

China Monetary Policy Report

Quarter One, 2007

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

Executive Summary

In the first quarter of 2007, the national economy maintained a momentum of steady and rapid growth. The growth of consumption accelerated, agricultural production remained stable, economic efficiency continued to be enhanced, and the consumer price index (CPI) increased slightly. In the first quarter, the GDP grew by 11.1 percent and the CPI rose by 2.7 percent year on year.

According to the State Council's overall arrangements, the People's Bank of China (PBC) continued to implement a sound monetary policy, strengthen the preemptive nature of monetary policy, and timely adopt a comprehensive package of policies with a view to strengthening macro-economic adjustment and maintaining balanced monetary aggregates. Sterilization instruments such as open market operations and reserve requirement policies, including four increases in the reserve requirement ratio of financial institutions by 2 percentage points since the beginning of 2007, were employed in an effort to withdraw excess liquidity in the banking system. As leverage, the benchmark deposit and lending rates of financial institutions were raised again. Meanwhile, the PBC made efforts to guide financial institutions to optimize the credit structure, steadily promote the reform of financial institutions, enhance RMB exchange rate flexibility, and improve foreign exchange management.

The financial industry performed in a sound manner. Under the combined effects of macro-management measures, the growth of money and credit moderated, but in general, they still grew at a relatively fast pace. At end-March, the outstanding balance of broad money M2 had increased 17.3 percent year on year, down 1.5 percentage points from the same period of the last year, but up 0.4 percentage points from end-2006. Loans of financial institutions increased rapidly. Outstanding RMB loans grew by 16.3 percent year on year to 24.0 trillion yuan, representing an acceleration of 1.5 percentage points from the same period of the last year. The elasticity of the RMB exchange rate was further strengthened. At end-March, the central parity of the RMB against the US Dollar was 7.7342 yuan per US Dollar, appreciating by 745 points over the end of the last year.

In general, the Chinese economy is expected to continue to develop relatively rapidly in the next period against the backdrop of strong economic growth, a still favorable

global economic environment, and improvements in the income of domestic households, enterprise profits, and fiscal revenues. However, some prominent issues still remain in the economy, such as economic growth will tend to accelerate, the growth of fixed-assets investment may rebound, the trade surplus will continue to increase, and liquidity will remain excessively abundant. These issues stem from deep-rooted economic structural problems. Moreover, pressures building in the economic environment from the high demand for resources that conserve energy and reduce pollutant emissions, which also inhibit sustainable economic development. During the next stage, a scientific development approach should be followed in all areas of economic and social development to maintain a consistent and stable macro-adjustment policy; efforts should be made to speed up the economic restructuring and the transformation of economic growth patterns, to prevent a relatively rapid overheating of the economic development, and to avoid dramatic up-and-downs so as to maintain rapid and sound economic development.

According to the State Council's overall arrangements, the PBC will further improve financial macro-management and the forward-looking and scientific nature of monetary policy and its effectiveness on macro-economic management. The PBC will continue to carry out a sound monetary policy, strengthening liquidity management, applying a mix of measures including open market operations and a reserve requirement ratio to drain excessive liquidity, maintaining appropriate sterilization through the coordinated use of different liquidity management tools to guide money and credit to grow at an appropriate pace and to maintain balanced aggregates. Coordination of the interest rate and exchange rate policy will be further strengthened. The market-based interest rate reform will be further advanced, and the establishment of a benchmark interest rate system will be promoted to strengthen the leveraging role of prices in the macro-economic adjustment. The reform of the RMB exchange rate regime will be promoted in a self-initiated, controllable, and gradual manner to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. Efforts will be made to promote the reform of the foreign exchange management system, improve a multi-layered external investment system, and accelerate the pace of "going out." The management model for official foreign exchange reserves should be diversified to improve reserve operations and management. Endeavors should be made to improve the credit structure, strengthen financial support to key areas and weak sectors including the agricultural economy, consumption, small and medium-sized enterprises, autonomous innovations, energy conservation, environmental protection, job creation, and help for students, and to strictly control

credit for high energy-consuming and heavy-polluting industries and industries with an excessive production capacity. The scale and structure of direct financing and indirect financing should be coordinated to promote the healthy development of the capital market.

Part 1 Monetary and Credit Performance

In the first quarter of 2007, the Chinese economy maintained steady and rapid growth with the financial industry performing in a sound manner. Under the combined effects of macro-management measures, the growth of money and credit moderated, but in general, they still grew at a relatively fast pace.

I. Money supply increased rapidly

At end-March, the outstanding balance of broad money M2 amounted to 36.4 trillion yuan, an increase of 17.3 percent year on year, down 1.5 percentage points from the same period of the previous year, but up 0.4 percentage points from end-2006. The outstanding balance of narrow money M1 reached 12.8 trillion yuan, an increase of 19.8 percent year on year and up 7.1 percentage points over growth during the previous year. The rapid growth of M1 was mainly due to the rapid increase in demand deposits of enterprises and organizations. On the one hand, enterprises and other organizations had stronger incentives to invest due to their good performance and the dynamic market, therefore their demand for current deposits grew dramatically. On the other hand, the growth in the issuance of bank acceptance bills slowed down, and may have prompted enterprises to hold more demand deposits for payment purposes. Cash in circulation M0 grew by 16.7 percent year on year to 2.7 trillion yuan, an acceleration of 6.2 percentage points from the same period of the previous year. Net cash injections in the first quarter totaled 31.5 billion yuan, 87.5 billion yuan more than that recorded in the same period of the previous year.

II. Growth of deposits of financial institutions slowed down, with an increasingly stronger preference for demand deposits

At end-March, outstanding deposits of all financial institutions (including foreign-funded financial institutions, as throughout this Report) denominated in both

RMB and foreign currencies increased by 15.3 percent year on year to 36.7 trillion yuan, a deceleration of 3 percentage points from the same period of the previous year. In particular, outstanding RMB deposits rose by 15.9 percent year on year to 35.4 trillion yuan, a deceleration of 3.7 percentage points from the same period of the last year; outstanding foreign currency deposits totaled US\$164.9 billion, an increase of 3.76 percent year on year.

