

MONETARY POLICY

In 2007, to ease over supply of liquidity in the banking system and the expansionary pressure on money and credit, and in response to large price hikes, the sound monetary policy was replaced by a tight monetary policy. The PBC took a variety of measures to strengthen liquidity management in the banking system, allow prices to play a leverage role, control growth of money and credit, guide the optimization of credit structure, and enhance the RMB exchange rate flexibility in order to promote balanced economy and financial development. At present, structural adjustment remains an urgent job and the overall situation has become even more complex given the remaining risks of overheating and stronger upward pressures on prices. In 2008, a tight monetary policy will be implemented and flexibility in policy operation will be maintained to address changing situation in the domestic and global economy to create a stable monetary and financial environment for economic growth and structural adjustment.

Monetary Policy Measures in 2007

Multiple measures were adopted to strengthen liquidity management In 2007, the PBC continued to use a mixture of tools such as open market operations and reserve requirement ratio, and basically sterilized the banking system liquidity supplied as a result of foreign exchange purchase. First of all, central bank bills were issued. A total of 4.07 trillion yuan of such bills was issued, 420 billion yuan more than that in 2006. At end-2007, the outstanding balance of central bank bills posted 3.49 trillion yuan, 460 billion yuan more than that at the beginning of 2007. Second, repurchase operations were conducted. After the issuing of special government securities, the repurchase of these instruments were stepped up. In 2007, the total amount of repo operations reached 1.27 trillion yuan, with 620 billion yuan remaining outstanding at end-2007, a growth of 560 billion from the year's beginning. Third, central bank bills with longer maturities were issued. In order to address the pressure on central bank to supply liquidity when central banks bills become due, the PBC resumed the issuing of 3-year central bank bills at end-January 2007. Fourth, the issuing interest rates of central bank bills edged up. The issuing interest rates of 3-month, 1-year, and 3-year central bank bills were up 90

percentage points, 126 percentage points and 155 percentage points respectively. Fifth, a combination of market-based issue and targeted issue of central bank bills was used to effectively drain liquidity and to give out clear policy signals.

While gearing up open market operations, the PBC continued to use reserve requirement ratio to drain liquidity and curb banking system's ability of money creation as reserve requirement is capable of deeply freezing liquidity and can be used by the central bank in a pro-active manner. The reserve requirement ratio was hiked for ten times by a total of 5.5 percentage points (see the table below). On January 25, 2008, a further hike of 0.5 percentage points was announced, raising the ratio for financial institutions in general to 15 percent. In addition, the differentiated reserve requirement ratio system remained in place, i.e. imposing a higher reserve requirement ratio on those financial institutions whose capital adequacy ratio is below the prescribed threshold level and NPL ratio higher than the prescribed level in order to contain blind asset expansion and promote sound business operation.

The interest rate was given a leverage role in macroeconomic management, and marketbased interest rate reform made progress The PBC used interest rate leverage flexibly and raised the bench-



mark lending and deposit rates six times in 2007. As a result, 1-year deposit rate went up by a total 1.62 percentage points from 2.52 percent at the beginning of 2007 to 4.14 percent at end-2007. 1-year lending rate rose by a total of 1.35 percentage points, from 6.12 percent to 7.47 percent. Furthermore, the money market benchmark interest rate system developed in a smooth manner. Since its launch on January 4, 2007, Shibor has basically established itself as a benchmark in the market. Shibor has become more and more accurate, sensitive and comprehensive, and displayed an increasingly stable spread with inter-bank borrowing and repo rates. A growing amount of transactions were based on Shibor.

The RMB exchange rate regime was improved and reform of the foreign exchange management system gathered pace Continued efforts were made to improve the managed floating exchange rate system based on market demand and supply with reference to a basket of currencies. At the same time, the foreign exchange management system reform was accelerated to promote a balanced BOP account. First of all, the RMB exchange rate became more flexible. On May 21, the daily floating band of RMB to the U.S. dollar trading price on the inter-bank

spot market was expanded from 0.3 percent to 0.5 percent. Second, market participants' demand to hold and use foreign exchange was further satisfied. The cap on amount outstanding of current account foreign exchange bank accounts of domestic institutions was abolished. An annual total transaction quota of US\$50 000 on foreign exchange purchase and sale by individuals was adopted. Third, capital outflow channels were expanded in an orderly manner. In 2007, another six qualified foreign institutional investors (QFIIs) were approved of investment quota of US\$950 million, bringing the total QFII investment quota of all 49 QFIIs to US\$9.955 billion. The investment quota and areas of qualified domestic institutional investors (QDIIs) were further enlarged. At end-2007, a total of 50 commercial banks, fund management companies and insurance companies became QDIIs, and transferred almost US\$35.3 billion for outward investment. Fourth, management over inflow of foreign exchange and foreign exchange purchase by banks was enhanced and improved. Efforts were made to improve management over foreign exchange receipts and foreign exchange surrender to banks and strengthen dynamic monitoring of exporting enterprises that have large foreign exchange receipts.

