil futures traded on the New York Mercantile Exchange dropped 1.0 percent from the previous quarter, up 30.6 percent from the same period of the last year. The average spot prices of copper and aluminum traded on the London Metal Exchange fell by 2.9 percent and 3.4 percent respectively from the previous quarter, but up 50.5 percent and 40.7 percent respectively from the same period of the last year.

Labor compensation continued to grow rapidly. In the first half of the year, the monthly salary of urban employees grew 13 percent year on year, faster than the growth during the same period of the last year. In particular, the salary of urban employees in collective enterprises and other types of enterprises (excluding private enterprises) grew faster than that of employees in state-owned entities.

Box 4 An analysis of labor costs

In general, labor costs usually refer to all the expenses that enterprises incur for employing the labor force, including wages and fringe benefits and vocational training costs, hiring-related expenses, taxes incurred during employment, and so forth. Labor costs have a significant impact on employment, total output, inflation, external trade, and other macroeconomic variables. Some countries and international organizations have compiled a Labor Cost Index (LCI) to monitor changes in labor costs. Since there is no such a system of indices that comprehensively cover the labor costs of enterprises in China, the labor costs are estimated mainly based on the employees' salary accounting system and the surveys on migrant workers.

Labor costs are a major component in production and service-provision costs; however, whether the changes in labor costs are reflected in the prices depends on the comparable relationship between labor costs and labor productivity movements. Ceteris paribas, when labor costs grow slower than labor productivity, product prices will not rise noticeably. When labor costs grow faster than labor productivity, product prices will rise. When the latter case becomes prevalent in the economy, cost-driven inflation occurs. Subsequently, the continued rise of the general price levels will shore up the living costs of employees, encouraging them to seek more compensation and causing labor costs to rise. Employers will raise product prices in order to absorb the impact of the rising labor costs on their profits and a "wage-price" spiral will occur.

Since the adoption of the reform and opening-up policies, the surplus labor force has been migrating from the agricultural sector to the urban areas, keeping labor costs at a relatively low level. Meanwhile, the rapid economic growth, in particular the boom in the labor-intensive export sectors since 2005 in particular, gradually shored up labor costs. In the latter half of 2009, with the Chinese economy gradually recovering from the global financial crisis, investment and export growth rapidly pushed up demand for labor and upward pressures on labor costs began to build. Statistics of the National Statistics Bureau show that the monetary wages of urban employees (excluding private enterprises) grew at an annual rate of 15.2 percent between 2005 and 2009, and reached 32,736 yuan in 2009; at the end of the first quarter of 2010, the monthly income of migrant workers posted 1,560 yuan, up 11.1 percent year on year. In terms of the trend, labor costs will continue to rise in the medium- and long-term. First, the demographic structure will change gradually. At end-2009, people at the age of 60 and above accounted for 12.5 percent of the population. With economic growth still heavily depending on labor-intensive industries, the aging population will affect supply and demand in the labor market and pressures for wage increases will build up. The second driver is the policy factor. As the economy and society have developed further, the Chinese government pays more attention to improving the social security and welfare of workers, and has adopted more policies to provide them with a better living environment and development opportunities for them. In recent years, a series of measures have been taken to improve the coverage and quality of social security. Since early-2010, about 15 provinces and municipalities have raised the minimum wage by an average of 20.6 percent. Furthermore, development in the central and western regions and policies supporting agriculture, the rural areas, and farmers have increased the opportunity costs for farmers who want to work in the urban areas.

Rising labor costs have an impact on China's economy and financial system on three fronts. First, upward pressures on prices will build up. Generally, labor productivity cannot be improved in the short run, whereas rising labor costs will undoubtedly aggravate inflationary pressures. However, in the long run, weakening advantages in labor costs will prompt domestic enterprises to adjust the input of different factors to offset the adverse impacts of higher labor costs by greatly enhancing labor productivity. From 2004 to 2008, wages in the manufacturing sector grew by 14.13 percent per annum whereas the growth of labor productivity reached 10.69 percent per annum during the same period, largely offsetting the inflationary pressures brought about by the wage increases. Second, rising labor costs will give a boost to industrial restructuring. The continued increase in wage costs will change the proportion of production factors in inputs, thus increasing the relative importance of production factors such as capital and technology, promoting industrial upgrading, and raising the added value of products. Third, rising labor costs will help improve income distribution and boost average consumption. The increase in labor costs will play a positive role in increasing the income levels of employees and the share of labor compensation in the income distribution, and thus will be conducive to the balanced growth of consumption, investment, and exports.