Companies and households had a stronger preference for demand deposits. At end-March, outstanding household RMB deposits totaled 17.5 trillion yuan, representing a growth of 12.9 percent year on year, a deceleration of 5.7 percentage points from the same period of 2006, an increase of 1.1 trillion yuan from the beginning of 2007, and a deceleration of 83.6 billion yuan from the increase recorded during the same period of 2006. In particular, the growth of household demand deposits increased by 206.5 billion yuan year on year, and the growth of time deposits was 290.1 billion yuan less than the growth of the previous year. Outstanding deposits of non-financial companies stood at 15.8 trillion yuan, representing a growth of 18 percent year on year, a deceleration of 2.1 percentage points compared with the increase recorded in the same period of the last year, an increase of 440.3 billion yuan from the beginning of the year, and a deceleration of 76.1 billion yuan year on year. In particular, outstanding corporate deposits amounted to 13 trillion yuan, representing a growth of 381.5 trillion yuan from the beginning of the year and an acceleration of 110.9 billion yuan year on year, among which corporate demand deposits increased by 81.9 billion yuan while time deposits increased by 29 billion yuan year on year. Outstanding fiscal deposits amounted to 1.4 trillion yuan, representing an increase of 300.6 billion yuan over the beginning of 2007 and an acceleration of 85.4 billion yuan from the previous year.

Two factors have contributed to the slowdown in the growth of household deposits. On the one hand, the steady increase in the income of urban and rural households strengthened their willingness to consume. On the other hand, the boom in the capital market attracted households to invest in high-profit stocks, funds, and other wealth management products, resulting in a rapid increase in the margins of securities companies and the diversion of some household deposits.

III. Loans of financial institutions increased rapidly and growth of consumer loans accelerated

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 25.3 trillion yuan at end-March, representing a growth of 15.7 percent year on year, an acceleration of 1.8 percentage points from the same period of the last year, and an increase of 1.4 trillion yuan over the beginning of the year, accelerating by 149.2 billion yuan compared with the growth during the same period of the last year. In particular, outstanding RMB loans grew by 16.3 percent year on year to 24.0 trillion yuan, representing an acceleration of 1.5 percentage points from the same period of the last year and an increase of 1.4 trillion yuan over the beginning of the year, 167.8 billion yuan more than during the same period of the last year; outstanding foreign currency loans rose by 11.2 percent year on year to US\$171.3 billion, representing an increase of US\$2.6 billion over the beginning of the year and an deceleration of US\$1.67 billion compared with the growth during the same period of the last year.

In terms of the sectoral distribution and maturity of RMB loans, the growth of loans to households, consumer loans in particular, accelerated remarkably and loans to non-financial companies and other sectors increased at a steady pace. At end-March, outstanding household loans reached 4.22 trillion yuan, representing an increase of 23.2 percent year on year, 10 percentage points higher than the increase recorded during same period of the last year and an increase of 332.1 billion yuan over the beginning of the year, 157.8 billion yuan more than the growth recorded during the same period of the last year. In particular, consumer loans to households registered an increase of 162.9 billion yuan over the beginning of the year, an acceleration of 119.9 billion yuan year on year. Business loans to households increased by 169.2 billion yuan from the beginning of the year, an acceleration of 38 billion yuan year on year. Outstanding loans to non-financial companies and other sectors grew by 14.9 percent year on year to 19.74 trillion yuan, representing an increase of 1 trillion yuan from the beginning of the year, basically unchanged from that in the previous year; in particular, the growth rate of paper financing maintained a declining trend since April 2006, the growth of short-term loans accelerated, and the growth of medium- to long-term loans stabilized. Most of the RMB medium- and long-term loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) went to the real estate industry, transportation, storage and postal services, production and supply of electricity, gas, and water, the manufacturing sector, water conservation, and the environmental and public facility management sectors. Medium- and long-term loans going to these

industries increased by 384.1 billion yuan from the beginning of 2007.

Broken down by financial institutions, the growth of RMB loans of policy banks and the four state-owned commercial banks decelerated compared with that during the same period of the last year, and the RMB loans of joint-stock commercial banks and other medium- and small-sized financial institutions witnessed a rapid increase. In the first quarter of 2007, the RMB loans of the policy banks and the four state-owned commercial banks increased by 85.8 billion yuan and 594.8 billion yuan respectively, a deceleration of 3.6 billion yuan and 5.7 billion yuan respectively year on year. The RMB loans of the joint-stock commercial banks, city commercial banks, rural financial institutions (including rural cooperative banks, rural commercial banks, and rural credit cooperatives), and foreign-funded financial institutions increased by 351.7 billion yuan, 89.4 billion yuan, 257.5 billion yuan, and 22.4 billion yuan respectively, accelerating by 65.3 billion yuan, 47.9 billion yuan, 67.9 billion yuan, and 6.4 billion yuan respectively compared with the increases recorded during the same period of the last year.

In recent years, the difference between outstanding deposits and loans of financial institutions has attracted attention from all strata of the society. Some believe that the widening of the difference between deposits and loans reflects insufficient support from financial institutions to the economy. Such a viewpoint is neither accurate or objective. Given that the PBC sterilized liquidity in the banking system by means of open market operations and a reserve requirement policy, central bank bills and required reserves held by commercial banks accordingly increased remarkably, resulting in the widening of the differential between deposits and loans. Under the banknote issuance system based on credit, the process of issuing loans is a process of creating deposits. If we do not consider that part of the deposits will be cashed, the increase of loans is equal to that of deposits in financial institutions as a whole. There is no direct link between the difference between deposits and loans and loan issuance, and it is impossible to narrow the difference through the issuance of more loans by the banks.

Box 1: Analysis of the Seasonal Movements of Loans

The credit expansion of China's financial institutions was evidently affected by seasonal factors. Before 1998, credit growth in financial institutions usually decelerated in the first half of the year but accelerated in the second half of the year, with new loans in the first half of the year accounting for only 30-40 percent of the

total. The main reason for this was the direct control approach of the central bank in imposing credit quotas on the commercial banks. Commercial banks would rush to lend at the end of a year in order to fulfill the year's quota, which constituted the basis for the central bank to allocate the quota for the next year. After the central bank abolished the credit quota control in 1998, the incentives for commercial banks to compete for credit quotas disappeared and the proportion of loans issued in the first half of the year increased accordingly, averaging 46.5 percent from 1999 to 2002. However, this balanced pace of credit issuance failed to continue. In 2003, credit growth began to accelerate in the first half of the year and decelerate in the second half, and new loans were particularly concentrated in the first quarter. Since 2003, the proportion of new loans in the first half of the year has remained above 60 percent, and even reached 68 percent in 2006 (the share of new loans issued in the first quarter accounted for nearly 40 percent). In the first quarter of 2007, new loans reached 1.42 trillion yuan, 167.8 trillion yuan more than the growth recorded the year before, suggesting a continued and large credit expansion. The seasonal movements of credit expansion are mainly attributed to the preference of commercial banks to "lend early in order to get returns early." At present, the internal performance assessments and credit management systems of China's commercial banks attach excessive importance to current year profits. The branches of the commercial banks overestimate the contribution of credit to current year profits when making credit decisions, and focus on the returns of the growth of credit assets in one year rather than in the entire operations. Especially for short-term loans with a maturity of less than one year, commercial banks apparently have stronger incentives to issue loans at the beginning of the year, while the seasonal fluctuations of medium- and long-term loans are not significant.

