China Monetary Policy Report, Quarter Two, 2005

Executive Summary

Further achievements were made in macroeconomic management in the first half of 2005. The national economy maintained steady and rapid growth; the excessively rapid growth of investment was contained; consumer demand increased markedly; price indices fell steadily; and great improvements were made in the fiscal revenue and the income of urban and rural residents. In the first half of 2005, GDP grew by 9.5 percent and the CPI increased by 2.3 percent on a year-on-year basis.

Under the guidance of the CPC Central Committee and the State Council, the People's Bank of China (PBC) continued to pursue sound monetary policy and strengthened the market-based means to control economic aggregates and promote structural adjustment. Specific measures included the following. First, the PBC managed the liquidity of the banking sector by flexibly conducting open market operations with a view to creating a favorable liquidity environment for the credit growth of the commercial banks and product innovation in the financial market. Second, measures were taken to enhance the role of interest rates in macroeconomic management. The interest rate for the excess reserves of the financial institutions deposited at the central bank was lowered, the ceilings on the interest rate for small-value deposits in the US dollar and Hong Kong dollar were raised, and the rules governing the calculation and payment of interest on RMB loans and deposits were revised. Third, the formation mechanism for the RMB exchange rate was reformed. After July 21, 2005, China adopted a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Fourth, the PBC implemented credit policies based on the principle of differentiating credit support to various sectors set by the central government, timely conveyed policy intentions to the financial institutions, and guided the commercial banks to take preemptive measures to respond to cyclical development and industrial changes and to improve their credit structure. The PBC also revised the policy for the individual housing loans of the commercial banks to promote the healthy and sustained development of the housing market. Fifth, measures were taken to develop short-term corporate financing bills and forward bond transactions in an effort to promote the healthy and rapid development of the financial market. The reform of financial enterprises was steadily advanced, and further steps were taken to improve the administration of foreign exchange.

In the first half of 2005, money and credit recorded appropriate growth and the financial sector performed soundly. As of end-June, broad money (M2) reached 27.6 trillion yuan, increasing by 15.7 percent over the same period of last year; base money amounted to 5.7 trillion yuan, a year-on-year growth of 11.8 percent; and loans registered 18.6 trillion yuan, up 13.3 percent over the same period of last year. Interest rates in the money market fell at a steady pace. As of end-June, foreign exchange reserves reached USD710.97 billion, 101.04 billion more than that recorded for the end of 2004.

In general, the economy will continue to grow steadily and rapidly in the second half of 2005, and the internal growth dynamics will remain strong. Nevertheless, the deep-rooted problems hindering the sustained, rapid, coordinated, and healthy development of the economy have not been effectively resolved, calling for further attention and efforts.

In the second half of 2005, under the guidance of the CPC Central Committee and the State Council, the PBC will continue to pursue a sound monetary policy. Efforts will be made to maintain policy consistency and stability to appropriately control money and credit aggregates. Preemptive and fine-tuning measures will be taken to maintain the steady growth of money and credit. The market will be allowed to play a greater role and achievements in macroeconomic management will be further consolidated. Steps will be taken in the following six areas. First, the PBC will seek to maintain appropriate growth of money and credit by using a mix of monetary policy instruments. Second, measures will be taken to further implement the market-based interest rate reform policy. Third, by differentiating credit support to various sectors, the role of credit policy in economic restructuring will be enhanced. Fourth, the development of financial markets will be actively promoted. Fifth, the reform of financial enterprises will be accelerated. Sixth, continued efforts will be made to improve the formation mechanism of the RMB exchange rate to promote balanced international payments and to maintain the RMB exchange rate basically stable at an adaptive and equilibrium level.

Part One: Monetary and Credit Performance

In the first half of 2005, the Chinese economy continued to expand at a steady and relatively fast pace. The growth of money and credit remained broadly appropriate, and the performance of the financial industry was sound.

I. Growth of monetary aggregates remained appropriate

Broad money M2 reached 27.6 trillion yuan at end-June, an increase of 15.7 percent y-o-y, with the growth registering 0.5 percentage points lower than a year earlier or 1 percentage point up from the end of 2004, continuing its trend of steadily rebounding since March, which was broadly consistent with the pace of economic growth. Narrow money M1 reached 9.9 trillion yuan at end-June, increasing by 11.3 percent y-o-y, 4.9 percentage points lower than a year earlier or 2.3 percentage points down from the end of 2004. Cash in circulation M0 amounted to 2.1 trillion yuan, increasing by 9.6 percent y-o-y. Cumulative net cash withdrawals in the first half of the year totaled 62 billion yuan, 10.8 billion yuan less than that recorded for the same period of 2004.

Table 1: Money Supply and Its Components at end-June, 2005

RMB trillion yuan

	Balance	Y-O-Y Percent Change%
Money and Quasi Money (M2)	27.6	15.7
Money (M1)	9.9	11.3
Cash in Circulation (M0)	2.1	9.6
Demand Deposits	7.8	11.7
Quasi Money	17.7	18.3
Time Deposits	2.9	24.9
Savings Deposits	13.2	16.3
Other Deposits	1.5	23.9

Note: Margin deposits for clients of securities firms are included in money and quasi money (M2).

Source: The People's Bank of China

II. Deposits of financial institutions expanded at a steady pace

Outstanding deposits of all financial institutions (including foreign-funded financial institutions) in both RMB and foreign currencies increased by 16.8 percent y-o-y to 28.3 trillion yuan at end-June, a growth of 2.68 trillion yuan from the beginning of the year or an acceleration of 494.8 billion yuan. In particular, RMB deposits rose by 17.2 percent y-o-y to 26.9 trillion yuan, up 2.59 trillion yuan over the beginning of the year or accelerating by 423.7 billion yuan. Foreign currency deposits totaled USD165.3 billion, increasing by 9.4 percent y-o-y or by USD10.51 billion over the beginning of the year, an acceleration of USD8.59 billion.

At end–June, RMB deposits from the corporate sector increased by 13.8 percent y-o-y to 9 trillion yuan, representing a growth of 548.9 billion yuan from the beginning of the year, 84.6 billion yuan less than growth during the same period of 2004. Savings deposits in RMB expanded by 16.3 percent y-o-y to 13.2 trillion yuan, increasing by 1.28 trillion yuan over the beginning of the year, 261.8 billion yuan more than the same period of the previous year, in large part attributable to an acceleration of time deposits. Fiscal deposits added 381.7 billion yuan in the first half, an acceleration of 129.7 billion yuan compared with the previous year..

III. Loans by financial institutions grew at a stable rate

Outstanding loans by financial institutions in both RMB and foreign currencies reached 19.9 trillion yuan at end-June, a growth of 13.2 percent y-o-y, or increasing by 1.59 trillion yuan over the beginning of the year, an acceleration of 27.2 billion yuan. RMB loans grew by 13.3 percent y-o-y to 18.6 trillion yuan, an increase of 1.45 trillion yuan over the beginning of the year, accelerating by 24 billion yuan, with the amount of new loans recording the second highest level in history, only behind that recorded in the same period of 2003. Foreign currency loans rose by 12.1 percent y-o-y to USD149.7 billion, a growth of USD16.22 billion over the beginning of the year, accelerating by USD0.4 billion.

In terms of loan destinations, overly rapid growth of medium and long-term loans has been effectively contained and the share of working capital loans increased somewhat. The loan structure further improved. In the first half, RMB medium and long-term loans increased by 645.5 billion yuan, a deceleration of 85.5 billion yuan, with the growth as a proportion of the total loans declining by 6.7 percentage points over the previous year. Short-term loans and bill financing for corporate working capital increased by 796.2 billion yuan, an acceleration of 128.6 billion yuan, accounting for 55 percent of total new loans, 8 percentage points up compared with the same period of the previous year.

In a breakdown by institutions, with the exception of lending by wholly state-owned commercial banks,[1] lending by all other financial institutions accelerated. In the first half, RMB loans by wholly state-owned commercial banks increased by 510.3 billion yuan, decelerating by 158.4 billion yuan over the same period of the previous year. Lending by policy banks, joint-stock commercial banks,[2] urban commercial banks, and rural cooperative institutions[3] expanded by 171.8 billion yuan, 319.4 billion yuan, 89.6 billion yuan, and 291.7 billion yuan, accelerating by 83.1 billion yuan, 52.9 billion yuan, 4.7 billion yuan, and 32.4 billion yuan respectively. Loans by foreign-funded financial institutions added 19.5 billion yuan, an acceleration of 14 billion yuan.

Box 1: Current monetary and credit developments

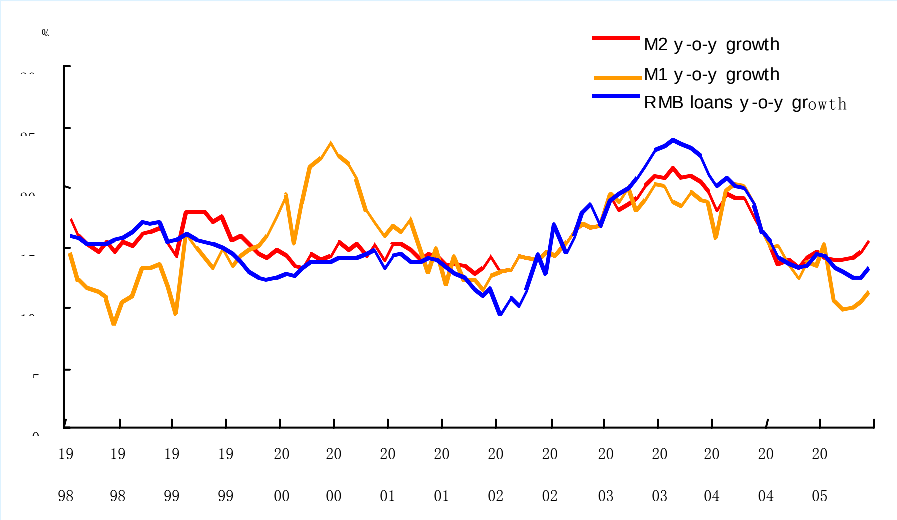
Since the beginning of 2005, the central bank conducted open market operations in a flexible manner, providing a relatively accommodating liquidity environment for commercial banks to maintain an appropriate growth of lending. At end-June, M2 grew by 15.7 percent y-o-y, basically consistent with economic growth. The y-o-y growth of outstanding RMB loans was 13.3 percent, 2.4 percentage points lower than that of broad money M2, while the growth of M1 was 4.4 percentage points lower that of M2. The changes in M2, M1, and loans were basically aligned, with varying rates of growth. Such developments deserve a full analysis.

Figure 1: A comparison of loan growth and money growth since 1998

[1] According to the statistical standard used by the Statistics Department of the PBC, wholly state-owned commercial banks comprise the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and the China Construction Bank.

[2] According to the statistical standard used by the Statistics Department of the PBC, joint-stock commercial banks consist of the Bank of Communications, the CITIC Industrial Bank, the Everbright Bank, the Huaxia Bank, the Guangdong Development Bank, the Shenzhen Development Bank, the China Merchants Bank, the Pudong Development Bank, the Industrial Bank, the Minsheng Bank, the Evergrowing Bank, and the Zhejiang Commercial Bank.

[3] According to the statistical standard used by the Statistics Department of the PBC, rural cooperative institutions include rural credit cooperatives, rural cooperative banks, and rural commercial banks. The Statistics Department of the PBC began to collect data on rural cooperative banks at the beginning of 2005.



Source: The People's Bank of China

The chart comparing loan growth with money growth since 1998 indicates that lending growth generally was slower or basically equal to M2 growth, except for during the over-investment period from the second half of 2002 to May 2004. Since the second half of 2004, the gradual easing of loan growth was due to many factors, basically a reasonable development. On the corporate front, with macro control measures yielding effects, the pace of production and operation by most enterprises tended to moderate from a fast level. A few enterprises cut inputs and outputs due to overcapacity, thus leading to a slowdown of effective corporate demand for financing. In the meanwhile, funding channels of enterprises diversified, with bill settlement, internal funding within the enterprise group, direct debt instruments, equity financing both domestically and globally, borrowing in foreign markets, export tax-rebates, and informal lending substituting for some loans and contributing to less reliance by enterprises on the banking sector for financing. In the first half, enterprises issued a total of commercial drafts worth 208.2 billion yuan, floated bonds (including short-term financing bills) worth 30.3 billion yuan, and raised 90 billion yuan in domestic and foreign equity markets, a direct substitution for loans. On the banking front, first, the advances in the joint-stock reform of commercial banks contributed to strengthened internal control of banks and more rational lending behavior. In the first half, loans by the four wholly state-owned commercial banks increased by 510.3 billion yuan, decelerating by 158.4 billion yuan over the same period of last year. Second, supervisors stepped up risk-based supervision. The constraint effect of the capital adequacy ratio requirement on the asset growth of commercial banks, coupled with an intensification of examinations by the China Banking Regulatory Commission, played a positive role in promoting sound operations of commercial banks.

To put the lower growth of M1 as opposed to M2 in the right perspective, the fall in the M1 growth rate does not mean a deterioration of the payment capabilities of enterprises. At the current stage, enterprise demand deposits are included in M1, accounting for around 80 percent of demand deposits in M1. Other demand deposits in M1 include demand deposits maintained by government agencies, social organizations, military units, and public institutions at banks, rural deposits, and credit card account deposits of individuals, which made up around 20 percent. Enterprise time deposits, as part of quasi money, are included in M2. At end-June, enterprise demand and time deposits totaled 9 trillion yuan, an increase of 13.8 percent, suggesting that the overall payment capabilities of enterprises were at a normal level. In particular, time deposits accounted for 33 percent, a y-o-y growth of 24.9 percent; demand deposits took up 67 percent, increasing by 9.1 percent y-o-y. The preference of enterprises for time deposits in terms of deposit maturity was associated with the hike in the interest rate on time deposits by the PBC last October, as enterprises converted some demand deposits to time deposits for economy purposes. At the same time, with the growth of bill financing, bank acceptance issuance growth led to fast expansion of margin deposits of enterprises, which fall into the category of time deposits, thus motivating enterprises to opt more often for time deposits.