Facing the rising labor costs, on the one hand we should fully recognize that there is a good reason for them and that this is a positive change. Further steps are necessary to improve social security and welfare, safeguard workers' rights and interests, and give workers full access to the benefits of economic development while enhancing resource allocation efficiency in the labor market. On the other hand, we should increase investment in human capital so as to improve labor skills and quality and offset the adverse impacts of the rising labor costs through improved labor productivity. At the same time, efforts are needed to promote technological advances and industrial upgrading in order to shift away fundamentally from an economic development pattern featuring low wages, low inputs, and low efficiency.

The GDP deflator rebounded rapidly. The GDP registered 17.3 trillion yuan in the first half of the year, representing real growth of 11.1 percent. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 5.1 percent, up 6.9 and 0.5 percentage points respectively compared with that during the same period of the last year and the first quarter of this year.

The price reform of resource goods advanced steadily. First, the prices of refined oil products were adjusted. In the first half of the year, the National Development and Reform Commission (NDRC) adjusted the prices of refined oil products two times with reference to the existing pricing mechanism for refined oil products and the oil price movements in the international market. From April 14 onward, the prices of petrol and diesel per ton were each raised by 320 yuan; from June 1 onward, the prices of petrol and diesel were cut by 230 yuan and 220 yuan respectively. Second, the electricity tariff discount for high energy-consuming enterprises was abolished. On May 12, the NDRC, jointly with the relevant ministries and commissions, issued the *Notice on Adjusting the Preferential Electricity Tariff Policies for High Energy-consuming Enterprises and Other Issues*, to terminate the electricity tariff discount for high energy-consuming enterprises, to stop local governments from announcing preferential electricity tariffs, to strengthen implementation of the policy of differentiated electricity tariffs, and to levy punitive tariffs on products consuming too much energy so as to put order into the electricity tariffs and to reinforce supervision. Third, a pilot resource-tax reform program was conducted. The pilot reform underway in Xinjiang Autonomous Region sought to switch the resources tax on natural gas from the specific tax system to an *ad valorem* system at a tentative rate of 5 percent. The program is expected to expand nationwide after the trial, and different tax rates will be applied to different resource products. Adjustment of resource prices will enable price levers to adjust the demand and supply of resource products and will promote energy conservation, emission reductions, economic restructuring, and a shift in the pattern of development. In full consideration of the affordability of the stakeholders, the reform of resource prices will be advanced in a prudent manner in order to better realize the fundamental role of the market in resource allocations.

4. Fiscal revenue grew by a large margin

With the economy recovering and growing and a low year-on-year base, fiscal revenue (excluding debt income) surged in the first half of 2010. Fiscal revenue increased 27.6 percent year on year to 4335 billion yuan, representing an acceleration of 30.0 percentage points from the corresponding period in 2009 and a deceleration of 6.4 percentage points from Q1 2010, whereas fiscal expenditures grew 17.0 percent to 3381.1 billion yuan, representing a deceleration of 9.3 percentage points from the first half of 2009 and an acceleration of 5.1 percentage points from Q1. Revenue exceeded expenditures by 953.8 billion yuan, representing an expansion of 446.50 billion yuan from the first half of 2009.

In the first half of 2010, tax revenue was up 30.8 percent year on year, an acceleration of 36.8 percentage points from the corresponding period of the last year and a deceleration of 5.1 percentage points from Q1. In particular, domestic VAT revenue, the business tax, and consumption tax revenue were up 12.9 percent, 33.4 percent, and 42.4 percent respectively year on year. Within the expenditure basket, the three largest items were education (479.7 billion yuan, or 14.2 percent of total spending), social security and employment (409.9 billion yuan, or 12.1 percent of total spending), and general public services (369.8 billion yuan, or 10.9 percent of total spending). Among all items in the basket, expenditures on science and technology, transportation and communications, and social security and employment registered relatively rapid growth of 55.7 percent, 33.0 percent, and 23.3 percent respectively.

5. The balance of payments account

In the first half of 2010, net foreign exchange inflows declined after a period of expansion but still remained generally massive. From January through April, pressures from the net inflows were huge due to stronger expectations of a RMB appreciation. From May onward, with the sovereign debt crisis worsening in Europe, the subsequent flight to the US dollar by international capital, and the higher US dollar interest rate on the international market, yuan appreciation expectations and pressures of net inflows weakened. In the first half of 2010, the major sources of net inflows were trade in goods, foreign direct investment, overseas listings by Chinese enterprises, and personal fund transfers. At end June, official foreign exchange reserves registered growth of US$55.1 billion from end-2009 to US$2454.3 billion. Though the world economy was gradually recovering, there were still uncertainties. The recovery and growth momentum of the Chinese economy continued, but the tasks of managing inflation expectations, continuing the stable and fairly rapid growth, restructuring the economy, and transforming the growth pattern remain arduous. As such, we do not expect notable changes in the BOP twin surplus in the near future. The net inflow of foreign exchange is likely to continue and remain at a noticeable size, yet the risk of an influx of outflows cannot be ruled out.