Unlike this practice, banks in mature market economies focus more on the sustained and steady growth of loans and profits and have established more scientific and appropriate performance assessment and credit management systems. Therefore, when the economy grows at a steady pace, the issuance of credit is evenly distributed across seasons and thus seldom suffers large seasonal movements. For instance, from 2003 through 2006, the proportion of new loans of US commercial banks in the first half of the year accounted for about 40-57 percent of those in the entire year, with an average of 47 percent.

The appropriate and balanced pace of lending helps satisfy the demands of enterprises for funds for production and operations at an appropriate time and maximizes the interests of enterprises as clients of commercial banks, hence contributing to the long-run development of these banks. Large fluctuations in credit growth within a year are not only incompatible with the actual demands of the real economy, adversely affecting the image of the commercial banks and their relations with their clients, but also are likely to lead to poor judgments about the macro-economic situation.

In response to the evident seasonal fluctuations in lending, the PBC held several window guidance meetings to facilitate the commercial banks' establishment of a philosophy of sustained and sound operations, strengthening risk management, pursuing profits at an appropriate level, and properly controlling the pace and scale of credit expansion. As an important monetary policy instrument, window guidance in combination with other instruments guides market expectations and contributes to the healthy development of commercial banks in the long run. Some developed countries have adopted similar measures.

It is more advisable for the commercial banks to strengthen self-discipline and risk control and to actively take measures for balanced credit growth. First, a more scientific and improved performance assessment system should be built with reference to the advanced concepts of the banking industry both at home and abroad so as to move away from pursuing short-term profit targets and from concentrating on short-term benefits, using fewer assessment indicators that measure profits at a certain point and adopting more indicators that fully reflect returns on an on-going operational basis. Second, the headquarters of the commercial banks should strengthen the monitoring and guidance of the pace of lending in their branches. Steps should be taken to establish reporting and projecting mechanisms to timely respond to credit growth trends and abnormal changes and to actively adopt various enterprise management means, including economic measures such as internal funds transfer prices and economic capital allocations, to strengthen management of the pace of credit expansion in their branches and to ensure balanced credit growth for the whole year. Third, the management and adjustment of credit plans should be improved to arrange lending in an appropriate and balanced manner according to demand based on considerations of fund constraints as well as capital, risk, and return constraints. Fourth, efforts should also be made to explore modes of sustainable business development to reduce the dependence on credit assets expansion, further improve the operation of existing assets, enhance the efficiency of new assets allocation, accelerate the development of fee-based businesses, and fully enhance the competitiveness and sustained profitability of the commercial banks.

IV. Base money grew at a stable pace, excluding the influence of the rise in the reserve requirement ratio

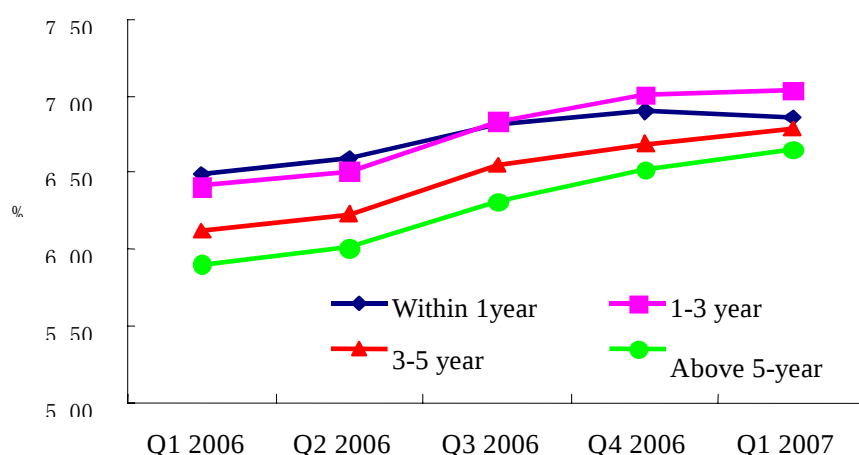
At end-March, the outstanding balance of base money amounted to 7.7 trillion yuan, 77.8 billion yuan less than that at the beginning of 2007, 101.4 billion yuan less than the decline recorded during the same period of the last year, and an increase rate of 23.1 percent year on year. Base money grew at a relatively high speed, which was mainly related to the PBC's freezing of liquidity by raising the reserve requirement ratio several times since the second half of 2006. Unlike central bank bills, required reserves are included in base money. From the second half of 2006 to the end of the

first quarter of 2007, the PBC raised the reserve requirement ratio five times (in particular, twice during the first quarter of 2007), resulting in an acceleration of base money as the frozen liquidity was included in the base money. If the liquidity frozen by the rise in the reserve requirement ratio since 2006 had been sterilized by the issuance of central bank bills, the growth of base money at present would be approximately that of the average level in 2006. At end-March, the excess reserve ratio of financial institutions stood at 2.87 percent, down 0.11 percentage points year on year. In particular, the excess reserve ratio of state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 2.47 percent, 2.79 percent, and 6.25 percent respectively.

V. The lending rates of financial institutions remained stable

In the first quarter, with the exception of the short-term lending rates of financial institutions that declined slightly, other medium- and long-term lending rates maintained a momentum of a steady rise. In particular, the weighted average lending rate of within 1 year (including 1 year) loans, 1-3 year (including 3 year) loans, 3-5 year (including 5 year) loans, and above 5 year loans was 6.86 percent, 7.04 percent, 6.79 percent, and 6.65 percent respectively, down 0.04 percentage points and up 0.03, 0.1, and 0.13 percentage points respectively from the previous quarter. The weighted average interest rate of 1 year RMB loans of commercial banks was 6.51 percent, 1.02 times the benchmark rate and down 0.07 percentage points from the previous quarter.