In general, monetary and credit conditions are basically consistent with the target of the steady and relatively fast growth of the economy at the current stage. Looking ahead, it is warranted to maintain the continuity and stability of monetary policy, to pay attention to preemptive adjustments and fine-tuning, and to keep the balance of aggregates. In the meanwhile, efforts shall be made to enhance the role of the market mechanism, to promote structural optimization, and to prevent large ups and downs.

IV. Base money grew steadily, and liquidity remained adequate in the banking sector

At end-June, the balance of base money totaled 5.7 trillion yuan, increasing by 11.8 percent y-o-y and decreasing by 149.3 billion yuan from the beginning of the year. The growth of base money was mainly driven by the significant rise in purchases of foreign exchanges as a result of large capital inflows. At end-June, the average excess reserve ratio of financial institutions was 3.72 percent, down 0.03 percentage points from the previous year. The wholly state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives recorded a ratio of 3.26 percent, 5.71 percent, and 4.70 percent respectively. Adequate liquidity in the banking sector accommodated the needs for appropriate loan growth.

V. Loan interest rates of financial institutions edged up, and the money market interest rate fell steadily

Loan interest rates of financial institutions moved up somewhat. In the second quarter, the weighted average fixed and floating interest rate for one-year RMB loans of financial institutions was 7.46 percent and 5.97 percent respectively, 1.34 and 1.07 times the benchmark interest rate, up 0.48 and 0.14 percentage points over the previous quarter. The PBC statistics on lending interest rates of financial institutions in the second quarter of 2005 have shown that among total new loans, loans with interest rates floating downward against the benchmark took up 18.72 percent, down 3.18 percentage points over the previous quarter; loans charged at the benchmark rate made up 21.96 percent, down 4.94 percentage points over the previous quarter; and loans with interest rates floating upward against the benchmark accounted for 59.32 percent, up 8.12 percentage points over the previous quarter.

Table 2：The Share of Loans with Rates Falling in Various Ranges in the Second Quarter of 2005

(by financial institution)

Unit：%

	Sum	[0.9，1)	1.0	Upward Adjustment				
				Sum	（1，1.3]	（1.3，1.5]	（1.5, 2]	above 2
Sum	100	18.72	21.96	59.32	24.98	15.77	14.56	4.01
State-owned commercial banks	100	30.55	29.49	39.96	35.60	3.67	0.56	0.13
Joint-stock commercial banks	100	30.14	37.49	32.37	31.03	1.08	0.24	0.02
Regional commercial banks	100	20.51	21.70	57.79	40.36	9.99	6.53	0.92
Urban and rural credit cooperatives	100	1.02	3.12	95.86	12.77	36.23	36.61	10.25

Note: The interest adjustment range for urban and rural credit cooperatives is（2，2.3）

Source: Reports of lending rates of commercial banks

In the first half, the interest rate on negotiable RMB deposits of commercial banks (above 30 million yuan) declined slightly. In particular, the weighted average interest rate of negotiable deposits with a maturity of 61 months in the second quarter stood at 4.12 percent, down 0.17 percentage points compared with the previous quarter and down 0.34 percentage points from the beginning of the year. The weighted average interest rate of negotiable deposits with a maturity of 37 months was 4.1 percent, down 0.11 percentage points over the previous quarter and down 0.22 percentage points from the beginning of the year.

Affected by the persistent interest rate hikes of the US Fed and interest rate rises in international financial markets, the interest rates on domestic foreign currency loans and large-value deposits continued to move up. In June, the weighted average interest rate of one-year large-value US dollar deposits (above USD3 million) stood at 3.74 percent, 1.47 percentage points higher than that at the beginning of the year; the weighted average fixed interest rate on one-year US dollar loans was 4.57 percent; and the weighted average floating interest rate on US dollar loans was 4.25 percent, up 1.14 and 0.87 percentage points respectively over the beginning of 2005.

Table 3：Average interest rates on large-value USD deposits and USD loans in the first half of 2005

Unit: %

	January	February	March	April	May	June
I. Large-value deposits						
Within 3 months	1.7964	1.5561	2.3159	2.4776	2.9717	2.3956
3—6months	2.1102	2.2490	2.5353	2.9351	2.7800	3.3701
6—12 months	2.4450	2.2419	2.6527	3.3083	2.3960	3.4914
1 year	2.3039	2.3694	3.3022	2.7471	3.5035	3.7372
II. Loans						
1 year（fixed）	3.5366	3.7720	4.2393	4.0664	4.5367	4.5664
1 year (monthly floating）	3.3315	3.6771	3.7462	4.0724	4.1575	4.2477

Source: Reports of foreign currency interest rates of commercial banks

In the first half, financial institutions were in sufficient liquidity, leading to a steady drop in the money market interest rates. The weighted average interest rates on 7-day inter-bank lending in June and the pledged bond repo in March were 1.57 percent and 1.1 percent, down 0.07 and 0.04 percentage points respectively over the previous month. Domestic short-term rates were lower than in foreign markets and the spread widened markedly, which was conducive to dampening speculative capital inflows.

VI. Official foreign exchange reserves continued to grow rapidly and the RMB exchange rate remained stable

A trade surplus of USD39.6 billion was recorded in the first half, an expansion of USD46.4 billion compared with the same period of the previous year. Capital inflows grew relatively fast. At end-June, official foreign exchange reserves reached USD710.97 billion, growing by USD101.04 billion over the end of 2004, or accelerating by USD33.65 billion over the growth recorded for the same period of last year. The RMB exchange rate stood at 8.2765 yuan per US dollar, on a par with the end of 2004.

In the first quarter of 2005, the overall external debt of China continued to rise, with the pace easing somewhat. New debt maintained the growth momentum and the proportion of short-tem debt increased slightly. At end-March, the balance of the external debt of China amounted to USD 233.409 billon (excluding that of Hong Kong SAR, Macao SAR, and Taiwan), up USD4.813 billion or 2.11 percent from the end of 2004. In particular, medium and long-tem debt reached USD 125.533 billon, accounting for 53.78 percent of total debt and growing by USD1.246 billion from the end of last year. Short-term debt totaled USD107.876 billion, accounting for 46.22 percent and increasing by USD3.567 billion from the end of the previous year.

Part Two: Monetary Policy Conduct

In the first half of 2005, the PBC continued to implement a sound monetary policy under the leadership of the central government, and increased the application of market instruments in aggregate control and economic restructuring while making efforts to promote the healthy development of the financial market, to steadily advance the reform of financial institutions, to gradually push ahead reform of the RMB exchange rate regime, and to improve the balance of international payments.

I. Open market operations were conducted flexibly

In the first half of 2005, the PBC continued to conduct flexible open market operations to sterilize the persistent large increase of foreign exchange in the market, and made proper arrangements for the issuance of central bank bills related to the issuance mode, size, and maturity structures, taking into account such factors as fiscal deposits, bond issuance and redemption, and cash in circulation that have a bearing on the liquidity situation in the market. The PBC also was involved in flexible repo operations which helped to bring the excessive growth of liquidity in the banking system under control and to prevent it from being overly volatile.. Broadly speaking, the banking system enjoyed sufficient liquidity, creating a favorable environment for the commercial banks to meet reasonable loan growth needs and product innovation in the financial market. Fluctuations of excess reserve ratios of financial institutions narrowed evidently compared with the same periods of the previous two years, and money market interest rates dropped steadily, laying a good foundation for the reform of the RMB exchange rate regime.

In the first half of the year, the PBC issued base money of 1000 billion yuan via foreign exchange open market operations, and recalled 761.6 billion yuan via RMB open market operations, resulting in a net issuance of base money of 238.4 billion yuan. There were 68 issuances of central bills in the period, with the value amounting to 1358 billion yuan, among which bills with a maturity of 1 year were worth 551 billion yuan and those with a maturity of 3 years were valued at 358 billion yuan. In the first six months, the outstanding balance of central bank bills increased by 688.8 billion yuan to 1663 billion yuan, with the outstanding balance of repo contracts reaching 70 billion yuan at the end of June.

II. Interest rates played a sufficient leverage role in the macroeconomic adjustment

On March 17, the PBC cut the interest rates on excess reserves of financial institutions to 0.99 percent in a bid to encourage the commercial banks to enhance the efficiency of capital use and further improve liquidity management. In face of the rising interest rates in international financial markets, on May 20 and July 22, the

PBC twice raised the upper limits imposed on interest rates offered by domestic commercial banks on small-value foreign exchange deposits denominated in US dollars and Hong Kong dollars. Specifically, the interest rate for one-year US dollar deposits was raised respectively by 25 and 50 basis points to 1.625 percent, while that for one-year Hong Kong dollar deposits climbed by 18.75 and 50 basis points to 1.5 percent. The upward adjustment of the interest rate of small-value foreign exchange deposits was conducive to rationalizing the relationship between domestic and foreign currency interest rates, stabilizing domestic foreign exchange deposits, and reducing the pressures on foreign exchange surrender. Rules and practices related to the calculation and payment of RMB deposits and loan interest were also revised and improved to allow commercial banks to formulate rules at their own discretion with regard to the calculation and payment of interest on all other types of deposits except demand deposits and time deposits, with the principal and interest paid up one time on maturity, which helped the commercial banks improve liability management and financial services.

III. The residential mortgage policy was adjusted

Measures were adopted to control housing demand and guide the rational expectation of future housing prices. On March 17, the preferential interest rate currently prevailing in the commercial banks' mortgage business was brought down to the level of the interest rate applicable to normal lending businesses of the same maturity, with a lower limit imposed to allow commercial banks in the capacity of legal persons to have the autonomy to determine the mortgage rate and internal pricing methodology. Meanwhile, the minimum down payment might be raised from 20 percent to 30 percent of the total financing of residential housing in cities or regions where property prices have seen excessive growth. The incorporation of commercial banks’ residential mortgage policy into the normal interest rate management system of the central bank has proved helpful to strengthen the commercial banks’ risk management and pricing mechanism.

IV. Window guidance and credit policy guidance for commercial banks were strengthened

The PBC implemented in earnest the macroeconomic strategy mapped out by the central government which called for “differentiated treatment to different sectors” by timely conveying to financial institutions the government’s policy intentions so as to guide the commercial banks in taking a forward-looking approach to respond to changes of economic cycles and industrial development and to improve the credit structure.

First, in collaborating with various policies of the government to support the rural economy, the PBC made great efforts to improve financial services in the rural areas. In the spring season, the quotas for agriculture-support central bank lending were revised in a timely fashion to enhance credit support for crop-planting activities. At present, 117.5 billion yuan worth of central bank lending is arranged for the rural credit cooperatives in the western areas and the major grain-producing areas to boost credit support for the rural economy. Continuous efforts were made to foster healthy growth of the rural credit cooperatives' micro credit and mutually guaranteed loan business to the farmers. In the meanwhile, actions were taken to build and cultivate the rural financial market and to guide the development of informal financing activities. Second, financial institutions were urged to further improve financial services, enhance financial innovation, and increase credit support to the rural economy, non-public sector, and the SMEs. Third, harmonization of the credit policy and industrial polices was strengthened and financial institutions were encouraged, through window guidance, to improve credit structure and prevent heedless and low-level duplicated construction. Fourth, institution building was accelerated to increase credit support for the re-employment of laid-off workers. In this vein, credit communities were established on a pilot basis to boost job creation and re-employment of laid-off workers. Fifth, the PBC made instructive policies to support consumption, promote coordinated growth of consumption and investment, and to prevent and mitigate consumption-related credit risks.

V. Reform of financial institutions was steadily advanced to maintain financial stability

The joint-stock reform of state commercial banks advanced smoothly. Based on the experiences attained in the joint-stock reform process of the Bank of China (BOC) and the China Construction Bank (CCB), on April 22, the Central Huijin Investment Company recapitalized the Industrial and Commercial Bank of China (ICBC) with foreign reserves totaling USD15 billion, bringing the ICBC's core capital adequacy ratio up to 6 percent. The pilot reform of the BOC and CCB also progressed smoothly.

The pilot reform of rural credit cooperatives continued to move ahead. By the end of June, the PBC had completed six issuances of special central bank bills targeting rural credit cooperatives participating in the pilot reform program after strict examination and performance assessment of these institutions conducted jointly with the China Banking Regulatory Commission (CBRC). The bills were issued to rural credit cooperatives located in 1468 counties or cities of 22 provinces or autonomous regions, amounting to 98.5 billion yuan. The proportion of the participating rural credit cooperatives in the pilot reform program and the involved financial support was 60 percent and 59 percent of the total respectively. At the same time, special loans worth 120 million yuan were issued to rural credit cooperatives in Jilin province. Out of the issued central bank bills, 81.1 billion yuan was used to replace the non-performing loans of the rural credit cooperatives, and the remaining 17.4 billion yuan was utilized to write off the losses accrued over the years. With the implementation of the financial support program and other preferential policies made for the rural credit cooperatives pilot reform, the historical burdens of the rural credit cooperatives could be dissolved gradually. If the issued central bank bills are accounted for, the NPL ratio of the rural credit cooperatives will drop to 17.5 percent, a fall of 19.4 percentage points from the pre-reform level.

VI. Foreign exchange administration continued to improve

To foster an orderly relationship between demand for and supply of foreign exchange and to promote a sound balance of payments, the PBC made efforts in the following three respects:

First, actions were taken to facilitate trade development. In particular, current account foreign exchange management was improved by enlarging the list of enterprises allowed to keep all foreign exchange earnings under current account transactions and extending the deadline to surrender foreign exchange in excess of the indicated limits by domestic institutions to 90 days. Second, the pilot reform of overseas investment-related foreign exchange management was extended across the nation so as to support domestic enterprises investing abroad. Third, capital account liberalization was steadily advanced to capitalize on the QFII system. Between May 2003 and June 2005, 26 qualified foreign institutional investors were licensed, with their total investment quota reaching USD4 billion. Support was also granted to domestic insurance companies to invest in the overseas securities market. For example, an overseas investment quota of USD1.75 billion was approved for the Ping An Insurance Company. Fourth, guidance was strengthened for capital inflow and foreign exchange surrender.