Reserve Requirement Ratio Adjustment					
					%
Time of Adjustment	Reserve Requirement Ratio Applicable to Different Categories of Financial Institutions				
	General Financial Institutions ¹	Rural Cooperative Banks	Urban Credit Cooperatives	Rural Credit Cooperatives	Others ²
Jan.15, 2007	9.5	8.5	8.0	7.0	10.0
Feb.25, 2007	10.0	9.0	8.5	7.5	10.5
Apr. 5, 2007	10.5	9.5	9.0	8.0	11.0
Apr.29, 2007	11.0	10.0	9.5	8.5	11.5
May 18, 2007	11.5	10.5	10.0	9.0	12.0
Jul. 30, 2007	12.0	11.0	10.5	9.5	12.5
Sep. 7, 2007	12.5	11.5	11.0	10.0	13.0
Oct.13, 2007	13.0	12.0	11.5	10.5	13.5
Nov.12, 2007	13.5	12.5	12.0	11.0	14.0
Dec.12, 2007	14.5	13.5	13.0	12.0	15.0

Notes: 1. Refers to Agricultural Development Bank of China, state-owned commercial banks, joint stock commercial banks, city commercial banks, rural commercial banks, finance companies, financial leasing companies, and foreign-funded financial institutions.
2. Refers to financial institutions whose capital adequacy ratio is below the prescribed threshold level.

The external borrowing quota of financial institutions was cut. Strict restriction was imposed on repatriation of funds for inward investment in real estate enterprises and in mergers and acquisitions of such enterprises, and management over external borrowing of foreign funded real estate enterprises was strengthened.

Window guidance and credit policy guidance was intensified In 2007, as credit was under strong expansionary pressures, the PBC continued to intensify window guidance and credit policy guidance for commercial banks and brought their attention to potential risks associated with excessive loan growth, asset and liability maturity mismatches and to the need of managing appropriate credit aggregate and the pace of lending. The principle of differentiated lending treatment for different sectors was followed to optimize credit structure, exercise adequate control over fixed asset and other medium and long term loans, restrict lending to the low-quality enterprises in industries with excess capacity, enhance credit support to employment, needy students, small and medium-sized enterprises, independent innovation, energy conservation and environmental protection and etc., expand fee-based services, enhance financial product innovation and improve financial services. Together with the China Banking Regulatory Commission, the PBC adjusted commercial real estate loan policy to strengthen management over home mortgage lending and raised the down payment ratio and interest rate of mortgages for second homes.

The Money and Credit Conditions Remained Generally Stable

In 2007, monetary policy worked in coordination with other macroeconomic policies and played an important role in curing excessive growth of money and credit and preventing overheating. Throughout the year, the financial sector performed in a stable manner that was commensurate with the demand of a rapidly and steadily growing economy.

Money supply remained large At end-2007, broad money M2 was up by 16.7 percent year on year, representing a deceleration of 0.2 percentage points and a decline of 1.8 percentage points from the year's peak. Narrow money M1 grew by 21.0 percent year on year, an acceleration of 3.5 percentage points, but a decline of 1.8 percentage points from the year's peak. Cash in circulation M0 grew by 12.1 percent while net cash injection in 2007 totaled 303.3 billion yuan, up 26.2 billion yuan from that in 2006.

A larger share of deposits became demand deposits At end-2007, the outstanding deposits with financial institutions were up 16.1 percent year on year. In 2007, enterprise deposits grew by 2 602.9 billion yuan, an acceleration of 857 billion yuan, including an acceleration of 603.5 billion yuan in demand deposits and 253.5 billion yuan in time deposits. Savings deposits grew by 1 096.7 billion yuan, a deceleration of 957.7 billion yuan, including a deceleration of 73.7 billion yuan in demand deposits and 883.9 billion yuan in time deposits. Fiscal deposits surged by 663.3 billion yuan, an acceleration of 371.4 billion yuan.

Lending expanded by a large margin At end-2007, the balance of loans outstanding of financial institutions went up by 16.1 percent year on year, representing an acceleration of one percentage point from a year ago but a decline of 1.6 percentage points from the year's peak. In 2007, new loans grew by 448.2 billion yuan from that in 2006 to 3.63 trillion yuan. Break down by destinations, new loans in the form of short-term lending and paper financing grew by 1.14 trillion yuan, representing a deceleration of 99.6 billion yuan, including a growth of 1.58 trillion yuan in new short-term loans or an acceleration of 442.8 billion yuan from a year ago, and a decline of 441.4 billion yuan in paper financing or a deceleration of 542.4 billion yuan from a year ago. Medium and long-term loans grew by 2.51 trillion yuan, representing an acceleration of 607.9 billion yuan from a year ago, including an acceleration of 458.7 billion yuan in



medium and long-term loans for the household sector.