The size of the external debt expanded by a small margin. At end-March 2010, the outstanding external debt totaled US$443.24 billion, an increase of 3.4 percent, or US$14.59 billion from end-2009. In particular, the outstanding registered external debt increased 3.6 percent, or US$9.49 billion, to US$276.44, accounting for 62.4 percent of the total outstanding external debt. With respect to the breakdown by maturities, outstanding medium- and long-term debt posted US$167.03 billion and accounted for 37.7 percent of the total debt; short-term external debt increased 6.5 percent, or US$16.94 billion, to US$259.26 billion, accounting for 60.5 percent of the total. In particular, outstanding trade credit amounted to US$166.8 billion, accounting for 60.4 percent of the total.

6. Sectoral analysis

Industrial output continued to grow rapidly and profits rose by a large margin. From January through May, the profits of statistically large enterprises were up 81.6 percent, representing a deceleration of 38.1 percentage points from the first two months of 2010 and a peak in the corresponding period of the recent ten years. Among all 39 sectors, 36 sectors (including the non-ferrous metal smelting and rolling industry, ferrous metal smelting and rolling industry, the production and supply of power and heat industry, chemical fiber manufacturing industry, and so forth) reported relatively large year-on-year growth in profits, and the petroleum processing, coking, and nuclear fuel processing industry saw a year-on-year decline of 8.9 percent in profits. From January through May, 38 out of the 39 sectors reported year-on-year growth in profits. The demand and supply situation for coal, power, and oil was generally relaxed. In the first half of 2010, the output of coal, power generation, and crude oil increased by 20.1 percent, 19.3 percent, 5.3 percent respectively year on year to 1570 million tons, 1970.6 billion kilowatts per hour, and 98.48 million tons respectively; a total of 15.0 billion tons of freight volume was handled, up 16.5 percent year on year.

(1) Real Estate Sector

With release and implementation of the *State Council Notice on Promoting Stable and Healthy Development of the Real Estate Market* on January 7, 2010, and the *State Council Notice on Containing the Excessive Growth in Real Estate Prices in a Decisive Manner* on April 17, 2010, the real estate market witnessed some positive changes, as reflected in the notable decline in commercial housing transactions and the deceleration in the growth of prices and real estate lending.

The volume of commercial housing transactions declined. In the first half of 2010, the sold floor area of commercial real estate was up 15.4 percent year on year to 394 million square meters, representing a deceleration of 20.4 percentage points from the previous quarter and 26.7 percentage points from 2009. In particular, the sold floor area of commercial housing was up 12.7 percent year on year, representing a deceleration of 21.5 percentage points from Q1. In the first half of 2010, the sale of commercial real estate was up 25.4 percent year on year to 1.98 trillion yuan, representing a deceleration of 32.3 percentage points from Q1 and a deceleration of 50.1 percentage points from 2009. In particular, the sale of commercial housing was up 20.3 percent year on year, representing a deceleration of 34.9 percentage points from Q1.

The growth of housing prices moderated. In June 2010, the index of housing prices in 70 large and medium cities was up 11.4 percent year on year but down 0.1 percent month on month, the first negative growth since March 2009, and housing prices were down month on month in 28 cities. The price of newly built commercial housing was up 14.1 percent year on year and was flat month on month; the largest year-on-year hike was in the five cities of Haikou, Sanya, Beijing, Jinhua, and Wenzhou, though the month-on-month decline in Jinhua was nearly the largest. The price of pre-owned homes was up 7.7 percent year on year and down 0.3 percent month by month; the largest year-on-year hike was in the five cities of Sanya, Haikou, Wenzhou, Zhanjiang, and Hangzhou, though the month-on-month decline in Sanya and Haikou was nearly the largest. In Q2, land prices were up 22.1 percent year on year, representing an acceleration of 0.9 percentage points from Q1; home rental prices were up 6.4 percent year on year, representing an acceleration of 4.2 percentage points from Q1.