VII. The RMB exchange rate regime was reformed

With authorization of the State Council, the PBC announced that starting from July 21, 2005, China would reform the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The PBC will announce the closing price of a foreign currency such as the US dollar traded against the RMB in the inter-bank foreign exchange market after the closing of the market on each business day, and will make it the central parity for the currency trading against the RMB on the following business day. Based on the calculation of the RMB exchange rate at an adaptive and equilibrium level, the RMB was revalued by 2 percent against the US dollar at 19:00 hours on July 21, 2005, i.e., the exchange rate of the US dollar against the RMB was adjusted to 8.11 yuan per US dollar. The revaluation of the RMB by 2 percent was a one-time action taken at the beginning of the reform of the RMB exchange rate regime that does not imply further revaluations in the future.

The PBC will make adjustments of the exchange rate band when necessary in line with the market development as well as the economic and financial situations. At the same time, the PBC will exercise due responsibility to conduct management and adjustment of the RMB exchange rate based on market supply and demand and by referring to exchange rate movements of the basket currencies in line with domestic and international economic and financial developments so as to safeguard a normal floatation and to ensure that the RMB exchange rate is basically stable at an adaptive and equilibrium level, to promote the basic equilibrium of the balance of payments, and to maintain macroeconomic and financial stability.

Box 2: Reform of the RMB Exchange Rate Regime

Reforming the RMB exchange rate regime is an inherent requirement for establishing and strengthening the socialist market economic system and for enabling the market to play its fundamental role in resource allocation in China; it represents an important component of the overall program to deepen the economic system reform and to improve the macroeconomic adjustment mechanism; and it also fits in with the reality of China's economic development. Since 1993, persistent efforts have been made to create favorable conditions for the reform of the exchange rate regime and substantial studies have been launched and deliberated to prepare for the reform. In October 2003, the 3rd plenary session of the 16th CPC National Congress clearly resolved to "improve the RMB exchange rate mechanism and maintain the RMB exchange rate basically stable at an adaptive and equilibrium level." In line with such a guideline, the State Council also decided on the sequence of various reforms, determining that the reform of the state-owned commercial banks, along with the relaxation of foreign exchange controls and construction of a foreign exchange market, should precede the reform of the RMB exchange rate regime. Given the substantial progress that was made in the reform of the state-owned commercial banks in 2004, a special group was formed by the State Council to engage in the study and design of the reform program for the RMB exchange rate regime. Beginning in 2005, foreign exchange controls were further relaxed, cultivation of the foreign exchange market was accelerated, more market instruments were introduced to facilitate transactions, and concrete progress was achieved with financial reforms on various fronts. In addition, macroeconomic management yielded apparent results, with the economy continuing to grow in a steady and relatively fast manner, and the world economy developed stably in conjunction with a solid appreciation of the US dollar. All these factors created a favorable environment for the reform of the RMB exchange rate regime and laid a solid foundation to ensure its success on July 21 when the carefully-tailored reform program was publicly announced and implemented.

(1) The principles and contents of the RMB exchange rate regime reform

The reform of the RMB exchange rate regime must proceed in a proactive, controllable, and gradual way. "Proactive" means the reform mode, contents, and timing must be based on the needs arising in the process of China's domestic reform and development. The impact of the exchange rate regime reform on macroeconomic stability, economic growth, and employment must be taken into full account. "Controllable" implies that we must be able to control the movement of the RMB exchange rate at the macro level so that the reform momentum can progress steadily to avoid large fluctuations in the financial markets and the economy. “Gradual” means the reform of the exchange rate regime must be carried forward in a sequenced manner to ensure sufficient resilience for all the parties involved. “Gradualism” is the principle applied in the reform of the RMB exchange rate regime rather than in the adjustment of the RMB exchange rate. The reform focuses not on the quantitative adjustment of the RMB exchange rate but on the improvement of the RMB exchange rate regime.

The reform has ushered in a new regime under which the RMB will adopt a managed floating system based on market supply and demand with reference to a basket of currencies. The RMB will no longer be pegged to the US dollar. Instead, the RMB exchange rate will be determined based on a basket of currencies with assigned weights selected in line with the real situation of China’s external economic development. At the same time, proper measures will be taken to manage and adjust the RMB exchange rate based on market supply and demand and according to the domestic and international economic and financial developments with reference to the calculated exchange rate indices of the basket currencies, as an effort to maintain the RMB exchange rate basically stable at an adaptive and equilibrium level. Reference to a basket of currencies indicates that the RMB exchange rate can be affected by the exchange rate changes between foreign currencies, but not necessarily a peg of the RMB to the basket currencies. The managed floating exchange rate regime must also be based on another important factor, that is, the market supply and demand situation. According to calculations of the RMB exchange rate at an adaptive and equilibrium level, the RMB was revalued by 2 percent to 8.11 yuan per US dollar on the date when the reform was publicly announced. Such an adjustment was mainly determined in consideration of the size of the trade surplus and the needs of trade restructuring, while at the same time taking into account the adaptability of the domestic enterprises to the restructuring. It was close to the adjustment level needed to achieve a basic equilibrium of the trade balance in goods and services.

(2) The reform of the RMB exchange rate regime is compatible with China’s fundamental interests

After the reform, the RMB will no longer be pegged to any single currency; instead the RMB exchange rate will become adjustable based on market supply and demand with reference to the exchange rate movements of the currencies in a basket. The exchange rate changes of major currencies in the international market will objectively reduce the volatility of the RMB exchange rate. In addition, with a strengthened role of market instruments like the exchange rate in resource allocation, an improved relationship between supply and demand of foreign exchange, and the enhancement of the stabilizing mechanism for the balance of payments, China’s BOP position is likely to be kept in broad equilibrium, which will lay a solid economic foundation for the stability of the RMB exchange rate.

Generally speaking, an appropriate revaluation of the RMB will have a positive impact on China's macroeconomy, enterprises, and the living standard of the people. At the macroeconomic level, the RMB revaluation will increase the US dollar value of China's GDP, both at the aggregate and per capita level, which will result in an increase of wealth for the Chinese people. Appreciation of the RMB will also boost imports and reduce exports to some extent, and will be helpful to contain the excessive growth of the trade surplus and the foreign exchange reserves currently recorded in China, which may in turn contribute to realizing a basic equilibrium of foreign trade and foreign exchange earnings and expenditures, improving resource allocation, and will be beneficial to reduce pressures on RMB sterilization operations, to strengthen the independence of monetary policy, to enhance the preemptiveness and effectiveness of financial macro control policies, and to promote aggregate economic equilibrium. For the long term, the reform of the RMB exchange rate regime is conducive to implementing a sustainable economic development strategy focusing on boosting domestic demand, optimizing demand and industrial structures, transforming economic growth patterns, improving resource allocations, and upgrading the overall efficiencies of the Chinese economy.

The impact of the reform varies for different enterprises. The RMB revaluation is good for improving China's terms of trade, thus is beneficial for enterprises importing technology, equipment, raw material, and spare parts. In face of the persistently rising prices of resource products like oil and mineral products in the world markets, the RMB revaluation will cut import costs for enterprises. For export enterprises and enterprises producing similar products to their foreign counterparts, the RMB appreciation will cause them to face heightened pressures in terms of market competition. In the short run, some less competitive enterprises may run into business difficulties. However, the adjustment of the exchange rate will also provide incentives for these enterprises to transform their operational mechanisms, to strengthen their innovative capacities, as well as to accelerate growth patterns and restructuring of foreign trade.

In terms of the impact of the reform on the people's living standard, an appropriate revaluation of the RMB will somewhat increase domestic residents' capability to consume and it will be cheaper to consume imported consumer products.. Foreign travel will also become more affordable. Therefore, the general welfare of domestic consumers will be improved, enabling the broad masses of the Chinese people to benefit more extensively from the economic reform and opening up.

Despite the fact that the reform of the RMB exchange rate regime is generally consistent with China's fundamental interests, some less competitive sectors and enterprises are bound to face intensified pressures for business restructuring. In this case, the enterprises will need to quicken their pace in restructuring, strengthen their self-innovative capacity, and improve their competitiveness by upgrading internal management and tapping their potentials through technological transformation. Meanwhile, they should lose no time to learn and master all possible instruments to hedge foreign exchange risks and to become more adaptable to the floating and movement of the exchange rate. As for the banking sector, it will need to learn how to manage and avoid risks using derivative products, and to provide more and better risk management instruments to the enterprises so as to create necessary conditions for the later introduction of derivative products in the foreign exchange market.

Part Three: Financial Markets Performance

I. Financial markets

In the first half of 2005, the financial markets remained broadly stable, featuring sufficient liquidity, smooth bond issuance, and brisk market activities. Significant progress was witnessed in financial market institutional building.

Compared to the same period of last year, the proportion of borrowing by the non-financial sectors (including households, enterprises, and government agencies) in terms of bank loans, equities, and cooperate bonds went up, while that of government securities slid. In the first half of 2005, funds raised by the non-financial sectors in the form of bank loans (in both domestic and foreign currencies), stocks (domestic and foreign tradable stocks only), government securities, and corporate bonds (including short-term bills) reached 1,808.9 billion yuan, down by 78.3 billion yuan, or 4.1 percent, from the previous year. In particular, bank loans went up by 27.3 billion yuan or 1.7 percent, and government securities issued declined by 132.4 billion yuan. Financing through bank loans, stocks, government securities, and corporate bonds stood at 87.8 percent, 5.0 percent, 5.5 percent, and 1.7 percent respectively.

Table 4: Financing by Domestic Non-financial Sectors in the 1st Half of 2005

	Total Financing (100 million yuan)		Percent （%）	
	1st Half of 2005	1st Half of 2004	1st Half of 2005	1st Half of 2004
Funds raised by non-financial sectors	18,089	18,872	100.0	100.0
Bank loans	15,882	15,609	87.8	82.7
Stocks	908	858	5.0	4.5
Government Securities	996	2,320	5.5	12.3
Corporate Bonds	303	85	1.7	0.5

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

1. Ample liquidity in the inter-bank market and a steady declining trend in interest rates

The first half of the year saw the accumulated turnover of bond repo in the inter-bank market going up by 2.18 trillion yuan, to 6.89 trillion yuan, and the average daily turnover increasing by 47.6 percent to 56.5 billion yuan when compared to the same period of last year. The accumulated turnover of bond pledged repo went up by 2.1

trillion yuan to 6.8 trillion yuan. The accumulated turnover of sell-buy back bond repo registered a total of 89.7 billion yuan. The total turnover of treasury bond repo carried out on stock exchanges stood at 1.39 trillion yuan, lowered by 38.3 percent y-o-y.

In the first half of the year, the inter-bank market reported an accumulated turnover of 637.3 billion yuan and a daily average turnover of 5.22 billion yuan, representing a year-on-year decrease of 178.1 billion yuan or 21.3 percent. The 7-day and overnight borrowing dominated the transactions. In particular, the 7-day borrowing accounted for 70.4 percent of the total, and the overnight borrowing accounted for 15.8 percent.

The money market rates showed a downward trend. In January, the monthly-weighted average interest rates of the inter-bank bond pledge repo market and inter-bank borrowing market stood at 1.91 percent and 2.07 percent respectively. Due to the large demand for funds by financial institutions before the Spring Festival, they were first high at 2.05 percent and 2.31 percent in February, then slid to 1.7 percent and 1.98 percent in March due to ample liquidity as a result of substantial fund inflows and a cut in the interest rate on excess reserves by the central bank. In the following months, the monthly-weighted average rates continued to slide to 1.10 percent and 1.46 percent toward the end of June.

In terms of fund flows, in the inter-bank bond repo market (including bond pledged repo and sell-buy back bond repo), the state-owned commercial banks continued to be the largest net providers of funds, lending out a total of 3.92 trillion yuan, 1,541.6 billion yuan more than during the same period of last year, while other commercial banks[4] and other financial institutions[5] and foreign financial institutions were the main recipients of funds, borrowing 1,865.8 billion yuan, 1,881.2 billion yuan, and 175.5 billion yuan, or 277.1 billion yuan, 1,094.2 billion yuan, and 170.2 billion yuan more year-on-year.

With respect to fund flows in the inter-bank market, the state-owned commercial banks and other commercial banks saw net lending of 178.9 billion yuan and 206.4 billion yuan, with the former down by 95.8 billion yuan and the latter up 29.7 billion yuan year-on-year. Other financial institutions and foreign financial institutions were the major fund recipients. Specifically, securities firms received the largest portion of funds. Borrowing by other financial institutions decreased by 116.4 billion yuan to 319.5 billion yuan, accounting for 82.9 percent of the total funds borrowed, 13.7 percentage points lower than the previous year., while borrowing by foreign financial institutions augmented 50.4 billion yuan to 65.9 billion yuan, or 17.1 percent of the total borrowing, up by 13.7 percentage points.

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4 Other commercial banks include joint-stock commercial banks and city commercial banks.
5 Other financial institutions include policy banks, rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities firms, and fund companies.

Table 5: Fund Flows of Financial Institutions in the Inter-bank Market in the First Half of 2005

Unit: 100 million yuan

	1st Half of 2005	1st Half of 2004
State-owned commercial banks	-1,789	-2,747
Other commercial banks	-2,064	-1,767
Other financial institutions	3,195	4,359
Of which: Securities firms	2,192	3,999
Foreign financial institutions	659	155

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

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

2. Trading in the inter-bank bond market was vibrant, with an upward trend of the bond index

In the first half of the year, the accumulated turnover of spot transactions in the inter-bank bond market increased by 1.16 trillion yuan to 2.38 trillion yuan, while the daily average turnover soared by 97.8 percent to 19.5 billion yuan. The turnover of government bond spot transactions at the Shanghai Stock Exchange totaled 137.8 billion yuan, 11.8 billion yuan less year-on-year.