Graph 1: Lending rates with different maturities by financial institutions since 2006



Source: The People's Bank of China.

Among all loans issued by financial institutions in the first quarter of 2007, the share of loans with interest rates at the benchmark rate, or floating downward, increased by 1.22 and 1.08 percentage points respectively from the previous quarter, while the share of loans with interest rates floating upward from the benchmark rate declined by 2.31 percentage points over the previous quarter.

Table 1: Share of loans with floating rates in various ranges during the first quarter of 2007

Unit: percent

	Sum	Floating downward	At benchmark	Floating upward				
		[0.9,1.0)	1.0	Sum	(1.0,1.3]	(1.3,1.5]	(1.5,2.]	Above 2
Sum	100	26.89	27.85	45.26	27.95	6.48	9.13	1.70
State-owned commercial banks	100	31.54	32.45	36.01	33.67	1.88	0.45	0.01
Joint-stock commercial banks	100	38.03	33.54	28.43	27.99	0.40	0.02	0.01
Regional commercial banks	100	29.71	15.62	54.67	38.72	9.56	5.77	0.62
Urban and rural credit cooperatives	100	2.66	4.77	92.57	18.52	23.86	42.03	8.16
Policy banks	100	25.48	72.95	1.56	1.56	0.00	0.00	0.00

Note: The interest rate floating range for urban and rural credit cooperatives is [0.9, 2.3]

Source: The People's Bank of China.

Inter-bank RMB deposit rates of financial institutions declined slightly. In particular, the share of the outstanding balance of inter-bank demand deposits took up 91.7

percent, and the weighted average interest rate was 1.38 percent, down 0.03 percentage points from the previous quarter; the share of the changes in time deposits took up 8.3 percent, and the weighted average interest rate was 2.29 percent, down 0.27 percentage points over the previous quarter.

The interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) increased slightly. In March, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 4.2 percent, up 0.03 percentage points from the beginning of the year; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 4.47 percent, up 0.28 percentage points from the beginning of the year.

The domestic interest rates on foreign currency loans and large-value foreign currency deposits (above US\$3 million) fluctuated slightly.

Table 2: Average interest rates on large-value dollar deposits and loans in the first quarter of 2007

Unit: percent

	Jan.	Feb.	Mar.	Apr.
I. Large-value Deposits:				
Within 3 months	4.0482	4.3192	4.1626	4.3773
3-6 months	5.2001	5.1244	5.2424	5.1802
6-12 months	5.1651	5.0632	5.3322	4.8745
1 year	5.2184	5.0020	4.3134	4.7066
II. Loans:				
1 year (fixed)	6.2126	6.2037	6.0972	6.0174
1 year (monthly floating)	6.1985	6.0936	6.2679	6.1866

Source: The People's Bank of China.

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

In the first quarter, the RMB exchange rate appreciated broadly, and the fundamental role of market supply and demand was further enhanced. At end-March, the central parity of the RMB against the US Dollar was 7.7342 yuan per US Dollar, appreciating by 745 points or 0.96 percent over the end of the last year; the central parity of the RMB against the Euro and the Japanese Yen was 10.3068 yuan per Euro and 6.5539 yuan per 100 Japanese Yen, depreciating by 0.39 percent against the Euro and appreciating by 0.14 percent against the Japanese Yen from the beginning of the year. From the exchange rate regime reform in 2005 to end-March 2007, the RMB cumulatively appreciated by 7.01 percent, 2.84 percent, and 11.47 percent respectively against the US Dollar, the Euro, and the Japanese Yen.

In the first quarter, the elasticity of the RMB exchange rate was further strengthened, and the linkage of the RMB exchange rate with the major currencies was strong. The peak and bottom central parities of the RMB against the US Dollar were 7.7303 yuan per US Dollar and 7.8135 yuan per US Dollar respectively. Among the 57 trading days, the inter-bank foreign exchange market saw RMB appreciations for 33 days and RMB depreciations for 24 days. The largest appreciation and depreciation of the central parity against the US Dollar in a single business day was 161 basis points and 90 basis points respectively; the daily fluctuation of the central parity averaged 46 basis points, further widening from the average of 40 basis points recorded in 2006.

Part 2 Monetary Policy Conduct

In the first quarter of 2007, the PBC, according to the State Council's overall arrangements, continued to implement a sound monetary policy, strengthen the preemptive nature of monetary policy, and timely adopt a comprehensive package of policies with a view to strengthening macro-economic adjustments and maintaining balanced monetary aggregates. The PBC made efforts to guide financial institutions to optimize the credit structure, steadily promote the reform of financial institutions, enhance the RMB exchange rate flexibility, and improve foreign exchange management. These actions have contributed to the relatively smooth and rapid development of the economy and to fundamental price stability.

I. Strengthen open market operations

In the first quarter of 2007, with closely monitored movements in the international financial market and in domestic money and credit, the PBC broadly sterilized the total liquidity from the RMB counterpart of foreign exchange assets supported with open market operations and reserve requirement policies in an effort to drain the liquidity in the banking system. First, the PBC strengthened the issuance of central bank bills. Due to the large amount of cash injections and withdrawals around the Spring Festival and the concentrated IPOs, the liquidity in the banking system fluctuated dramatically during the first quarter. The PBC reasonably arranged the portfolio of time-limited open market operation tools. The issuance of central bank bills totaled 1.8 trillion yuan in the first quarter, accelerating 0.5 trillion yuan from the previous year. At end-March, outstanding central bank bills amounted to 3.9 trillion yuan, up 0.9 trillion yuan from end-2006. Second, the PBC extended the maturity of central bank bills accordingly. In order to reduce the liquidity pressures due to the concentrated maturity of central bank bills, the PBC reissued 3-year central bank bills at the end of January, along with 1-year and 3-month central bank bills, to drain the excess liquidity in the banking system. The issuance of 3-month, 1-year, and 3-year central bank bills in the first quarter totaled 357 billion yuan, 1002 billion yuan, and 464 billion yuan respectively. Third, the PBC properly provided short-term liquidity. To support the settlement needs of commercial banks before the Spring Festival, the PBC offered 90 billion yuan of liquidity through short-term reverse repo operations. This not only eased the liquidity pressures of financial institutions before the Spring

Festival, but also created a relatively stable market for the issuance of central bank bills. Fourth, the issuance of market-based central bank bills was combined with the issuance of special central bank bills. Along with maintaining the pace of issuance of central bank bills on a market basis, the PBC also issued 101 billion yuan of 3-year special central bank bills to commercial banks with relatively rapid credit growth and sufficient liquidity. This measure not only withdrew liquidity but also served as a warning to banks with high credit growth. Fifth, the interest rate for central bank bills was raised appropriately. Based on the rise in the benchmark interest rate for deposits and credit in the middle of March, the issue rate of 3-month, 1-year, and 3-year central bank bills was raised by 12, 18, and 22 basis points respectively since March. Meanwhile, this will also induce a rise in market interest rates to adjust the supply of and demand for capital in the market.