Growth of investment in commercial real estate development and the floor area of newly started projects remained rapid after some moderation, the first ever since the beginning of 2010; the growth of acquired land was fairly large. In the first half of 2010, a total of 1.97 7yuan was invested for real estate development, up 38.1 percent year on year, representing an acceleration of 3 percentage points from Q1 and a deceleration of 0.1 percentage points from the first five months of 2010, the first deceleration since the beginning of 2010. Investment in commercial housing was up 34.4 percent to 1.37 trillion yuan, representing acceleration of 1.4 percentage points from Q1 and a deceleration of 1.3 percentage points from the first five months and accounting for 69.3 percent of real estate development investment. The floor area of newly started housing projects was up 67.9 percent year on year to 805 million square meters, representing an acceleration of 7.1 percentage points from Q1 and a deceleration of 4.5 percentage points from the first five months of 2010. In the first half of 2010, land purchases by real estate development companies were up 35.6 percent year on year to 185 million square meters, representing an acceleration of 5.6 percentage points from Q1. The rapid expansion of real estate development investment and the floor area of new projects took place from a relatively small base in the same period of the last year and did not reflect new developments in the market due to the time lag.

The expansion of real estate loans decelerated. With the implementation of various austerity measures, the upward trend in real estate loan indicators moderated since May. At end June, outstanding real estate loans of major financial institutions were up 40.2 percent year on year to 8.71 trillion yuan, representing an acceleration of 2.1 percentage points from end-2009 and a deceleration of 4.1 percentage points from the end of Q1. In particular, outstanding land development loans were up 45.5 percent year on year to 791.5 billion yuan, representing a deceleration of 58.6 percentage points from end-2009 and 34.6 percentage points from the end of Q1; outstanding real estate development loans were up 20.3 percent year on year to 2.18 trillion yuan, representing an acceleration of 4.5 percentage points from end-2009 and 0.7 percentage points from the end of Q1. Outstanding mortgage loans were up 48.8 percent year on year to 5.74 trillion yuan at end-June. The growth of mortgage loans declined in both May and June, with mortgage loans for pre-owned homes declining at a faster rate than mortgage loans for new homes. At end-June, the share of real estate loans in total outstanding loans was 20.4 percent. In the first half of 2010, new real estate loans posted 1.38 trillion yuan, a reduction of 494.7 billion yuan from the first half of 2009. In June, new real estate loans registered 127.3 billion yuan, the lowest since the beginning of 2010.

(2) Iron and Steel Industry

As a pillar industry in the national economy, the iron and steel industry is related to many other sectors and plays a large role in economic and social development, resource conservation, and environmental protection. Due to the spillover of the international financial crisis that started in the second half of 2008, the domestic iron and steel industry had to deal with the difficult situation of a sharp decline in demand and prices, thus incurring losses. In response, the State Council released the *Program of Restructuring and Rejuvenating the Iron and Steel Industry.* Since its implementation, the *Program* has gradually produced its intended policy effect. In the first half of 2010, with demand stable at home, the output of the iron and steel and iron sector surged and exports continued to grow, contributing to the recovery and growth of the national economy. However, deep-rooted problems remain unresolved in the sector, including serious duplication of similar projects, excess capacity, disorder in the distribution of iron ore, and improper behavior of enterprises in resource conservation and environmental protection.

Fixed-asset investments surged without contributing to the easing of the excess capacity and structural problems. In the first half of 2010, fixed-asset investments in the sector (including mining) totaled 195.3 billion yuan, up 10.4 percent year on year. Iron and steel enterprises faced upward inventory pressures and stronger market risks. According to a survey of the Iron and Steel Association on the inventory of the five major steel products in 22 large and medium cities, the steel inventory was up 34.2 percent from the beginning of 2010 to 10.80 million tons at end-June. The excess capacity in the iron and steel sector is structural, as reflected in the excess obsolete capacity and the output of low- and medium-grade products. In the first half of 2010, output of crude steel, pig iron, and rolled steel was 323 million tons, 304 million tons, and 399 million tons respectively, up 21.1 percent, 17.0 percent, and 26.1 percent year on year, continuing the upward momentum. According to a calculation based on calendar days, the average daily output of crude steel was up 21.2 percent year on year to 1.785 million tons, translating into annual output of 652 million tons. Given a nominal consumption (or available supply) of crude steel of 565 million tons in 2009, the total output of crude steel apparently is excessive as is the domestic supply.

However, high value-added steel products with high technology content are in short supply and must be imported from overseas.