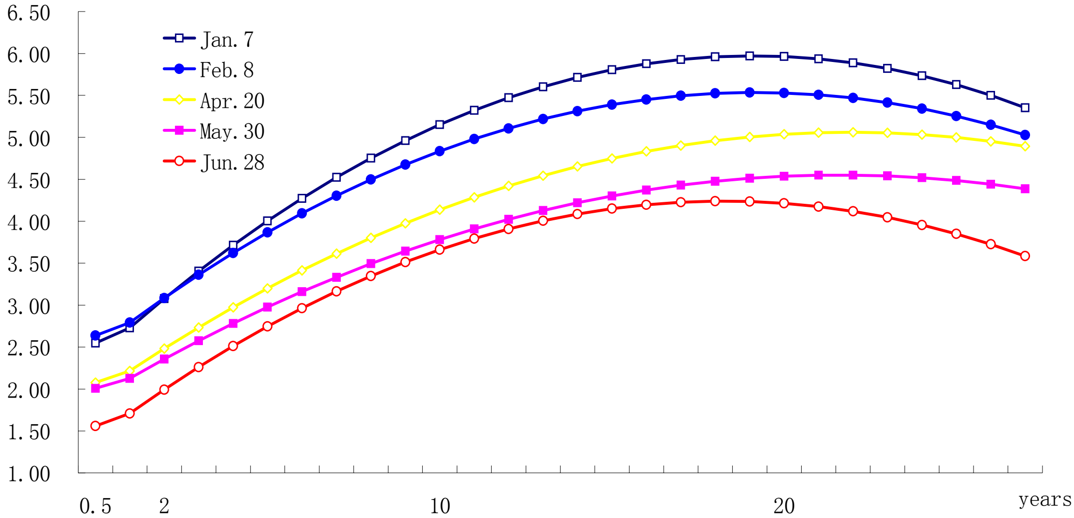
In the period under review, the bond indices of the inter-bank market and exchange market both displayed a rising trend, while the yields witnessed a fall. The China Securities Index climbed by 5.63 percent from 104.02 at the beginning of the year to 109.88 at the end of June. During the same period, the treasury bonds index at the Shanghai Stock Exchange moved up 10.10 from 95.69 at the beginning of the year to 105.35.

The yield curve shifted downward as the bond prices moved steadily upward. The yield curve of government securities in the inter-bank market (hereafter referred to as "the curve") demonstrated a steady downward trend as prices went up after the central bank cut the interest rate on excess reserves and the market was swamped with liquidity. Longer-term bonds witnessed a comparatively larger drop of yields. As a result, the yield curve flattened.

In the first half of the year, a total of 316.5 billion yuan worth of government securities were issued, a year-on-year decrease of 18 percent or 69.6 billion yuan.

Compared to the same period of last year, among the new issues, bearer's treasury bonds decreased by 100.7 billion yuan to 120 billion yuan; book-entry treasury bonds increased by 31.1 billion yuan to 196.5 billion yuan. A total of 190 billion yuan worth of policy financial bonds were issued, close to the level of last year; and a total of 30.3 billion yuan worth of corporate bonds were issued, 21.8 billion yuan more than in the previous year.

Figure 2: Yield Curve of Government Securities in the Inter-bank Market in the First Half of 2005



Source: China Government Securities Depository and Trust Corporation

The interest rates of bearer's treasury bonds were high compared to last year's level. In the first half of the year, the interest rates on 3-year and 5-year bearer's notes reached 3.37 percent and 3.81 percent, 0.85 percentage points and 0.98 percentage points higher than those in the last year. On the other hand, the issuing interest rates for 5-year and 7-year book-entry notes dropped by 1.12 and 1.52 percentage points respectively, to 3.30 percent and 3.37 percent.

3. The commercial paper market enjoyed sound development

By the end of June, the accumulated amount of commercial papers reached 2.08 trillion yuan, a year-on-year growth of 30 percent. The accumulated amount of discount bills totaled 2.98 trillion yuan, increasing by 36 percent, while that of rediscount bills reached 2.15 billion yuan, down 15 billion yuan. At the end of June, the outstanding balance of commercial papers reached 1.69 trillion yuan, up 25 percent on a year-on-year basis. The outstanding balance of discount bills amounted to 1.2 trillion yuan, up 15 percent, while that of rediscount bills declined substantially by 6.2 billion yuan to 1.255 billion yuan.

The commercial paper market continued to grow steadily as market regulation was further strengthened. The market showed the following characteristics. First, financing by commercial paper continued to grow as a share of new loans and has become an important source of enterprise working capital. In the first half of the year, newly issued commercial paper accounted for 17 percent of new loans, up by 8 percentage points. Second, facing growing competition, commercial banks strengthened centralized management of the commercial paper business using an internal system. As an instrument of low risk, high liquidity, and stable returns, commercial paper has become increasingly favored by the commercial banks. Third, the market players continued to specify in business lines, with the share-holding commercial banks and small financial institutions concentrating on bills acceptance and the state commercial banks concentrating on discount. Fourth, the interest rates of commercial papers, reflecting the supply and demand in the market, have become an important part of the transmitting mechanism of macroeconomic adjustment. Fifth, the rediscount transactions declined with time, gradually fading out.

3. **4. Fund raising in the stock market recovered slightly**

In the first half of the year, the turnover in the stock market declined on a year-on year basis. The combined turnover of the Shanghai and Shenzhen stock exchanges shrank by 1.17 trillion yuan to 1.43 trillion yuan, while the average daily turnover decreased by 45.1 percent to 12.3 billion yuan. The turnover of the A-share market dropped 1.17 trillion yuan to 1.39 trillion yuan, and the daily average turnover slid by 45.6 percent to 12 billion yuan.

The Shanghai Composite Index rose to a high of 1,329 in February before it nose-dived to a low of 998 in June and recovered to 1,081 at the end of the month, 14.65 percent lower than that at the end of last year. The Shenzhen Composite Index climbed to 3,481 in March before plummeting to 2,591 in June and then recovering to 2760, 10 percent lower than at the end of last year.

In the first half of the year, a total of 90.8 billion yuan was raised in the stock markets, a year-on-year increase of 5 billion yuan or 5.8 percent. There were more funds raised by enterprises in overseas markets than last year, of which H-share financing reached USD6.879 billion, USD1.299 billion or 23.3 percent more year-on-year. In addition, funds raised in the A-share market (including IPO, and rights and additional share issuance) totaled 33.9 billion yuan, up by 1.2 percent. As a result, new financing by H-shares accounted for 62.7 percent and by A-shares for 37.3 percent of the total.

In the first half of the year, securities investment funds grew in leaps, with 30 new funds launched. The gross volume of securities investment funds reached 443.8 billion yuan and the net asset value totaled 390.8 billion yuan, representing a growth of 34.1 percent and 20.4 percent respectively compared to the end of last year.

5. The insurance market maintained robust growth, with noticeable changes in the asset structure

In the first half of the year, the premium income of the insurance sector aggregated 270.9 billion yuan, a year-on-year growth of 14.1 percent. The property premium income reached 67.8 billion yuan, growing by 15.6 percent. Statistics also showed that the accumulated insurance claim payments during this period amounted to 53.9 billion yuan, up by 12.9 percent y-o-y. The total assets of the insurance sector grew by 26.2 percent y-o-y, reaching 1.3633 trillion yuan at end-June.

Along with the rapid growth of the insurance sector, the usable funds of the insurance companies continued to build up, with a lion share being invested rather than being placed with banks. At the end of June, the proportion of investment in government securities continued to rise, reaching 24 percent, 7.3 percentage points higher over the same period of last year; while the proportion of assets in the form of bank deposits decreased by another 10.9 percentage points to 37.2 percent; investment in securities investment funds accounted for 6.5 percent of the total assets, 0.1 percentage points higher than the previous year..

Table 6: Investment of Insurance Funds

	Outstanding balance (100 million yuan)		Share of total assets (%)	
	1st Half 2005	1st Half 2004	1st Half 2005	1st Half 2004
Total assets	13,633	10,806		
In which: Bank deposits	5,065	5,194	37.2	48.1
Investment	7,165	4,538	52.6	42.0
Government securities	3,270	1,805	24.0	16.7
Securities investment funds	885	692	6.5	6.4

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

6. Inter-bank foreign exchange transactions continued to grow substantially

In the first half of the year, inter-bank foreign exchange transactions continued to grow significantly. The accumulated market turnover in all currencies increased by 84.2 percent from the previous year to USD146.1 billion. In particular, the turnover of transactions in US dollars soared by 84.9 percent to USD142.9 billion. On May 18, 2005, spot transactions of 8 pairs of foreign currency were launched. By end-June, the total turnover of transactions of currency pairs amounted to an equivalent of USD 2.067 billion.

II. Institutional building in the financial markets

1. Further progress was made in regulating the issuance of inter-bank financial bonds

As the inter-bank bond market continues to grow and the group of issuers is expanding, it has become imperative to put into place a framework to regulate the issuance of financial bonds. On April 27, 2005, the PBC released *Administrative Rules for the Trading and Circulation of Financial Bonds in the National Inter-bank Bond Market (the Administrative Rules)*, which became effective on June 1, 2005. The Administrative Rules laid out specific requirements regarding the application, authorization, issuing registration, custody, redemption, information disclosure, and legal responsibilities related to bond issuance by policy banks, commercial banks, finance companies, and other financial institutions that have legal person status in the inter-bank market. The Administrative Rules will facilitate the development of the bond market by enabling financial institutions greater access to direct financing and allowing them to optimize their asset structures.

2. Enterprises were allowed to issue financial bills in the inter-bank market

On May 23, 2005, the PBC released *Administrative Rules on the Issuance of Financial Bills* and two complementary documents, *Rules on Financial Bills Underwriting* and *Rules on Financial Bills Information Disclosure*. The documents which took effect immediately after being released allow qualified enterprises to issue financial bills to qualified institutional investors in the inter-bank market. Aiming to facilitate the development of the money market, these documents provide specific regulations for the issuance and trading of financial bills, allowing enterprises greater access to direct financing. By the end of June 2005, 6 enterprises had successfully launched 8 financial bills, raising a total of 12.9 billion yuan.

Box 3: Financial Bills

On May 23, 2005, the PBC released *Administrative Rules on the Issuance of Financial Bills* and two complementary documents, *Rules on Financial Bills Underwriting* and *Rules on Financial Bills Information Disclosure*, allowing qualified businesses to issue financial bills to qualified institutional investors in the inter-bank market.

Introducing financial bills in the inter-bank bond market is a breakthrough in financial market institution-building in terms of expanding direct financing channels, reducing the imbalance between direct financing and indirect financing, improving the monetary policy transmission mechanism, coordinating the development of the money market and capital market, and maintaining financial stability.

The regulatory framework for financial bills is characterized by market-oriented principles. With regard to market-entry, market discipline is emphasized and administrative intervention deemphasized; with regard to issuing approaches, marketing on commission, underwriting, and bidding are used to allow the interest rate to be determined by market competition. With regard to market development, the principles of market orientation and gradualism are followed. With regard to risk management, market discipline, such as information disclosure and credit rating, is stressed and investors are expected to make their own judgments and bear the costs of taking risks.

On May 26, 2005, Huaneng Power International Inc., Shanghai Zhen Hua Port Machinery, China Minmetals Corporation, Air China, and China Development and Investment Company successfully launched 7 financial bills with a face value of 10.9 billion yuan in maturities of 3 months, 6 months, 9 months, and one year. The Commercial Bank of China, Bank of China, China Construction Bank, and Everbright Bank were the leading underwriters. The availability of this new instrument lends valuable support to good enterprises to obtain low-cost financing and to strengthen their competitiveness in their reform and development.

On July 7, 2005 China Unicom registered with the PBC for issuance of 10 billion yuan of financial bills. On the same day, the pool of lead underwriters expanded to include qualified share-holding commercial banks. The financial bills market is growing rapidly.

3. Forward bond transactions were launched successfully

In recent years, as interest rate reform moved forward and bond prices became more volatile, interest rate risks have become non-negligible. Effective tools to manage these risks were called for. On May 11, 2005, the PBC released *Administrative Rules on Forward Bond Transactions in the National Inter-bank Market*, which became effective on June 15, 2005, signaling the launching of the first financial derivative instrument in China’s bond market. Introducing forward bond transactions in the inter-bank market provides a risk-mitigating instrument for investors. This will have a profound impact on the development of the money market, the market pricing mechanism, financial stability, and the central bank’s conduct of monetary policy. By June 30, 2005, 15 financial institutions had entered into 23 forward contracts for a total amount of 1.4 billion yuan. Since then, the market has performed smoothly.

Box 4: Forward Bond Transactions

A forward bond transaction refers to a transaction in which the parties agree to purchase/sell a predetermined amount of bonds at a given price on a predetermined date in the future. As one of the basic derivative instruments, a forward bond transaction can be used to mitigate financial risks and price products accordingly. On May 11, 2005, the PBC released *Administrative Rules on Forward Bond Transactions* *in the National Inter-bank Market (the Administrative Rules)*, which became effective on June15, 2005, signaling the launching of the first financial derivative instrument in China's bond market.

The launching of forward bond transactions as the first derivative instrument is of great importance to the development of China's financial market. First, investors can make a profit in whatever direction the market is moving through two-way transactions. The forward transaction enriches the investors' asset management strategies, promotes spot transactions, and increases market liquidity. Second, forward transactions provide investors with an instrument to manage risks, contributing to the sound operation of commercial banks and, to a large extent, the stability of the financial market as a whole. Third, forward transactions can be used solely or in combination with other instruments by the central banks in conducting open market operations, therefore expanding the central bank's policy tools. By activating bond trading and improving market pricing, forward transactions help to improve the rationality and effectiveness of monetary policy. Fourth, the introduction of forward transactions will help market-participants gain experience in the trading of future derivative instruments, especially over-the–counter instruments, such as interest rate futures and interest rate swaps, and will lay the foundation for financial innovation and the future introduction of a complete series of products.