II. Appropriately adjust the reserve requirement ratio

With the continued increase in the twin surpluses under the BOP, to maintain liquidity at a proper level the PBC announced it would raise the reserve requirement ratio by 0.5 percentage points on January 5 and February 16, effective on January 15 and February 25 respectively. About 330 billion yuan of liquidity was frozen. According to the dynamic movements of liquidity, the RMB reserve requirement ratio was raised by another 0.5 percentage points on April 5 and April 29 respectively, taking effect on April 16 and May 15 accordingly. The use of central bank bills and the reserve requirement ratio helps enhance the central bank's autonomy and effectiveness in withdrawing excess liquidity, adjusting the commercial banks' credit extension, and maintaining growth of aggregate credit and money at an appropriate level.

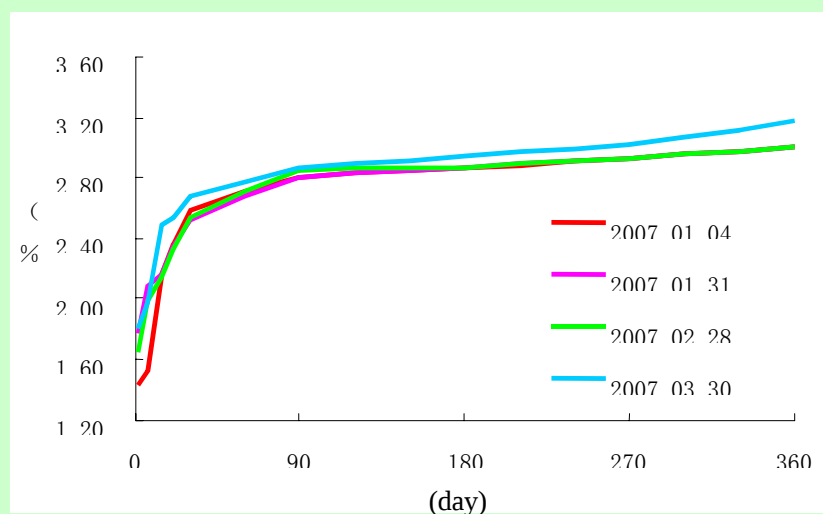
III. Promote a market-based interest rate reform to play a leveraging role

The PBC announced it would raise the benchmark interest rate on RMB deposits and loans effective from March 18, 2007. The one-year benchmark deposit and lending rates were raised by 0.27 percentage points, the former up to 2.79 percent from 2.52 percent and the latter up to 6.39 percent from 6.12 percent. The benchmark interest rates on deposits and loans in other maturities were adjusted accordingly. The hikes in the benchmark interest rates on RMB loans and deposits are conducive to guiding the

appropriate growth of investment and credit, maintaining a generally stable price level and a sound financial system, optimizing the economic structure and balancing economic development so as to promote the sound and rapid growth of the economy.

The daily Shanghai Inter-bank Offered Rate (Shibor) of different maturities has formulated a complete yield curve covering a range from overnight to 1-year maturity since the Shibor was launched in January 2007. With a smooth feature, the yield curve provided the money market with a preliminary pricing reference since different Shibors could comprehensively reflect the maturity structure and capital supply and demand. Many financial products derived from it emerged in the market, diversifying money market products and helping the deepening of the money market. As to the end of the first quarter, based on the Shibor, 19 financial innovative products were created, including an interest rate swap, forward interest rate agreement, inter-bank borrowing, inter-bank discount, bond trade, financial wealth management products, and inter-bank cross currency deposits, and some commercial banks even linked the price of internal funds transfers and performance evaluations with the Shibor, indicating the growing influence and the benchmark role of the Shibor. In the first quarter, the Shibor was adjusted synchronically with money supply and demand in the money market; interest rate fluctuations in the short-end were higher than in the long-end, with the 3-month interest rate climbing slightly.

Graph 2: Shibor Curve



Source: National Inter-bank Funding Center.

IV. Strengthen window guidance and credit policy guidance

To cope with the increasing pressures from credit extension, the PBC strengthened window guidance and credit policy guidance, required commercial banks to pay great attention to potential risks arising from an excessively rapid credit growth, to establish a philosophy of sustainable and sound operations, to further implement the overall arrangements of the central government regarding strengthening the macro-adjustment, and to reasonably curb credit volume and growth. Meanwhile, following the principle of “different treatments for different borrowers,” commercial banks should optimize the credit structure, reasonably control medium- and long-term lending such as infrastructure construction loans, strictly restrain lending to high energy-consuming or heavily polluted enterprises, and strengthen financial services to small and medium-sized enterprises, autonomous innovation, natural resource conservation and environmental protection, job creation, and weak economic sectors. Furthermore, the PBC further improved financial services for the establishment of a socialist new countryside, encouraged financial institutions to intensify effective lending to the agricultural economy and to enhance financial services to rural migrant workers through organizational, product, and institutional innovations.

V. Smoothly promote the reform of financial enterprises

Breakthroughs were made in the reform of state-owned commercial banks. With the joint-stock reform and the successful listing on capital markets both at home and abroad, the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), and China Construction Bank (CCB) have basically established a relatively standard corporate governance structure, increased the capital adequacy ratio, improved asset quality, and enhanced profitability and risk management abilities. Meanwhile, state-owned shares obtained significant returns and maintained their value. Currently, the ICBC, BOC, and CCB are endeavoring to further deepen the reforms and to consolidate the reform outcomes in line with the requirements of the *Opinions of the State Council on Deepening a Full-fledged Financial Reform to Promote the Sustainable Healthy and Sound Development of the Financial Industry* (hereafter referred to as the *Opinions*). According to the *Opinions*, relevant departments will study the reform experiences of the ICBC, BOC, and CCB to steadily promote the share-holding reform of the Agricultural Bank of China and to earnestly put in place relevant fundamental works in line with the principle of

supporting the agricultural economy, and carrying out an overall reform of commercial operations and listings at a proper time. At the same time, efforts should be made to regulate the establishment and exit, organizational structure, corporate governance, and business management of county banks, lending companies, and rural fund cooperatives, and to standardize the approval procedures for the set up of these institutions so as to provide an institutional arrangement for financial services offered by such new rural banking institutions to the agricultural economy. This will help improve the rural financial system and rural financial services. Based on the clearance and consolidation of the original regulations on trust investment companies, achievements have been made to improve the regulations on trust businesses, to promote trust investment companies to becoming non-banking financial institutions, and to provide wealth management and other products so as to facilitate the scientific development of trust investment companies and to protect the legitimate interests of the investors.