The profitability of enterprises is limited by rising production costs and declining prices. According to the Iron and Steel Association survey, the 77 large and medium-sized iron and steel enterprises made a profit of 50.72 billion yuan in the first half of 2010. With a return on sales of 3.47 percent, the sector's profitability was relatively low compared with the industrial enterprise average. In the first half of 2010, the rising price of imported iron ore heightened the cost pressures on iron and steel enterprises. In June, the average price of iron core recorded by the customs office had risen 61.5 percent from the beginning of 2009 to US$139.85 per ton. But due to the austerity measures targeting the real estate sector, domestic steel prices started to fall in the beginning of May. Both higher production costs and declining prices of steel products squeezed the profit margins of the iron and steel sector.

Pressures on resource supplies and environmental protection are growing. Statistics released by the Ministry of Industry and Information Technology show that in 2009 almost 70 percent of domestic iron ore demand in China was satisfied by imported iron ore. With a small number of countries such as Brazil and Australia holding power of iron ore pricing, resource manipulation is becoming greater and Chinese iron and steel companies have only a limited voice in the pricing of iron ore. Though the key large- and medium-sixed enterprises have reached the objective of reducing comprehensive energy consumption per ton of steel to less than 620 kilograms of standard coal, ahead of the projection the *Steel and Iron Industry Development Policy,* which outlines an objective of 730 kilograms of standard coal to be reached of 2010. However, due to the limited concentration in the domestic iron and steel industry, the top ten enterprises represent just 44 percent of total iron and steel capacity, and a large number of enterprises operate with obsolete capacity. As a result, the steel and iron industry is a heavy polluter and massive energy consumer and must complete the difficult task of phasing out outdated capacity to reduce energy consumption and emissions. As approved by the State Council, export tax rebates for certain steel products were eliminated as of July 15, 2010 to contain the excessive expansion of steel exports and to promote the industry's restructuring.

To address the deep-rooted problems in the iron and steel industry's rapid development in line with the scientific development approach, to further implement the *Iron and Steel Industry Restructuring and Rejuvenation Program,* and to help realize the energy conservation and emission-reduction objectives outlined in the 11th Five-Year Program and to restructure the iron and steel industry, on June 4, 2010 the State Council released *Several Opinions on Further Promoting Energy Conservation and Emission Reductions and Speeding up Restructuring of the Iron and Steel Sector,* to take advantage of market changes and to employ economic, technical, legal, and necessary administrative measures to press for rapid progress in industry restructuring, energy conservation, and emission reductions and to promote comprehensive, balanced, and sustainable development of the industry. The *Opinions* also point out the need to contain excessive capacity expansion, strengthen standards in the examination of loan applications and approval procedures, enhance efforts to phase out obsolete capacity, conserve energy and reduce emissions, promote and speed up mergers and reorganization of iron and steel enterprises, encourage technology innovation and upgrading, regulate the distribution of iron ore in the domestic market, and promote development of domestic iron ore mining and facilitate implementation of the “going global” strategy of enterprises.

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

Ⅰ. Outlook for the Chinese economy

At the current stage, the Chinese economy is developing in the direction intended by the macroeconomic management policies and the national economy is expected to move toward stable and sustainable growth after the rapid rebound. In terms of external demand, despite uncertain factors such as the sovereign debt crisis in some European economies, the world economy has maintained a momentum of recovery. In terms of the domestic sector, in accordance with the new developments in economic performance, while maintaining consistency and stability, macroeconomic policies have become better targeted and more flexible since the beginning of 2010, with improvements in the intensity, pace, and priorities of policy measures. A number of measures have been launched to strengthen regulation over local government financing platforms and to guide the healthy development of the property market, playing a positive role to fend off potential fiscal and financial risks and to maintain the stable and healthy development of the economy. Furthermore, the central government has announced a series of new measures to support economic growth, focusing on revitalizing the emerging industries of strategic importance, speeding up the construction of government-subsidized housing and rebuilding shanty areas, encouraging and guiding private investment, accelerating development of the Xinjiang Autonomous Region, and promoting the develop-the-west strategy. All these measures will help accelerate economic restructuring and bring about the emergence of more sustainable economic growth points. Enthusiasm to speed up local development remains high and urbanization and upgrading of the consumption structure will continue to drive economic growth, all of which are conducive to achieving stable and relatively fast economic growth. The surveys conducted by the PBC on entrepreneurs, bankers, and urban depositors in the second quarter show that the major indicators continued to rise or stabilized to some extent and in general remained at high levels.