The forward bond transaction framework consists of four components. First, the People's Bank issues administrative regulations with regard to the institutional framework, essential transaction procedures, risk-management, and transparency requirements. Second, the intermediate institutions that are responsible for trading and settlement establish trading and settlement rules and detailed administrative requirements based on the framework laid out by the People's Bank. Third, market-participants work together to draw up and sign a framework agreement, a multilateral agreement that defines defaults and approaches to deal with them in time of need, as an industry self-regulatory document. Fourth, the market-participants set up internal risk control systems to strengthen their capacity in regard to market analysis, risk measurement, and risk management.

The products were designed with a forward-looking vision. The PBC has taken careful consideration of the experiences of developed markets as well as the reality of China's financial market, balancing the need for risk control at the initial stage of forward transactions and the need for future market development. In terms of market-participants, all members of the inter-bank market can do forward business so that the risk management needs of different market players can be satisfied and liquidity stress due to the homogeneity of the market players can be avoided. In order to mitigate risks and ensure transactions are carried out smoothly, the Administrative Rules set out requirements for maturity, securities traded, transaction ceilings, and means of settlement. In terms of contracts and trading practices, market-participants are required to sign the framework agreement, transaction contracts, and in some cases supplementary contracts. All transactions are required to be settled through the central trading system of the National Inter-bank Market. Following international practices, the contracted counter-parties can decide on the safeguard mechanism (with funds or securities) and custodian practices between themselves.

4. Foreign currency trading was launched

On May 18, 2005, foreign currency trading was formerly launched in the inter-bank foreign exchange market. Spot transactions of eight currency pairs were carried out, namely the euro vs. US dollar, the Australian dollar vs. the US dollar, British pound vs. the US dollar, the US dollar vs. the Swiss franc, the US dollar vs. the HK dollar, the US dollar vs. the Canadian dollar, the US dollar vs. the Japanese yen, and the euro vs. the Japanese yen. Foreign exchange trading will be conducive to the further development of the inter-bank foreign exchange market, enriching trading currencies and expanding market size and activities. This move will also enable small domestic financial institutions to have direct access to foreign currency trading and to connect with the international financial market rather than being excluded due to their size and risk profile. Foreign currency trading will enable market-participants to obtain experience in such transactions and to improve their risk management capacity.

5. The reform for the separation of tradable and non-tradable shares was officially launched

With the approval of the State Council, the China Securities Regulatory Commission issued *Notice on Issues Relating to the Pilot Program for Reform of Tradable and Non-tradable Shares*, signaling the official start of the pilot reform program.. The pilot program will unfold gradually based on the principles of maintaining market stability, applying fair and uniform rules, forming reform plans based on negotiation, voting by the tradable shareholders, and orderly implementation. At present, the first phase of the pilot program has been completed and the second phased has started. This reform intends to remove the institutional impediments to stock market development, to improve investor confidence, and to stimulate stock market development.

6. Further expanding the investment channels for insurance funds

On June 17, 2005, with the approval of the State Council, the China Insurance Regulatory Commission issued *Notice on Issues Relating to Overseas Investment of Foreign Exchange Insurance Funds*, allowing insurance companies to invest in overseas stock markets. This document allows insurance companies to expand the use of insurance funds, to optimize their investment portfolios, and to increase investment returns.

Part Four: Analysis of Macroeconomic Developments

I. The global economic and financial situation and forecast for 2005

Since the start of 2005, the global economy has sustained its rapid growth. The US economy maintained its strong momentum of growth and employment continued to improve. The economies in the euro zone continued to improve. The Japanese economy continued to recover but had yet to shake off the trouble of deflation. The Latin American and Asian emerging economies remained generally robust. It was forecast that the world economy would continue to maintain its momentum of growth and that such uncertainties as rising oil prices would remain major risks in the foreseeable future.. As reliance on imported oil and efficiency of energy utilization vary from country to country, the adverse impact of rising oil prices on economic growth and price levels in developing countries will exceed that in developed countries. The International Monetary Fund (IMF) forecast in April 2005 that global economic growth would reach 4.3 percent, 0.8 percentage points lower than that in 2004.

1. Economic development of the major economies

The US economy continued to maintain strong growth momentum. In the first quarter, the annualized quarterly GDP growth rate posted 3.8 percent over the previous quarter. In the second quarter, the strong momentum continued, with the annualized quarterly GDP growth rate estimated at 3.4 percent. US employment continued to improve.. Unemployment rates recorded in the 6 months of the first half of 2005 were markedly lower than those over the same period of the previous year. In particular, the unemployment rate in June was 5.0 percent, the lowest since 2002. In the second quarter, the consumer price index (CPI) registered 3.5 percent, 2.8 percent, and 2.5 percent on a year-on-year basis respectively in March, April, and May, averaging 2.9 percent, 0.1 percent lower than the figure recorded in the first quarter. Inflationary pressures persisted. As exports increased and imports decreased, US foreign trade deficits contracted from USD56.9 billion in April to USD55.3 billion in May 2005.

The economic situation in the euro zone continued to improve. In the first quarter, GDP grew by 1.3 percent, being flat compared with that in the same period of 2004. Starting from May 2005, the unemployment rate fell slightly, with the rate posting 8.7 percent both in May and June, 0.1 percent lower than that in the previous four months. In the first half-year, the monthly rise of the Harmonized Index of Consumer Prices (HICP) ranged from 1.9 percent to 2.1 percent on a year-on-year basis. Those in the second quarter registered 2.1 percent, 1.9 percent, and 2.1 percent respectively, averaging 2 percent which was equal to the figure in the first quarter. The European Central Bank (ECB) forecast that the HICP would likely fluctuate around the current level and with the rising oil prices would remain higher than 2 percent in the coming months. However, at the same time the ECB pointed out that the forecast did not imply that inflationary pressures were building up in the euro zone.

The Japanese economy continued to recover. In the first quarter, GDP grew by 1.2 percent on a quarter-on-quarter basis, or 4.9 percent on an annualized basis. The labor market improved further. The annualized unemployment rate posted 4.2 percent in June 2005, lower than the 4.5 percent in January and the 4.7 percent in February, reaching a record low level since 1999. The monthly CPI rose by 0.0 percent, 0.2 percent, and –0.5 percent on a year-on-year basis respectively in the second quarter, averaging at –0.1 percent and 0.1 percentage points higher than the figure in the first quarter.

The major developing economies in Asia and Latin America continued to grow with a favorable outlook. Heightened inflationary pressures, however, constituted a major risk confronting the emerging economies in Latin America.

2. Developments in the international financial markets

Since the start of 2005, in general the US dollar was on the rise. On June 30, the euro closed against the US dollar at USD1.21, with the dollar strengthened by 12 percent over end-2004. The US dollar ended against the yen at JPY110.8, with the dollar strengthened by 8 percent over end-2004.

Yields of long-term government bonds in major economies dropped. Since the latter half of 2004, the central banks in developed countries such as the US, the UK, and Australia one by one raised short-term interest rates against the backdrop of economic recovery and heightened inflationary pressures, whereas long-term interest rates dropped instead of rising. In the past year, the rate of federal funds rose by 225 basis points, while the yield of 10-year US Treasury bonds dipped by 80 basis points. In G-7 member countries, with the exception of Japan, long-term interest rates fell to varying degrees. In the second quarter, the yield of long-term government bonds in the major economies continued to decrease. On June 30, 2005, the yields of 10-year US Treasury bonds and government bonds in the euro zone and Japan registered 4.00 percent, 3.25 percent, and 1.24 percent respectively, decreasing by 0.73, 1.19, and 0.53 percentage points respectively over the same period of the previous year.

In the first half-year, the US stock market declined, while the stock markets in the euro zone witnessed an overall rise. On June 30, the Dow Jones Industrial Average and the Nasdaq Composite Index closed down 2.5 percent and 3.9 percent respectively over the beginning of the year. The Financial Times Stock Exchange 100 Index, the Dow Jones Euro Stoxx 50 Index, and the Nikkei 225 Stock Average ended up 6.7 percent, 8.1 percent, and 3.1 percent respectively.

3. Monetary policies of the major central banks

The Federal Open Market Committee (FOMC) raised the federal-funds target rate to the current level of 3.25 percent by increments of 25 basis points respectively on February 2, March 22, May 3, and June 30, with the Fed raising the interest rate 9 successive times since June 2004. The monetary policies of the European Central Bank, the Bank of Japan, and the Bank of England remained unchanged.. The Governing Council of the European Central Bank continued to keep the interest rates unchanged from June 2003 up to the present, i.e., the interest rates of deposit facilities, main refinancing operations, and lending facilities remained at 1 percent, 2 percent, and 3 percent respectively. The Bank of Japan (BOJ) continued to keep the upper limit of the total current account balance held with the BOJ by commercial banks at around JPY35 trillion in order to ensure sufficient liquidity in the market. The Bank of England currently keeps the repo rate unchanged at 4.75 percent after lifting the rate four times in 2004.

II. Analysis of China's macroeconomic movements

In the first half of 2005, macro control produced further results. The national economy maintained steady and rapid growth. The momentum of faster-than-desired investment continued to be curbed. Consumption demand grew rapidly. Various price indices fell steadily. Urban and rural household incomes and fiscal revenue increased immensely. In terms of economic performance, however, there were not only old problems such as a larger-than-desired size of fixed-asset investment and prominent contradictions due to resource and energy constraints, but also new problems such as falling profits in some sectors, a slowdown of imports, and aggravation of trade frictions. In the first half of 2005, GDP grew by 9.5 percent, 0.2 percentage points lower than that recorded in the same period of 2004. The CPI rose by 2.3 percent, 1.3 percentage points lower than that in the same period of last year. The trade surplus registered USD39.6 billion, 46.4 billion more than that recorded in the same period of the previous year.

1. Consumption demand grew rapidly, investment demand remained stable, and the trade surplus expanded further

Household income and consumption grew rapidly. In the first half of 2005, the per capita disposable income of urban residents stood at 5,374 yuan, representing an inflation-adjusted real growth of 9.5 percent over the previous year. The per capita earnings in cash by farmers came to 1,586 yuan, representing a real growth of 12.5 percent. The growth rates represented an acceleration of 0.8 and 1.6 percentage points respectively. The total volume of retail sales reached 2.96 trillion yuan, representing a nominal growth of 13.2 percent, an inflation-adjusted real growth of 12 percent, and an acceleration of 1.8 percentage points over the same period of last year. In particular, the total volume of urban retail sales was 1.99 trillion yuan, up 14.2 percent; that at the county level and below was 0.97 trillion yuan, up 11.1 percent.

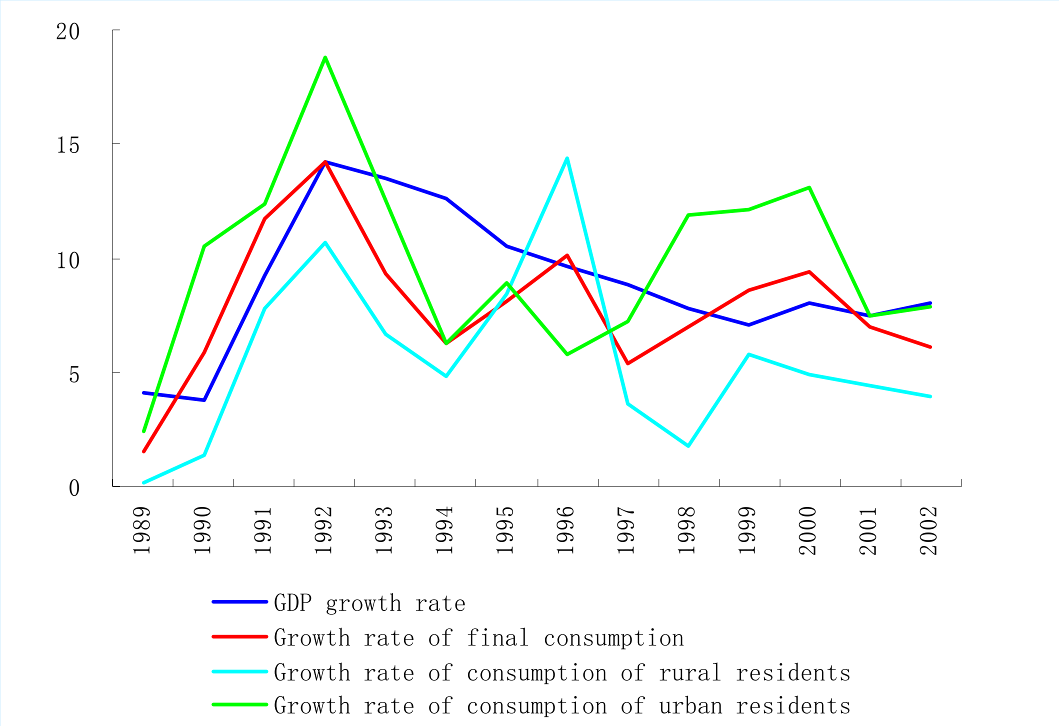
Box 5: Expanding domestic consumption to promote the steady and rapid growth of the national economy

In recent years, while enjoying rapid growth, in the national economy there has been an increasing reliance on foreign trade, a persistent rise in the investment ratio, and a decline in the consumption ratio. In the first half of 2005, the trade surplus reached USD39.6 billion, up 46.4 billion over the same period of last year. In 2004, the capital formation ratio was 43.9 percent and the final consumption ratio was 53.6 percent. According to World Bank statistics, the world average final consumption ratio was around 79 percent, while that in East Asia and the Pacific region was around 60 percent.