The reform of the rural credit cooperatives (RCCs) also experienced important advances and produced results. First, with the gradual implementation of the financial support policy, their asset quality improved markedly. At end-March, the PBC, together with the CBRC, provided 166.1 billion yuan of funds, accounting for 99 percent of the planned volume of financial assistance, to the RCCs through special bill issuances and special lending. The PBC also redeemed 18.8 billion yuan in special bills in 285 counties (cities) in 8 pilot provinces, such as Jiangsu. According to statistics from the supervisory authorities, the non-performing loan ratio of the RCCs on the basis of the four-category loan classification system was 10.6 percent, down 26.3 percentage points from end-2002. The capital adequacy ratios of rural credit cooperatives, rural commercial banks and rural cooperative banks have reached 8.2 percent, 8.0 percent and 10.6 percent respectively. Second, their capacity to support rural economic activities was enhanced significantly with marked capital improvements. At end-March, the outstanding deposits and loans of RCCs stood at 4.2 trillion and 2.9 trillion yuan, up 112 percent and 107 percent respectively from end-2002. Outstanding agricultural loans posted 1.4 trillion yuan, accounting for 47 percent of the total loans issued by the rural credit cooperatives, compared with 40 percent at the end of 2002. The RCCs' share of agricultural loans issued by all financial institutions nationwide increased from 81 percent at the end of 2002 to 93 percent. Third, the RCCs' property rights system reform advanced smoothly, with acceleration of the establishment of a legal person structure. At the end of March, 93 banking institutions had been established nationwide by RCCs, including 14 rural

commercial banks and 89 rural cooperative banks, and a county-wide single legal person structure had been put in place by RCCs in 1,453 counties. However, we must be aware that RCCs still face many difficulties and problems, including mainly extensive operations, unsound constraint mechanisms, strong administrative interventions in provincial-level RCC associations, a yet-to-be improved legal person governance structure in the RCCs, a supporting policy of local governments not in place and under expectations of solving the historical burdens. In general, there are still arduous tasks ahead to realize the reform targets.

VI. Improve the exchange rate formation mechanism, accelerate the reform of the foreign exchange management system, and promote a broad balance under the BOP

The PBC will continue to improve the managed floating exchange rate regime based on market supply and demand with reference of a basket of currencies, further give market supply and demand a fundamental role in the RMB exchange rate formation, and strengthen the RMB exchange rate flexibility and maintain it at an adaptive and equilibrium level. Meanwhile, reform of the foreign exchange management system should be strengthened to promote a broadly balanced BOP. First, the *Administrative Rules on the Foreign Exchange of Individuals* were implemented on February 1, 2007 to allow individuals to sell or purchase foreign exchange up to US\$50,000 per year. In the first quarter, individual purchases of foreign exchange amounted to US\$4.4 billion, an increase of 207 percent y-o-y. In addition, to facilitate individuals' foreign exchange needs within the annual quota, examination of the authenticity of over-quota foreign exchange sales was strengthened as well. Second, management of trade-related foreign exchange receipts and sales was further strengthened. The definition of enterprises "of concern" was standardized and efforts were made to strengthen the examination of the authenticity of the foreign exchange sales of these enterprises. Third, management of the purchase of domestic real estate by foreign institutions and external debts and foreign exchange sales of foreign real estate enterprises were strengthened. In the first two months, new external debts of foreign real estate enterprises fell 36.3 percent y-o-y, and the sales of foreign exchange by foreign institutions to buy real estate declined by 31.8 percent y-o-y. Fourth, the indexes of the short-term external debts of financial institutions in 2007 were adjusted by gradually abolishing the indexes of the outstanding volume of the short-term external debts of financial institutions and encouraging financial institutions to increase funding sources through money market borrowing and swaps. Fifth, the RMB business in Hong Kong was further extended. On January 14, 2007, domestic

financial institutions were approved to issue RMB-denominated bonds in Hong Kong and more channels were provided for RMB held by residents and enterprises in Hong Kong to be returned to Mainland China.

Box 2: Exploring the Multi-layered and Diversified Use of Foreign Exchange

Since the reform and opening-up, the bulk of foreign exchange revenues from the BOP surplus has been managed by the central government. Since 2003, the increase in the BOP surplus has accelerated and resulted in continued foreign exchange inflows and rapid growth of outward investment. However, in China the government has remained the primary user of foreign exchange and has invested heavily in financial assets. In 2005, China's external assets totaled US\$1218.2 billion, among which reserve assets amounted to US\$825.7 billion (foreign exchange reserves being US\$818.9 billion) and accounted for 67.8 percent; direct outward investment registered US\$64.5 billion, accounting for only 5.3 percent. At end-2006, official foreign exchange reserves increased to US\$1066.3 billion; in contrast, the external investment of non-financial entities totaled only US\$73.3 billion. From the experiences of the developed countries such as Japan, Germany, and the oil-producing countries, non-governmental external investment is an important element to balance the BOP and non-financial investments constitute a considerable share. Taking Japan as an example, at end-2005, the government sector accounted for 24.5 percent of total external assets, the banking sector 24.5 percent, and combined enterprises and individuals 51 percent. As for Germany, the share of the government sector in external assets was only 4.4 percent at end-2005, the banking sector 45.5 percent, and combined enterprises and individuals 50 percent. The per capita national income in China reached US\$1740 in 2006. According to international experience in the correlation between per capita national income and external investment, China is likely to enter a period of a rapid increase in outward investment. In reality, China, as an important international manufacturing center and a major consumer of bulk commodities, needs both international and domestic markets to stabilize its supply of resources, explore markets, and manage relevant risks. Accordingly, China should explore a diversified and multi-layered approach to make use of foreign exchange, expand the investors' base, and increase the channels for using foreign exchange.