However, it should be noted that facing the complex and grave environment at home and abroad and a host of uncertain and destabilizing factors, macroeconomic policies still face a dilemma. The recovery of the world economy is not yet firmly based, and the international financial environment remains unstable. At home, the foundation for growth of domestic demand is not yet balanced; private investment and endogenous growth dynamics need to be strengthened; it is still an arduous task to improve income distribution and to promote economic restructuring; and energy conservation and emission reductions and fiscal and financial risks require attention. It is necessary to combine efforts to maintain the current stable and relatively rapid development momentum with initiatives to create sound conditions for long-term development, and to unswervingly speed up the shift in the economic growth pattern.

The price situation remains complex, and management of inflation expectations must be reinforced. The global economic recovery is relatively slow; prices of primary commodities in the international market have generally stabilized; domestic production capacity is relatively adequate; the growth of the economy is more stable; and growth of money and credit supply has decelerated. All of these will help stabilize price levels. But inflation expectations and risks of upward prices should not be neglected. Affected by uncertain factors such as the sovereign debt crisis, countries are more prudent in their policy exit strategies and global monetary conditions are expected to remain accommodative. With excess capital looking for a variety of possible investment opportunities, inflationary pressures will remain. Rising labor costs, increasing resources, environmental protection costs, and the ongoing resource products pricing reform are likely to influence inflation expectations. The survey by the PBC on urban depositors in the second quarter indicates that the price satisfaction index dropped 4.2 percentage points in the second quarter from the previous quarter, hitting a historical low. The future price expectation index jumped to 70.3 percent, a relatively high level compared with the same periods in previous years.

Ⅱ. Monetary policy in the next stage

Going forward, the PBC will continue to follow the scientific outlook on development, implement a moderately loose monetary policy in accordance with the overall arrangements of the State Council, and properly manage the policy’s intensity, pace, and priorities, maintain its consistency and stability, make it better targeted and more effective, properly handle the relationship between maintaining stable and relatively fast economic development, adjusting the economic structure, managing inflation expectations, improving the sustainability of using financial measures to support economic development, and safeguarding the healthy and stable development of the financial system. More efforts will be made to strengthen policy coordination and optimize the policy mix, with a focus on shifting to the institutional reform and economic restructuring so as to speed up the transformation of the economic growth pattern and to enhance endogenous dynamics for economic development.

First, the PBC will strengthen liquidity management and guide money and credit to grow at a proper pace. In view of the economic and financial developments and changes in foreign exchange flows, the PBC will deploy a wide range of monetary policy tools and carefully arrange the mix and terms of the policy tools and manage the intensity of monetary policy operations to enhance liquidity management, so that liquidity in the banking system will grow at a reasonable level and money and credit will grow properly, to satisfy credit demand for economic development and to create a sound monetary environment for keeping the general price level basically stable and for managing inflation expectations. It is necessary to guide financial institutions to properly pace the provision of loans around the year in line with the macroeconomic management policies and the needs of economic development.

Second, the PBC will step up financial support to promote transformation of the development pattern and economic restructuring. It will continue to implement differentiated credit policies and to improve the credit structure. Specifically, the PBC will enhance credit policies to support the weak links in the economy, employment, and education and emission reductions, phasing out the outdated capacity, emerging industries of strategic importance, and industrial relocation; continue to work hard in providing financial services to university graduates working as village leaders, earthquake and disaster relief efforts, poverty alleviation, and so forth; address the financing difficulties facing the agricultural sector and small enterprises; effectively solve the difficulties of SMEs in accessing loans; ensure that loans to key projects are granted; and rein in lending to high energy-consuming and polluting industries and industries with overcapacity. Efforts will be made to speed up innovation of rural financial products and services and actively explore new approaches for supporting agriculture with financial services so as to satisfy the demands of agriculture, rural areas, and farmers for multi-layered and diversified financial services. Measures will be adopted to implement differentiated mortgage policies to promote the healthy and stable development of the real estate market. Measures will be adopted to improve risk warnings to financial institutions and enhance management of risks of loans extended to local financing platforms. Moreover, establishment and improvements in the macro-prudential management framework will be explored and, taking advantage of a framework that works against the wind, raising capital restrictions and liquidity requirements for systemically important banks so as to maintain the soundness of the financial system, prevent systemic risks, and improve the sustainability of financial support to economic development.