Consumption is the final demand; a lower-than-desired consumption ratio will do harm to the virtuous circle of the national economy and to the improvement of the people’s living standards. Weighing domestic and foreign demand, developing countries should encourage and expand exports during a certain period, which will be conducive to spurring rapid economic growth. Excessive reliance on exports, however, will intensify external factor constraints on the economy, increasing the risks of a volatile macroeconomy. Meanwhile, a larger-than-desired trade surplus will escalate trade frictions. Furthermore, exports of high resource- and energy-consuming commodities with high levels of pollution will result in dire shortages of domestic raw materials and energy, thus delaying the process of economic structural adjustment. From the perspective of the relationship between investment and consumption, if the consumption ratio is lower than desired for too long a period and rational proportions of consumption and investment are not formed, final demand will not support investment growth. In turn, there will be redundant, low-level, and blind construction across the board, thus impacting the economic returns of enterprises, financial performance, and the stability of the macroeconomy.

In recent years, China has promulgated an array of policies and measures to spur consumption. Consumption has been growing steadily and the consumption structure has been upgraded.. The ratio of food consumption to total consumption declined steadily, and the weight of expenditures for transportation and communications rose gradually. At present, however, there are still some problems in that the growth of final consumption is lower than that of GDP in the same period and the growth of rural consumption has been lower than desired for a long period.

Figure 3: Growth of final consumption since 1989



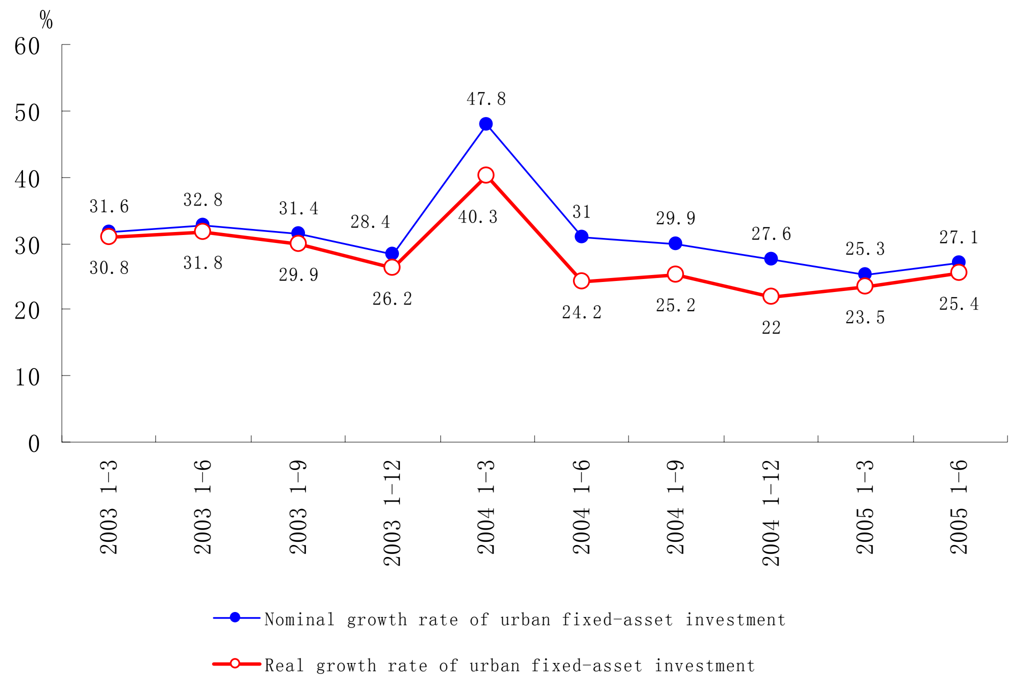
Source: National Bureau of Statistics (NBS)

Generally, expenditures for consumption are mainly influenced by such factors as disposable income, expected future income, real interest rates, and net assets, as well as the social and cultural climate. The lower-than-desired consumption ratio is related to the long history of a tradition of industriousness and frugality of the Chinese people.. It is also related to a number of other factors. The social safety net has yet to be improved in the course of the transition. Residents are expecting large future expenditures for healthcare, the education of their children, and for pensions. They are not yet certain about future income. The consumption of rural residents is more obviously influenced by the above factors.

As China is a country with a large population, it shall use domestic demand to promote the sustained and healthy development of the economy. The Central Conference on Economic Work clearly pointed out that one of the focuses of work in 2005 would be the continuous adjustment of the relationship between investment and consumption, enhancing the consumption capability of urban and rural residents, and reinforcing the role of consumption in promoting economic growth. At present, we should study policies and measures to encourage consumption, focus on implementation of measures to ensure an increase in farmers' income, increase public expenditures on education, healthcare, and the social safety net, and endeavor to improve the consumption environment. We should cultivate new consumption hot spots, guide consumption expectations, and strengthen consumer confidence. We should continue to improve the construction of an individual credit information system, continue to expand the size of consumption credit, increase the varieties of credit businesses, expand the fields of consumption credit, and support residents in their consumption upgrades in a gradual manner in a bid to promote the sustained growth of the economy.

The momentum of faster-than-desired fixed-asset investment was held in check and the investment structure improved. In the first half of 2005, total fixed-asset investment posted 3.29 trillion yuan, representing a growth of 25.4 percent and a deceleration of 3.2 percentage points compared with that recorded in the previous year. In particular, urban fixed-asset investment accounted for 2.8 trillion yuan, representing a growth of 27.1 percent and a deceleration of 3.9 percentage points on a year-on-year basis. If adjusted for inflation, the real growth of fixed-asset investment in the first half-year was slightly higher than that in the same period of last year and remained steady. In the first half-year, the price index of fixed-asset investment was 1.7 percent. Geographically speaking, in the first half-year, investment in the eastern areas grew by 24.4 percent over the same period of last year, that in the central areas grew by 33.0 percent, and that in the western areas grew by 30.3 percent. The growth in the 3 areas represented a year-on-year deceleration of 4.3, 2, and 6.8 percentage points respectively. In terms of industrial segmentation, growth of investment accelerated in the areas of agriculture, forestry, animal husbandry and fishery, railway transportation, and equipment manufacturing in which investment was encouraged, whereas it decelerated in the metallurgical and non-ferrous metal industries and building materials in which investment was restricted. Generally, although the momentum of faster-than-desired fixed-asset investment has been kept in check at present, it is still at a high level. The energy and resource supply bottlenecks are still prominent, in particular the electric power and transportation supply fell short of demand.

Figure 4: Nominal and real growth of fixed-asset investment since 2003



Note: Real growth of fixed-asset investment is based on its nominal growth adjusted by the price index of fixed-asset investment. However, the statistics for the price index of fixed-asset investment do not cover completely all items of fixed-asset investment. They only cover price changes in the purchase of equipment and instruments, construction and decorating projects, and other fees and charges, and do not cover changes in real estate prices. In the first half of 2005, investment in real restate development accounted for 24 percent of the total fixed-asset investment.
Source: "Monthly Report of Economic Activities in China," *National Bureau of Statistics*

Inventory growth continued to decelerate, while raw material inventory growth accelerated slightly. A survey by the PBC of 5,000 industrial enterprises indicated that in general the year-on-year growth of inventory of the 5,000 enterprises was decelerating since November 2004. At end-June 2005, the inventory had grown by 17.1 percent over the same period of last year. In particular, the raw material inventory grew by 19.1 percent, being flat compared with that in May. The finished products inventory grew by 11.0 percent, decelerating by 1.0 percentage points. The level of management of enterprise inventory improved. Inventory turnover continued to speed up. At end-June, the inventory turnover ratio was 4.63 times, up 0.17 times compared with that in the same period of last year; the finished product turnover ratio was 16.76 times, up 1.65 times.

The trade surplus widened further. In the first half-year, exports and imports totaled USD645.0 billion, up 23.2 percent on a year-on-year basis. In particular, exports posted USD342.3 billion, increasing by 32.7 percent and decelerating by 3 percentage points; imports registered USD302.7 billion, increasing by 14.0 percent and decelerating by 28.6 percentage points. The net result of exports and imports was a trade surplus of USD39.6 billion, compared with a trade deficit of USD6.8 billion. The trade surplus widened mainly because the demand for exports remained stable, while imports slowed down, in particular imports for processing products and finished products in machinery and electronics and high-tech industry which were closely related to fixed-asset investment. In the first half-year, contracted FDI posted USD86.191 billion, up 18.99 percent over the same period of last year; actual utilization of FDI registered USD28.563 billion, down 3.18 percent.

2. Growth of the primary industries accelerated, while that of the secondary and tertiary industries decelerated

According to preliminary accounting practices, in the first half-year, the value-added of the primary industries grew by 5 percent and accelerated by 1 percentage point over the same period of last year; that of the secondary industries grew by 11.2 percent and decelerated by 0.3 percentage points; that of the tertiary industries grew by 7.8 percent and decelerated by 0.3 percentage points. The proportions of the three industries were 10:59:31.

The situation for agricultural production was relatively good. The summer grain achieved a bumper harvest. The total output of summer grain reached 106.27 million tons, up 5.12 million or 5.1 percent. And early rice was likely to achieve a bumper harvest. The sown area of grain in 2005 was likely to increase by 20 million mu over that in 2004. Animal husbandry grew rapidly. In the first half-year, total meat output grew by 6.2 percent. However, the purchasing price of grain declined, while prices of agricultural production materials remained high, which will limit further increases in farmers' incomes. In the first half-year, production prices of agricultural products rose by 4.1 percent over the same period of last year. In particular, grain prices climbed by 3.1 percent. Prices of materials for agricultural production surged by 10.4 percent.

Industrial production grew rapidly, with returns apparently differing from enterprise to enterprise. In the first half-year, statistically large industrial enterprises realized industrial value-added of 3.2 trillion yuan, increasing by 16.4 percent and decelerating by 1.3 percentage points over the previous year. Their total profits grew by 19.1 percent and decelerated by 22.5 percent. The enormous deceleration of growth of profits realized by industrial enterprises represented a rational regression. A major problem, however, was that profits were not very evenly distributed among all industries. At present, the fastest profit growth is mainly in upstream industries, such as the mining of raw materials, e.g., oil and natural gas exploitation, non-ferrous metal mining and ore dressing, coal mining and washing, and other mining industries etc. Those with a deceleration in profit growth are mainly in downstream industries, e.g., oil processing, manufacture of communications and transportation equipment, non-metal mineral products, manufacture of chemical fibres, etc. Such a marked division in enterprise returns is mainly attributable to the persistent surge over a long period in the purchasing prices of raw materials, fuels, and power and the inability of the price transmission in downstream industries as a result of fierce competition in downstream industries or price restrictions by the government.

Box 6: Analyses of economic results in industrial enterprises

In the first half of 2005, profits realized by statistically significant industrial enterprises grew by 19.1 percent and decelerated by 22.5 percentage points over the same period of last year, while losses incurred by losing enterprises surged. Based on this fact, some have contended that the returns of China's industrial enterprises have dipped markedly at present, that the capability for independent development by micro participants has weakened, and that the macroeconomy is likely to experience a turnaround. This issue merits an in-depth analysis.

Analysis of the economic results of an enterprise generally involves ratio analyses in terms of the capability of repayment, asset management, capital structure, profitability, and market valuation. In terms of profitability, good measurements are various profit ratios, e.g., sales margins, ratios of profits to cost, ROA, ROE, etc. The growth of total profits is influenced by the base figure. If the base profits in the previous year were nil, the growth of profits would be infinite. If an enterprise changed from a previously losing one into a profitable one, there is no way to calculate the profit growth rate. If the base profit was slight, a small growth would produce a high growth rate, which, nevertheless, does not actually represent a considerable improvement in the economic results of the enterprise.

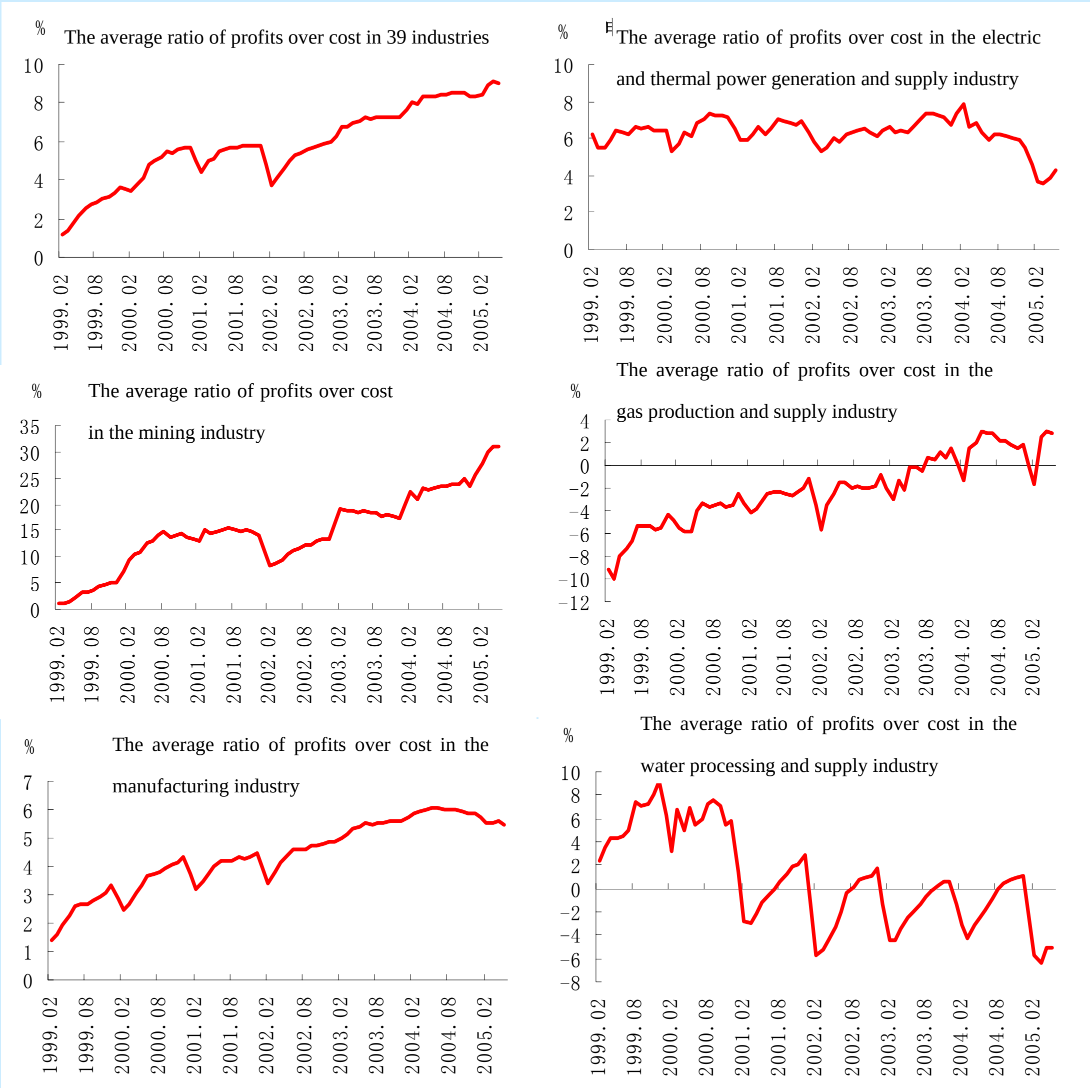
The ratio of profits over cost[7] (hereinafter referred to as the profit ratio) in China's 39 industrial sectors showed that the profit ratio in most sectors was increasing or remaining stable. In the first 5 months of 2005, the arithmetic average of the profit ratios in 39 sectors increased by 0.7 percentage points over that recorded at end-2004. In particular, the average profit ratio for the mining sector was 31 percent, up 7 percentage points, that for processing and manufacturing was 5.5 percent, down slightly 0.4 percentage points, and that for water, electricity, and gas was 0.7 percent, down 2.1 percentage points.