To establish such an approach, it is necessary to gradually relax the policy restrictions on the holding and purchase of foreign exchange and overseas investment by non-governmental entities; as a result, enterprises and households can keep foreign exchange income under the BOP or can purchase foreign exchange with RMB and

then use the foreign exchange abroad at their own will. Take the country as a whole, as different economic agencies have different risk preferences, a complete foreign exchange investment product line will come into being with different risks and corresponding returns. Based on the demands of the economic agencies, foreign exchange can be reallocated so as to help enhance the efficiency of resource allocation, improve the resource allocation structure, and address supply and demand imbalances in the foreign exchange market and rapidly reach an external equilibrium.

Combining the reality in China with international experience, the following factors should be taken into consideration to explore a diversified and multi-layered foreign exchange investment mode. First, a government foreign exchange investment institution that operates on a market basis to manage foreign exchange in line with relevant regulations should be established. Such an institution will receive foreign exchange at cost and will operate under supervision with a view to increasing the value of foreign exchange. Second, outward investment channels for domestic enterprises and households should be expanded, they should be encouraged to invest in shares, funds, and basic financial products, and returns on foreign exchange investment should be increased. Third, based on comparative advantages, the relocation of production chains through the establishment of new enterprises with direct outward investment should be promoted to accelerate the upgrading of the domestic industrial structure. Fourth, domestic non-governmental entities should be supported to stabilize supplies of resources and to invest in leading industries via international markets; Fifth, the development of commercial banks in a global perspective should be defined and financial enterprises should be encouraged to go abroad since the joint-stock reform of commercial banks has achieved progress.

It is crucial to encourage enterprises and households to invest abroad. According to international experience, government policy support is a main driving force to promote non-governmental external investment. A series of policies to relax restrictions on the holding and use of foreign exchange by non-governmental entities has been adopted since the reform of the RMB exchange rate regime in 2005. First, approval requirements for opening foreign exchange accounts under the current account were abolished, and the quota on foreign exchange retention by domestic institutions in their foreign exchange accounts under the current account was increased. Enterprises that need to pay for imports are allowed to purchase foreign exchange in advance and foreign exchange sales and payment procedures for the services trade have been streamlined as well. Second, foreign exchange purchase procedures for domestic residents were simplified and an annual quota was adopted to

facilitate foreign exchange receipts and payments by individuals. Third, limits on foreign exchange purchases for FDI were relaxed. The case-by-case approval of guarantees provided by domestic-designated foreign exchange banks to enterprises for financing their overseas investments was replaced by annual balance management. Fourth, domestic banks have received support for providing overseas wealth management services to their clients. As of end-2006, 15 commercial banks were approved a total foreign exchange purchase quota of US\$13.4 billion for their overseas wealth management business on behalf of clients. Fifth, securities companies including fund management companies were promoted to invest in foreign securities on a pilot basis. Sixth, insurance companies were encouraged to invest abroad with purchased foreign exchange. As of the end of 2006, 15 insurance companies were allowed a total overseas investment quota of US\$5.174 billion.

To accelerate non-governmental external investment in the future, efforts should be made to strengthen policy coordination among relevant departments, advance RMB convertibility under the capital account, establish a policy supporting system to support external investment, improve the mechanism for taking and transferring RMB exchange rate risks, and create a favorable policy environment. First, efforts should be made to continue to relax the restrictions on enterprises and the holding of foreign exchange by residents and to increase their independence in holding foreign exchange. Second, the external investment channels for financial institutions, enterprises, and residents should be expanded. Third, legislation should be adopted to support and provide guarantees for outward direct investment. Fourth, non-governmental external investments should be encouraged and supported through the government foreign exchange investment company.

Wider use of foreign exchange by China will not affect US Dollar assets. First of all, we are studying how to expand foreign exchange investment channels under the circumstances of continued foreign exchange inflows in order to find a way to invest the foreign exchange increments. The existing foreign exchange assets will not be affected. And we will not sell a large amount of US Dollar assets. Furthermore, the US Dollar remains the major reserve currency held by many countries in their official foreign exchange reserves. The US money and capital market is the leading mature market in the world in terms of depth and scope. In the long run, US Dollar assets will be a major component in the external investments by various countries, including China, and their non-governmental entities.

Part 3 Financial Market Performance

I. An overview of financial market performance

In the first quarter of 2007, the financial market continued to evolve in a sound and steady manner, with brisk trading activities on the money market and capital market, an upward and steeper yield curve on the bond market, rapid development of the foreign exchange market, and improved market structure and institutional building.

Since the beginning of 2007, there has been stable and rapid growth in the national economy, a strong fund demand from enterprises, especially a large increase in the volume and shares of loan financing and stocks financing by the domestic non-financial institution sector, including households, enterprises, and the government sector. In contrast, the volume of government financing dropped slightly in the first quarter mainly due to the decrease in the fiscal deficit and long-term construction treasury bonds after the continued implementation of a sound fiscal policy. Corporate bonds saw a large decrease year on year due to various factors such as short-term financing bonds coming due, 61.3 billion yuan of which came due in the first quarter, 59.8 billion yuan more than in 2006.

Table 3: Financing by the Domestic Non-financial Sector in Q1, 2007

	Volume of financing (100 million yuan)		As a percentage of total financing (percent)	
	Q1, 2007	Q1, 2006	Q1, 2007	Q1, 2006
Financing by domestic non-financial sectors	14631	14048	100	100
Bank loans	14293	12822	98	91
Equities	316	72	2	1
Government securities	-19	349	0	2
Corporate bonds	41	805	0	6

Source: The People's Bank of China.

1. Trading volume on the inter-bank market reached a new high and market interest rates remained low

The first quarter of 2007 saw brisk transactions and a new high of daily trade volume on both the inter-bank repo and borrowing market due to a series of factors, such as the stable and rapid growth of the national economy, the brisk stock market, and Chinese Spring Festival. Fund demand continued to display a trend of shortening maturities. Most of the transactions were overnight products featuring borrowing and repo overnight products, accounting for more than half of the total on the inter-bank market, a record high level. In the first quarter of 2007, the turnover of bond repo on the inter-bank market registered 7.8 trillion yuan, with a daily turnover averaging 131.8 billion yuan and a year-on-year growth of 53.6 percent. Inter-bank borrowing reached 1 trillion yuan, with the daily turnover averaging 16.3 billion yuan and a growth of 1.6 times year on year.