The RMB exchange rate flexibility continued to strengthen The RMB exchange rate has moved in both directions in increasingly greater flexibility since the exchange rate reform. The trading days in 2007 totaled 242 days, of which, 151 days registered appreciation, 91 days devaluation; the largest single-day appreciation was 0.41 percent (310 basis points). As of end-2007, the RMB appreciated 13.3 percent against the US dollar in cumulative terms. According to calculation based on the BIS data, the nominal effective exchange rate of the RMB was up by 1.6 percent, and the real effective exchange rate by 5.1 percent.

In the context of BOP imbalances, financial measures of macroeconomic management are subject to substantial constraints in order to maintain RMB exchange rate basically stable. Despite this, the money and credit supply in the recent five years remained basically appropriate and played an important role in maintaining aggregate balance. The annual growth of broad money M2 was controlled at around 17 percent amidst 40 percent growth of official foreign exchange reserves and over 10 percent of economic growth per annum. The M2 to GDP ratio reversed its relatively fast growth and stabilized at slightly over 1.6 percent in the past years.

Monetary Policy Outlook for 2008

The year 2008 marks the first year in implementing the strategic plan outlined in the 17th CPC National Congress and the 30th anniversary of reform and opening-up. It is of great importance to continuously improve financial regulation in maintaining the sound momentum of economic and social development. At present, the risk remains with the relatively fast growing economy becoming overheated. Pressure from price hike has built up and the economic restructuring presents a pressing task. At the same time, with the

impact of the US sub-prime mortgage crisis unfolding, there are relatively large downside risks in major economies, the US economy in particular, and the overall situation is even more complex. A tight monetary policy as decided by the Central Economic Work Conference to be implemented in 2008 is necessary for the implementation of the scientific approach to development and the construction of a harmonious socialist society, represents a continuation of the sound monetary policy in place since 2003 and most recently the appropriately tight monetary policy, and it clearly signals heightened risks in macroeconomic performance and the policy orientation concerning economic aggregates in the future.

The PBC will follow the overall arrangements of the State Council, implement a tight monetary policy, apply a mix of monetary policy instruments based on comprehensive analysis of the international economic and financial situation and changes of monetary policies in major economies from a global perspective, maintain appropriate regulation and operational flexibility, curb excess money and credit growth and endeavor to maintain the price level basically stable.

First, liquidity management of the banking system will be strengthened. Open market operations will be conducted based on the dynamics of liquidity in the banking system, and reserve requirement ratio will be increased at proper timing by an appropriate margin. Efforts will be made to keep the excess reserve ratio of financial institutions at a low level so as to contain money creation ability of the banking system.

Second, the RMB exchange rate flexibility will be enhanced. The fundamental role of market demand and supply in the formation of the RMB exchange rate will be strengthened. In 2007, the RMB appreciated by 7 percent against the US dollar but depreciated against the euro. Efforts will be made to strengthen the role of exchange rate in adjusting the balance of payments, guiding economic restructuring and reining in price hikes, and to improve the independence and effec-

tiveness of monetary policy. Public education will be enhanced to bring the public attention to the perspective of effective exchange rate.

Third, the leverage role of interest rate will be used. The market-based reform of the interest rate will be forged ahead. The impact of the change in aggregate demand and supply, pass-through of international prices and reform of resources pricing on the price level will be analyzed. The interest rate will be given a leverage role in preventing overheating and curbing inflation. In addition, inflation expectations of the general public will be guided.

Fourth, window guidance and credit policy guidance will be strengthened. Efforts will be made to strengthen the guidance of credit planning of individual financial institutions, reasonably control the credit aggregate and pace, continue the differentiated treatment of various sectors, and optimize credit structure. Measures will be adopted to control the growth of medium and long-term lending including infrastructure construction loans, rigorously restrict credit to high energy consuming and highly polluting industries and low-quality enterprises in industries with over-capacity, and extend more credit support to agriculture, rural areas and farmers, the services sector, small and medium-sized enterprises, independent innovation, energy saving and environmental protection and other weak areas as well as economic restru-

cturing.

Fifth, continue to improve foreign exchange administration. Efforts will be made to adapt to the new situation, deepen the reform of foreign exchange administration system, improve foreign exchange surrender and purchase and continue to promote capital account convertibility. More accommodating policies will be adopted to encourage capital outflow and encourage enterprises, individuals and financial institutions to make overseas investment. The RMB will be used more frequently in overseas economic activities to help address over liquidity in the domestic market. Monitoring over cross-border capital movement especially short-term capital will be strengthened.

Sterilization and credit control are not able to address the root causes of liquidity generation and structural problems in the economy, as they can create a stable monetary and financial environment for economic growth and restructuring. It is imperative to intensify restructuring efforts and make new progress in treating root problems in the endeavor to attain balanced growth in a timely manner. The current window opportunity of continued rapid economic growth and fiscal revenue increase should be seized to implement a package of restructuring policies that expand consumer demand, and deepen, specify and intensify detailed measures so as to promote the equilibrium of the balance of payments.