The main reason for the decrease in the profit ratio in the processing and manufacturing industries was that the rise in the prices of raw materials, power, and fuels remained higher than the factory prices of industrial products in the processing and manufacturing sectors. In terms of sector segmentation, most processing and manufacturing sectors could absorb the rise in the price of upstream energy and raw materials and their profit ratios continued to climb or remained basically unchanged. Only the three sectors of oil processing, manufacturing of chemical fibres, and non-metal mineral products were adversely impacted by the rise in the price of upstream products and their profit ratios dropped markedly. As for the two sectors of manufacture of telecommunications equipment, computers, and other electronic equipment and manufacture of communications and transportation equipment, their profit ratios fell partly because of the cost increase but mainly because of the excessive competition in these two sectors. The profit ratio for the manufacture of telecommunications equipment, computers, and other electronic equipment in 2000 was as high as 7 percent, but in May 2005 it had declined to 3 percent. The profit ratio for the manufacture of communications and transportation equipment in 2003 was over 8 percent, but by May 2005 it had dipped to 3.5 percent. In the manufacturing industry, with exception of a very few sectors, the level of the profit ratio was basically proportionate to the monopoly level, e.g., tobacco sectors had an average profit ratio as high as 35 percent, the highest among all sectors. This was

[7] The ratio of profits over cost reflects costs by the enterprise for the purpose of producing profits and assesses the earning capability from the perspective of expenditures. The higher the ratio is, the lower the costs are for the profits earned by the enterprise, the better the enterprise controls its costs, and the stronger the earning capability of the enterprise.
Formula for the ratio: ratio of profits over costs=(total profits/total costs)*100%
In the formula, by "total profits" we mean profits of profitable enterprises minus losses of losing enterprises.
By "total costs" we mean the sum of sales (operations) costs, sales (operations) fees, administration fees, and financial charges.

followed successively by pharmaceuticals (9.5 percent) and beverages including wines (8.4 percent). Wholly competitive industries include textiles, manufacture of telecommunications equipment, computers, and other electronic equipment, etc. The average profit ratios in such industries are usually around 3-4 percent.

Figure 5: Movements of the average ratios of profits over cost in 39 industries since 1999



Source: National Bureau of Statistics (NBS)

The main reason for the current losses and profit decreases in water, electricity, and gas is the price distortions. For example, the water industry lost money mainly because the price of water was too low to cover costs and over the long term there has been severe waste.. The profits ratio for electricity fell from 8 percent in 2004 to 4 percent in 2005, mainly because the rise in the price of electricity could not keep up with the rise in the price of coal..

Generally, the reasons for profit decreases or losses in some industries were multifaceted. In particular, price distortions were an important factor. Therefore, on the one hand, we should continue to strengthen and improve macroeconomic control to prevent excessive fixed-asset investment from recurring and thus to contain a faster-than-desired rise in the prices of energy and raw materials. On the other hand, we should speed up reform of the price system, correcting the relationships among various prices.

3. Various price indices fell steadily

The rise in the Consumer Price Index (CPI) decelerated steadily on a year-on-year basis. In the first half of 2005, the CPI grew 2.3 percent on a cumulative year-on-year basis. In particular, the CPI rose 2.8 percent in the first quarter, while it climbed 1.7 percent in the second quarter. In terms of segmentation, the rise in food prices decreased the effect on the CPI, while the rise in non-food prices increased the impact on the CPI. In the first half-year, food prices rose by 4.4 percent, accounting for 1.5 percentage points in the increase of the CPI and representing a contribution of 65 percent. Non-food prices rose by 1.2 percent, accounting for 0.8 percentage points in the hike of the CPI and representing a contribution of 35 percent. As for non-foods, energy prices such as oil surged by 12.7 percent, accounting for 0.2 percentage points in the rise of the CPI. In particular, the prices of gasoline, liquefied petroleum gas, and pipeline gas soared by 17.5 percent, 13.6 percent, and 13.4 percent respectively. Excluding food and energy, the CPI rose by 0.9 percent. From the perspective of consumer goods and services, the rise in the price of services has always been greater than that of consumer goods and has continued to accelerate since November 2004, which merits attention. In the first half of 2005, the price of services rose by 3.5 percent, while the price of consumer goods edged up by 1.9 percent.

The increase in the Producer Price Index (PPI) tended to decelerate but still remains at a high level. In the first half-year, the purchasing price index for industrial raw material, fuels, and power increased by 9.9 percent over the preceding year. In particular, that for fuels and power and that for non-ferrous metal materials rose by 16.2 percent and 17.1 percent respectively in June over the preceding year. Factory prices of industrial products increased by 5.6 percent over the same period of last year. In particular, crude oil soared by 32.7 percent, gasoline by 16.9 percent, diesel oil by 16.1 percent, kerosene by 13.6 percent, and crude coal by 26.1 percent in June over the same period of the previous year. The rise in the prices of various steel products ranged from 3 percent to 9 percent, while those of copper, aluminum, lead, zinc, and nickel ranged from 9.5 percent to 21.3 percent. In the first half-year, the differential between the purchasing prices for industrial raw materials, fuels, and power and the factory prices for industrial products stood at 4.3 percent, 0.8 percentage points less than that in the same period of the previous year, indicating that pressures have eased for enterprises to absorb the rise in the prices of upstream products.

The p**rice of international crude oil fluctuated at a high level.** At end-2004, the price of international crude oil dropped markedly. Starting from February 2005, however, the price rallied vigorously. On April 4, 2005, prices of WTI May futures climbed to USD58.87 per barrel in the New York Mercantile Exchange, a record high since the beginning of dealing in oil futures on the exchange in March 1983.. In late May, the price of international crude oil fell back to the level of USD46 to USD50 per barrel. In June, however, it rebounded to as high as over USD60 per barrel.

Prices of both imports and exports declined. In the first and second quarters, the customs price of exports increased by 7.6 percent and 2.6 percent respectively, while that of imports rose by 10.1 percent and 6.2 percent respectively. In particular, with the improved terms of trade, the price of both exports and imports climbed by 1.2 percent..

Rise in real compensation decelerated. In the first half of 2005, the total amount of compensation for employees in urban units increased by 14.6 percent, decelerating by 1.8 percentage points over the first quarter. Average compensation increased 13.2 percent, decelerating by 1.7 percentage points.

The GDP deflator was lower than that in the same period of the preceding year. In the first half-year, the nominal GDP growth rate was 14.7 percent while the real GDP growth rate was 9.5 percent, with their differential reaching 5.2 percent or 0.7 percentage points lower than that in the same period of last year.

In general, all price indices fell steadily in the first half of 2005, creating room for adjusting the prices of utilities and public welfare like water, electricity, fuels, and urban transport. Moderate hikes in the prices of utilities could improve price relations and bring into better play the role of the price lever in resource allocation.

4. The fiscal budget was implemented well

Growth of fiscal revenue was basically stable. In the first half of 2005, fiscal revenue was 1.64 trillion yuan, representing a growth of 14.6 percent and a deceleration of 16 percentage points over the same period of last year. The main factor behind the figures was the export tax rebate. In the first half-year, the export tax rebate was 150.3 billion yuan, up 104.4 billion yuan over the previous year. Excluding the growth from the export tax rebate, fiscal revenue grew by 21.9 percent on a comparable basis.

Fiscal expenditures proceeded normally with the expenditure structure being further optimized. Major items of expenditure for agriculture, the social safety net, and education were well protected. In the first half of 2005, fiscal expenditures were 1.24 trillion yuan, representing a growth of 15 percent and an acceleration of 3.2 percentage points over the preceding year. In particular, the direct grain subsidy for farmers was 9.53 billion yuan, accounting for 72 percent of the annual direct grain subsidy arranged according to estimates. The subsidy for social security grew by 9.8

billion yuan or 22.6 percent over the previous year. Expenditures for retirement allowances in administrative units and institutions increased by 6.8 billion yuan or 14.4 percent. Expenditures for compensation funds and funds for social welfare and relief rose by 4.1 billion yuan or 21.4 percent. Expenditures for education gained 25.1 billion yuan or 17 percent.

5. Analyses of hot-spot industries

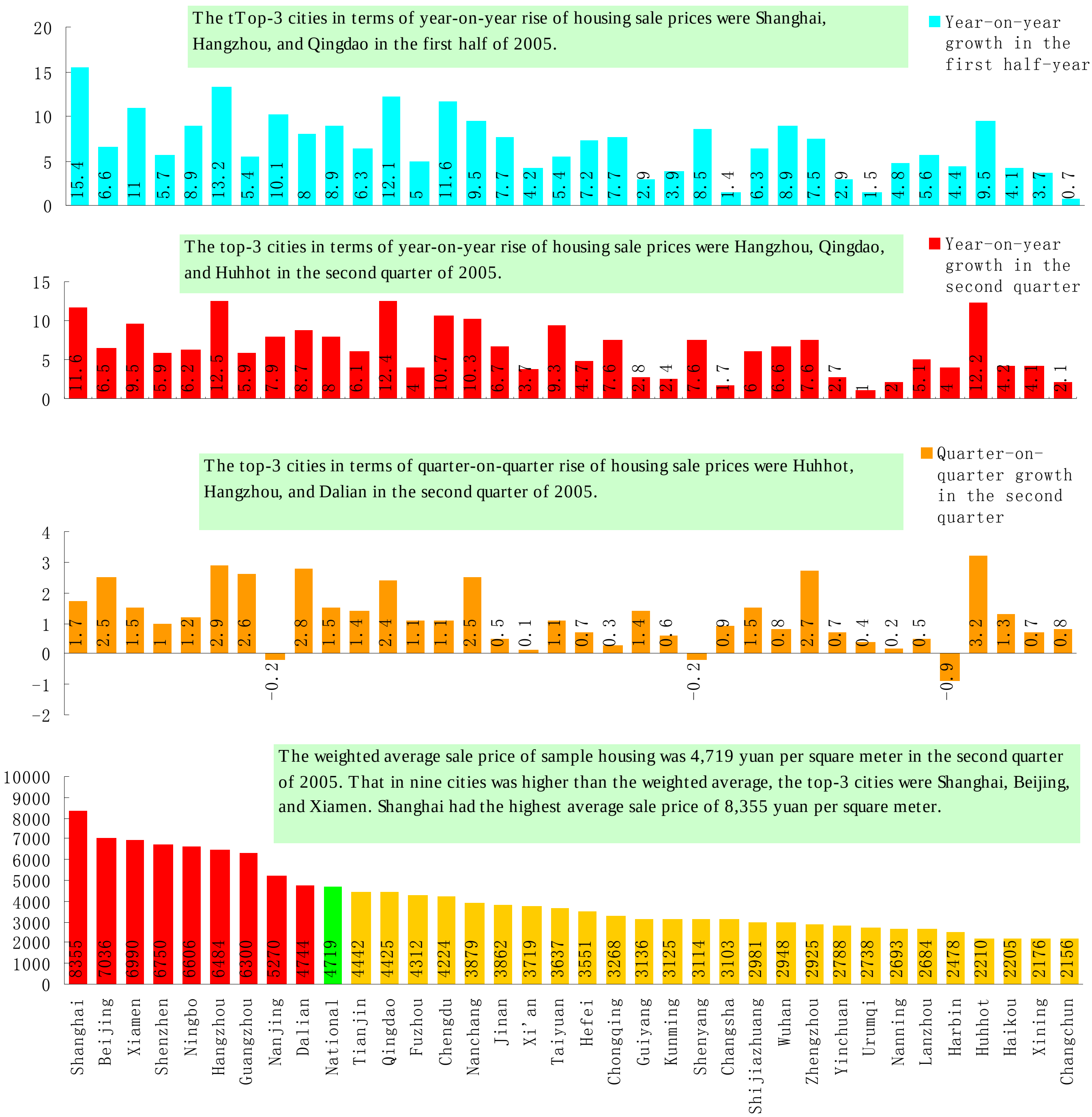
(1). The real estate industry

In the second quarter of 2005, with further implementation of various macro control measures, growth of real estate credit and investment for real estate development decelerated continuously. Growth of sales in the area of commercial housing was slower than that of completed areas for two consecutive months. New individual mortgage loans decreased. In some areas, residents apparently held cash to wait and weigh whether to purchase housing. Real estate developers slowed down the tempo of their activities. Movements in housing prices were yet to be seen..