Third, the PBC will steadily advance the market-based interest rate reform and improve the RMB exchange rate regime. It will press ahead with the establishment of a benchmark interest rate system on the money market to improve the pricing ability and strengthen the role of the price leverage. The PBC will, in accordance with the principles of reforming the RMB exchange rate regime, further improve the RMB exchange rate regime based on market supply and demand with reference to a basket of currencies. The exchange rate floating bands will remain the same as previously announced in the inter-bank foreign exchange market so as to keep the RMB exchange rate basically stable and at an adaptive and equilibrium level. The PBC will promote the development of the foreign exchange market and introduce more tools for managing exchange-rate risks. It will steadily advance the pilot program for RMB settlement of cross-border trade transactions to facilitate trade and investment and will support the going-global initiative. It will deepen the reform of the foreign exchange administration system to promote balanced capital flows. It will also regulate cross-border capital flows and step up monitoring and management of irregular and abnormal fund flows.

Fourth, the PBC will promote the healthy development of the financial market. The PBC will continue to deepen the reform of financial institutions, speed up the establishment of a modern financial enterprise system, and improve the system for organizations providing financial services. Efforts will be made to accelerate innovation of financial products and to strengthen the building of market infrastructure. It will broaden the channels for enterprises to access direct financing, accelerate the development of the bond market, and actively and prudently promote the opening-up of the inter-bank bond market.

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

Appendix 1

Highlights of China's Monetary Policy in Q2 2010

On April 14, the People's Bank of China reported to the Finance and Economy Committee of the National People's Congress on the conduct of monetary policy in the first quarter of 2010.

On April 21, the People's Bank of China, jointly with the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission, issued the *Emergency Notice on Financial Services in the Areas Affected by the Yushu Earthquake* (PBC Document [2010] No. 121). The *Notice* specifies that greater efforts should be made to strengthen cash deployment and supply, to make sure the payment and clearing system and the treasury system perform properly, and to guide financial institutions to earnestly step up their credit support for disaster relief and post-quake reconstruction so as to meet the basic living requirements of the affected people in the quake areas.

On May 2, the People's Bank of China decided to raise the RMB reserve requirement ratio for depository financial institutions by 0.5 percentage points, effective from May 10, 2010. Rural credit cooperatives and village and township banks were temporarily exempted from the ratio hike.

On May 10, the *China Monetary Policy Report in the First Quarter of 2010* was released.

On May 28, the People's Bank of China, jointly with the China Banking Regulatory Commission, issued the *Opinions on Provision of Financial Services to Support Energy Conservation and Emission Reductions and to Eliminate Backward Production Capacity*. The *Opinions* urge financial institutions to improve credit management and financial services in a comprehensive manner and to closely monitor and prevent credit risks so as to support energy conservation and emission reductions.

On June 8, the *China Regional Financial Sector Operations Report (2009)* was issued.

On June 19, in view of the recent economic situation and financial market developments at home and abroad and the balance of payments situation in China, the People's Bank of China decided to proceed further with the reform of the RMB exchange rate regime and to enhance the RMB exchange-rate flexibility. In furthering the reform of the RMB exchange rate regime, continued emphasis will be placed to reflect market supply and demand with reference to a basket of currencies. The exchange rate floating band will remain the same as previously announced in the inter-bank foreign exchange market.

On June 21, the People's Bank of China, jointly with the China Banking Regulatory Commission, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission, released the *Opinions on Further Improving Financial Services to Small- and Medium-sized Enterprises* (PBC Document [2010] No. 193). The *Opinions* seek to enhance reform and innovation of the SME credit management system, improve the multi-layered financial organization system for SME financial services, expand the financing channels in line with the characteristics of the SMEs, develop a credit-enhancing system for SMEs, and support efforts by SMEs to go abroad by a variety of means.

On June 22, the People's Bank of China, jointly with the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the China Banking Regulatory Commission, released the *Notice on Expansion in the Pilot Renminbi Settlement of the Cross-border Trade Program*. The *Notice* expands the pilot cross-border renminbi trade settlement areas by increasing the domestic pilot cross-border renminbi trade settlement areas and eliminating geographical limitations to trading partners. The pilot cross-border renminbi settlement business was expanded from trade in goods to other BOP items. The expansion will further meet the practical demands of enterprises for cross-border trade settlement in yuan and will enhance the role of the program.

Appendix 2

Monetary Policies of the Central Banks of the Major Economies in the First Half of 2010

I. The U.S. Federal Reserve

At its regular meetings held on January 27, March 16, April 28, and June 23, the Federal Open Market Committee (FOMC) announced that the federal funds target rate would remain unchanged within a band between 0 and 0.25 percent.