Growth of investment for real estate development kept on falling, with an apparent tendency of deceleration. In the first half-year, investment for real estate development grew by 23.5 percent and decelerated by 5.2 percentage points over the previous year. In particular, investment for commercial housing gained 21.3 percent and decelerated by 8.4 percentage points over the preceding year.

Growth in sales of real estate was lower than that for the completed areas. In the first half-year, the sales area of commercial housing increased by 14.4 percent, 3.9 percentage points lower than that for completed areas. The momentum of stronger-than-desired demand for commercial housing eased. At end-June, idle commercial property amounted to 100 million square meters, up 7.9 percent over last year. In particular, idle commercial housing amounted to 59 million square meters, up 2.2 percent.

Figure 6: Average sale price and price index of housing in 35 large- and medium-sized cities in the second quarter of 2005



Source: National Development and Reform Commission (NDRC) and National Bureau of Statistics (NBS)

Growth in the sale price of housing decelerated. In the second quarter, the weighted average sale price of sample housing in 35 large- and medium-sized cities registered 4,719 yuan per square meter. The average sale price in nine cities was higher than the weighted average. The top-3 cities were Shanghai, Beijing, and Xiamen. Shanghai had the highest average sale price of 8.355 yuan per square metre. The sale price for housing increased by 8 percent over last year, the quarter-on-quarter growth rate was 1.5 percent, decelerating by 1.8 percentage points and 1.2 percentage points respectively over that in the first quarter. In terms of segmentation, growth in the sale price of secondary housing was higher than that of new commercial housing. If is noteworthy that the price of land transactions rebounded, increasing by 10.7 percent and 3.8 percent respectively on a year-on-year and quarter-on-quarter basis.

The growth in real estate loans continued to decelerate. At end-June 2005, real estate loans in commercial banks reached 2.60 trillion yuan, representing growth of 214 billion over the beginning of the year and a deceleration of 23.7 billion over the same period of the preceding year. Loans increased by 23.20 percent, representing a deceleration of 12.85 percentage points on a year-on-year basis. In particular, loans to real estate developers posted 845.945 billion yuan, increasing by 18.65 percent and decelerating by 7.69 percentage points over the previous year.

New household housing mortgage loans contracted, and repayments before maturity merits attention.. In the second quarter of 2005, monthly increases in household housing mortgage loans decreased markedly. Household housing mortgage loans in May came to 14.489 billion yuan, representing a deceleration of 15.937 billion yuan and the lowest monthly increase of household housing mortgages since March 2003. At end-June, household housing mortgage loans reached 1.74 trillion yuan, increasing by 25.59 percent and decelerating by 16.38 percentage points. Surveys of some commercial banks indicated that the ratio of monthly mortgage repayments before maturity to total mortgage loans continued to rise.. Repayments before maturity indicated that the expenditure structure for borrowers had changed and the change might influence their other activities and plans for consumption.

(2). The coal industry

In 2004, electric power, iron and steel, building materials, and the chemical industry developed rapidly, driving a rapid increase in demand for coal. In the coal industry, production and sales were both brisk multiplying the profits for the industry. In 2005, the coal industry continued to maintain a good momentum of development.

Shortage of coal supply eased. With the results of the macro control gradually bearing fruition, growth of fixed-asset investments decelerated. Expansion slowed down in downstream industries such as coal, iron and steel, and cement. Consequently, the shortage of the coal supply tended to ease. In the first half-year, the output of coal was 940 million tons, increasing by 9.7 percent and decelerating by 5.3 percentage points over the previous year. Sale of commercial coal reached 915 million tons, increasing by 11.5 percent and decelerating by 7.2 percentage points over the preceding year. Net coal exports dropped. In the first half-year, coal exports posted 36.72 million tons, down 15.9 percent on a year-on-year basis. Coal imports registered 12.09 million tons, up 56.1 percent. Railway departments stepped up efforts to transport coal, easing to some extent the shortages in the supply of coal. In the first 5 months of 2005, railway coal transportation reached 437 million tons, up 38.06 million or 9.5 percent. At end-June, the total coal inventory was 115 million tons and it had grown by 11.49 million tons from the beginning of the year, increasing by 12.7 percent over the same period of last year. Coal prices tended to remain at a stable high level. Due to lingering factors, however, the rise in the price of coal remained high over the previous year. In June, the factory price for coal mining and washing grew by 25.9 percent over the previous year, 20.7 percentage points higher than that of industrial products. In particular, the price of crude coal increased by 26.1 percent.

Profits in the coal industry continued to grow rapidly, while growth decelerated. In the first 5 months of 2005, coal enterprises realized profits totaling 20.06 billion yuan, increasing by 88.8 percent and decelerating by 54.3 percent over the same period of last year. The ratio of profits over costs was maintained at around 11 percent, ranking the sixth among 39 industrial sectors. In the first 5 months, statistically large loss-making coal enterprises lost 730 million yuan after subsidies, up 36.3 percent over the previous year. The number of loss-making coal enterprises increased. The coal industry was gradually implementing a structural adjustment under the macro control.

Fixed-asset investment in the coal industry grew rapidly. In the first half of 2005, fixed-asset investment in the coal industry grew by 81.7 percent, 54.6 percentage points higher than the total fixed-asset investment during this period. The ratio of liabilities over assets increased in the coal industry. By end-May 2005, liabilities of the whole coal industry totaled 458.65 billion yuan, up 29.8 percent over the preceding year. The ratio of liabilities over assets was 61 percent, up 3 percentage points. The immense growth of investment in the coal industry was conducive to the easing of shortages in coal supplies. Nevertheless, as the construction cycle of large- and medium-sized mines was rather long and the coal industry, as an upstream industry, had a lag period in response to final demand in the market, the investment risk was gradually building up. Efforts should be made to properly handle the relationship between immediate interests and long-term interests.

Coal is an important fundamental energy and raw material in China, and possesses an important strategic position in the national economy. With China's economic development, the coal industry achieved considerable development. Coal output continued to increase.. The level of production technology was gradually enhanced. Safety conditions for coal production improved. However, the noteworthy problems of the irrational structure, extensive growth mode, frequent occurrence of accidents, serious waste of resources, and lagging environment control continue to exist. We should carry out "Some Opinions on Promoting Healthy Development of the Coal Industry" promulgated by the State Council on June 7. We should, guided by the concept of scientific development, construct a new coal industrial system suitable for a socialist market economy. We should promote the coal industry to gradually follow the road of sustainable development with a high-level utilization of resources, guarantees for safety, good economic results, and less environment pollution.

Part Five: Monetary Policy Stance to be Adopted for the Next Period

I. Macroeconomic prospects

In general, the economy will continue to grow steadily and rapidly in the second half of 2005, and the internal growth dynamics will remain strong. Nevertheless, the deep-rooted problems hindering the sustained, rapid, coordinated, and healthy development of the economy have not been effectively resolved, calling for further attention and efforts.

The growth of consumer demand has been strong. With the rapid growth of the economy and the adoption of a series of policy measures aimed at supporting agriculture and grain production, the income of urban and rural residents is expected to increase further, which will lead to stronger consumer demand. The results of a survey on urban household savings in the second quarter of 2005 show that the income confidence index rose by 1.6 over the same period of last year. However, efforts to raise the farmers' income have been adversely affected by certain factors, such as the lower purchasing prices for grain, the high prices of agricultural production materials, and natural disasters. Given the changes in the consumption structure and the trend of urbanization, the growth of the investment demand is expected to remain strong. In particular, the bottleneck industries, including coal, electricity, fuel, and the transportation sectors, are likely to maintain rapid growth. In the first half of 2005, total planned investment for new projects and for projects in construction increased by 24.3 percent and 28.4 percent respectively over the same period of last year; the funds that had been put in place increased by 26.5 percent; and the self-raised funds had increased by 35.4 percent. With respect to foreign trade, given that the global economy is expected to maintain moderate growth, China's economic development will continue to be supported by relatively strong external demand. However, exports will be affected by greater uncertainties as trade protectionism in some industrial countries has strengthened against the backdrop of aggravated global imbalances.

The government has taken a series of measures to contain the excessively rapid growth of demand for certain resources including water and energy. These measures aimed at removing price distortions will help stabilize price development in the long run. At present, inflationary pressures remain despite the fall in the CPI. The results of a survey on urban household savings in the second quarter of 2005 show that 32.5 percent of the respondents believed that prices will go up in the next period, 3.4 percentage points higher than the previous quarter but 7.1 percentage points lower compared with the same period of last year, and 59.5 percent of the respondents expected a basically unchanged price level, 1.6 percentage points lower than the same period of the previous year. Preliminary estimates show that the year-on-year increase of the CPI will decline in the third quarter but will increase in the fourth quarter.

As the macroeconomic management measures have achieved expected results and will continue to play a positive role, the economy will maintain steady and rapid growth momentum in the second half of 2005, and the financial sector will continue to perform soundly. According to preliminary estimates, money and credit targets for 2005 set at the beginning of the year will be achieved, with the money supply growing by around 15 percent and RMB loans of financial institutions reaching 2.3-2.5 trillion yuan.

II. Monetary policy stance to be adopted in the second half of 2005

In the second half of 2005, under the leadership of the CPC Central Committee and the State Council, the PBC will continue to pursue a sound monetary policy. Efforts will be made to maintain policy consistency and stability to appropriately control money and credit aggregates. Preemptive and fine-tuning measures will be taken to maintain the steady growth of money and credit. The market will be allowed to play a greater role and the achievements in macroeconomic management will be further consolidated.

1. Maintain appropriate growth of money and credit by using a mix of monetary policy instruments

Open market operations will be conducted in a flexible manner. Based on the forecast of liquidity development in the banking sector and according to the need for monetary policy implementation and the changes in the liquidity of the banking system, the PBC will appropriately control the frequency and scale of open market operations. Efforts will be made to maintain an appropriate growth of money and credit by ensuring a proper total amount and reasonable structure of market liquidity and the general stability of the money market interest rate.

2. Continue to implement the market-based interest reform policy

In accordance with the requirement of market-based interest rate reform, the PBC will continue to implement the reform measures, review the policy effects, and guide the commercial banks to enhance risk pricing and liability management. Steps will be taken to improve the formation and transmission mechanism of interest rates, to strengthen systematic research on the money market interest rate, the unofficial lending rate, and the interest rates of deposits and loans with a view to establishing an effective interest rate management system. The PBC will also guide the rural credit cooperatives to improve the interest rate pricing mechanism and to steadily push ahead with the market-based interest rate reform.

3. Enhance the role of credit policy in promoting economic restructuring

The role of window guidance and credit policy will be further strengthened to improve the credit structure. The commercial banks will be encouraged to adopt different credit policies for different sectors and enterprises. More working capital loans will be provided to those enterprises with marketable products, good profitability, and to those contributing to job creation. Credit support will be strengthened to promote the development of agriculture, small- and medium-sized enterprises, consumer spending, employment, and education. Research will be carried out on the policy measures to support and encourage consumption by improving the social security system. Continued efforts will be made to promote the development of credit cards and other consumer credit businesses based on an improved individual credit reporting system. The financial ecological environment will be further improved. The commercial banks will be encouraged to strengthen their ability to respond to cyclical changes in economic development and to improve incentives and disciplinary mechanisms in the loan business. The monitoring system for the term structure of assets and liabilities of the commercial banks will be further strengthened and the growth of medium- and long-term loans will be appropriately controlled. Measures will be taken to carefully review the implementation of policies for the housing industry, closely monitor the development of the housing market, strengthen the coordination between various policies, support a rational housing demand, and promote and safeguard the healthy development of the housing market.

4. Actively promote the development of financial markets

Priority efforts will be made to promote financial product innovation so as to expand the direct financing channel, speed up the construction of the financial market infrastructure, and accelerate the development of the entire financial market system. Steps will also be taken to actively develop the institutional investors and promote the development of financial derivatives to meet the diversified needs of the market. The market infrastructure will be strengthened to create a sound legal and technical environment for the development of the financial market. Regulation and supervision of the financial market will be enhanced to ensure the effective implementation of monetary policy and the smooth operation of the financial market.

5. Speed up the reform of financial enterprises

Efforts will be made to push ahead with the reform of the financial system and financial enterprises. First, the state-owned commercial banks will take further steps to carry out the joint-stock reform, to establish a modern corporate structure, to enhance internal control, to strengthen management, and to improve services. Second, the reform of the rural credit cooperatives will be actively advanced to enable the rural financial system to play a greater role in supporting the development of agriculture and the rural economy. The PBC will also take measures to enhance the role of its fund support in promoting the reform of the rural credit cooperatives. Third, the reform of the joint-stock commercial banks and the city commercial banks will be accelerated to enable them to establish sound corporate governance, strengthen internal control, and improve asset quality. Fourth, continued efforts will be made to promote the reform and development of the securities and insurance industries, regulate activities in the securities and insurance market, and improve the corporate governance and operating mechanisms of the securities and insurance companies. Fifth, reform of the policy financial institutions will be accelerated. Sixth, efforts will be made to push ahead with the reform of the asset management companies. Seventh, active steps will be taken to deepen the reform of the postal savings system.

6. Further improve the formation mechanism of the RMB exchange rate to promote a balance of payments equilibrium

Steps will be taken to further improve the formation mechanism of the RMB exchange rate to promote a balance of payments equilibrium. First, the PBC will continue to provide explanations and clarifications regarding the reform of the formation mechanism of the RMB exchange rate to help the market correctly understand the objectives, principles, and key elements of the reform. Second, the market response and the impact of the reform on various sectors of the economy will be closely monitored, and measures will be taken to further improve the RMB exchange rate system so as to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. Third, efforts will be made to speed up the development of the foreign exchange market and foreign exchange derivatives, and to provide more and better risk-hedging instruments to customers by introducing inter-bank foreign exchange forward transactions and swaps between RMB and foreign currencies. Fourth, various supportive measures for the exchange rate reform will be enhanced to further deepen the reform of the foreign exchange administration system and improve bank management of foreign exchange positions.. Fifth, a market-based mechanism for managing the balance of payments will be established and improved to promote balanced international payments.