As the financial market gradually resumed its functions, the Federal Reserve phased out the extraordinary liquidity support instruments designed for crisis assistance, with the exception of the Term Auction Facility (TAF). On February 1, the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, and the Swiss National Bank jointly put an end to the currency swap arrangements that they had put in place during the financial crisis. On February 18, the Federal Reserve raised the discount rate to 0.75 percent, the first interest rate adjustment since December 2008. As a result, the spread between the discount rate and the federal funds target rate expanded to 0.5 percentage point. On April 30, the Federal Reserve announced the establishment of a Term Deposit Facility (TDF) as one of several tools that the Federal Reserve could employ to drain liquidity when policymakers judged that it was appropriate. However, the Federal Reserve emphasized that development of the TDF was a matter of prudent planning and had no implications for the near-term conduct of monetary policy.

With the deepening of the European sovereign debt crisis, the Federal Reserve, the Bank of Canada, the Bank of England, the European Central Bank, and the Swiss National Bank announced the re-establishment of temporary US dollar liquidity swap facilities. These facilities were designed to help improve liquidity conditions in US dollar funding markets and to prevent the spread of strains to other markets and financial centers. On May 10, the Federal Reserve reopened a dollar swap agreement with the Bank of Japan. On May 28, the Federal Reserve announced that it would have three small-value auctions of term deposits through its Term Deposit Facility (TDF) scheduled over the next two months. In the meantime, the Federal Reserve emphasized that these auctions were a matter of prudent planning and had no implications for the near-term conduct of monetary policy. On July 22, Chairman Bernanke presented the Semiannual Monetary Policy Report to the Committee on Financial Services of the House of Representatives and pointed out that the Fed anticipated that economic conditions were likely to warrant exceptionally low levels in the federal funds rate for an extended period. In addition, since the US economy was still facing significant uncertainties, the Federal Reserve would continue to prudentially evaluate current economic and financial conditions and was ready to take further policy measures.

II. The European Central Bank

In the first half of 2010, the Governing Council of the European Central Bank (ECB) decided at its various regular meetings to keep the benchmark interest rates unchanged, the interest rate on the main refinancing operations, the marginal interest rate on the deposit facility, and the marginal interest rate on the lending facility at 1.00 percent, 0.25 percent, and 1.75 percent respectively. At its regular meeting on March 4, the Governing Council of the ECB discussed how to gradually exit from the extraordinary operations and measures in view of the development of the economy and the financial market, and how to avoid distortions as a result of the prolonged use of the extraordinary measures while continuing liquidity support on favorable terms to banks in the euro zone. On May 10, in order to address the serious tensions in certain market segments, the Governing Council of the ECB decided to intervene in the public and private debt securities market in the euro area, to reactivate the temporary liquidity swap lines with the Federal Reserve, and to adopt a fixed-rate tender procedure with full allotment in the regular 3-month and 6-month longer-term refinancing operations (LTROs), so as to meet the full liquidity demands of financial institutions. On June 30, the Governing Council of the ECB announced that it had fully completed the Covered Bond Purchase Programme (CBPP), which had started in July 2009, and the nominal value of purchases under the programme was EUR 60 billion. The euro system central banks intended to keep the purchased covered bonds until maturity.

III. The Bank of Japan

In the first half of 2010, the Bank of Japan decided at its various regular meetings to keep the uncollaterized overnight call rate unchanged at 0.1 percent. On several occasions the Bank of Japan noted that Japan faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. In the conduct of monetary policy, the Bank of Japan will aim to maintain an extremely accommodative financial environment. On January 28, with the improvements in the functioning of the financial market, the Bank of Japan confirmed the expiration of its temporary liquidity swap line with the Federal Reserve, effective February 1, 2010. On March 17, the Bank of Japan decided to expand the measures that were introduced in December 2009 to encourage a decline in longer-term interest rates by substantially increasing the amount of funds to be provided through fixed-rate operations, and increased the volume of money available to banks under the fixed-rate fund supply operations from 10 trillion yen to 20 trillion yen. On May 10, the Bank of Japan announced it would reopen the US dollar swap line with the Federal Reserve. On May 21, the Bank of Japan unveiled a new fund-provision framework to facilitate the strengthening of the foundation for economic growth. On June 15, the Bank of Japan announced that, in accordance with the fund-provision measure, it would provide up to 3 trillion yen to financial institutions. The Bank of Japan expects that financial institutions will utilize the fund-provision measure appropriately and effectively, taking it as an opportunity to expand lending and investment to businesses that will contribute to raising productivity or creating new demand.

IV. The Bank of England

At its regular meetings held in the first half of 2010, the Bank of England announced it would keep the official rate of 0.5 percent unchanged and would maintain the asset purchase program of GBP 200 billion. On May 10, in response to the deepening of the European sovereign debt crisis, the Bank of England reopened the currency swap line with the Federal Reserve.