Money market interest rates fluctuated slightly in the first quarter of 2007 due to the implementation of monetary policies, Chinese Spring Festival, and the issuance of new stocks, but rose at end-March stemming from the effective implementation of central bank policies. In general, interest rates in the money market remained low and liquidity was abundant in the first quarter of 2007. The interest rates of 7-day bond pledged repo and 7-day Shibor were both 1.97 percent. Short-term rates continued to be affected significantly by the issuance of new stocks, especially the financing of big caps. In particular, 7-day bond pledged repo rates rose to a new peak of 4.6 percent on February 12 due to the 38.9 billion yuan IPO of Ping An of China, up 0.6 percentage points over the peak in 2006.

On the repo market (including bond pledged repo and outright bond repo), there was a large increase in the net lending of state-owned commercial banks in the first quarter, which amounted to 3 trillion yuan. The state-owned commercial banks had a large increase in lending and an evident increase in fund lending on the inter-bank market in the first quarter, reflecting the abundant liquidity in the state-owned commercial banks. Other commercial banks¹ and foreign financial institutions saw a rapid increase in fund borrowing, indicating their large demand for funds. On the inter-bank

¹ Other commercial banks include joint-stock commercial banks and city commercial banks.

borrowing market, net lending by other commercial banks increased markedly compared with the same period of the previous year, while net borrowing by securities companies and fund management companies rose remarkably.

Table 4: Fund Flows among Financial Institutions in Q1, 2007

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	Q1, 2007	Q1, 2006	Q1, 2007	Q1, 2006
Four State-Owned Commercial Banks	-29494	-25221	-313	-602
Other Commercial Banks	3112	8039	-2328	-1116
Other Financial Institutions	20277	14831	1980	1232
Of which: Securities and Fund Management Companies	3213	4193	1439	730
Insurance Companies	5512	3913	—	—
Foreign Financial Institutions	6105	2351	661	486

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

Source: The People's Bank of China.

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

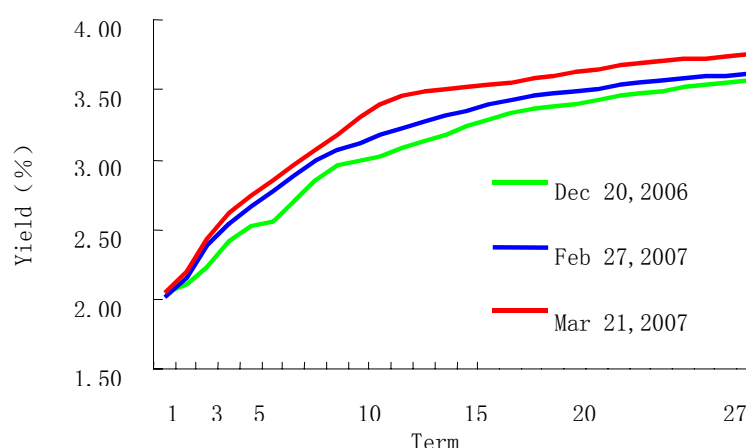
The spot market traded briskly in the first quarter of 2007 with a large fund demand on the market. The turnover of spot transactions on the inter-bank bond market totaled 2.6 trillion yuan, with a daily turnover averaging 43.8 billion yuan, a year-on-year increase of 14 percent. The turnover of government bond spot transactions on the organized exchanges registered 31.7 billion yuan. Interest rate swap transactions, as an effective instrument in interest rate risk management on the bond market, rose dynamically since 2007 and played a positive role in safeguarding financial stability and accelerating financial market development. The principal in interest rate swap transactions amounted to 39.1 billion yuan in the first quarter of 2007, surpassing the

total principal in 2006. Bond forward transactions were buoyant, with a turnover of 34.7 billion yuan in the first quarter and large shares of short-term products.

On the inter-bank spot transaction market, the state-owned commercial banks were the largest net purchasers, with a net purchase of 248.5 billion yuan, a year-on-year increase of 65.3 percent. Other commercial banks and securities companies had a large increase in fund demand, with a net sale of 329.9 billion yuan and 89.8 billion yuan respectively, a year-on-year increase of 93 percent and 6.3 percent each. The rapid increase in fund demand by the securities companies was fueled by the booming domestic stock market during this quarter.

The inter-bank market bond index and the stock exchanges bond index remained stable in the first quarter of 2007. The inter-bank market bond index dropped to 116.51 points at end-March from 116.79 at beginning-2007. The stock exchanges bond index rose to 111.73 points at end-March from 111.39 points at beginning-2007. Bond prices on the inter-bank market declined steadily, accompanied by a rising bond yield across the spectrum. Affected by multiple factors such as the interest rate hike and the issuance of 10-year government securities, the yield curve of government securities on the inter-bank bond market displayed an overall upward trend. The yield of long-term bonds climbed evidently, with a steeper yield curve. The market has stronger expectations of rising interest rates in the future.

Graph 3: Yield Curve of Government Securities on the Inter-bank Bond Market in Q1, 2007



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

The primary market continued to expand steadily. In the first quarter of 2007, a total of 343.4 billion yuan in bonds (excluding central bank bills) was issued, an increase of 27.2 billion yuan, or 8.6 percent, from the previous year. In terms of instrument category, financing instruments on the market were still dominated by government securities, policy financing debt, and corporate debt, with issuance of 116.0 billion yuan, 117.1 billion yuan, and 66.4 billion yuan respectively and a combined market share of 87 percent of the total on the market.

Innovative products on the bond market were further diversified. Direct financing by commercial banks expanded, with the stock of commercial bank financial bonds reaching 78 billion yuan at end-March. The short-term financing bill market showed steady growth. In the first quarter, a total of 59 short-term financing bills, worth 60.49 billion yuan, was issued by 56 enterprises, a year-on-year increase of 6.3 percent. In particular, one-year short-term financing bills took the lion's share, accounting for 76.4 percent of the total. At end-March, a total of 379 short-term financing bills, worth 494.14 billion yuan, had been issued by 235 enterprises; a total of 145 short-term financing bills, worth 228.26 billion yuan, had been redeemed at maturity; a total of 234 short-term financing bills were not due, with an outstanding balance of 265.88 billion yuan.

The issue rates of bonds edged up and financing costs continued to rise, affected by expectations of inflation and a series of macro-economic management measures, especially the hike in the deposit and lending rate by 0.27 percentage points. In March, the interest rate on 10-year book-entry treasury bonds issued in March was 3.4 percent, up 0.48 percentage points from September 2006; the interest rate on 5-year fixed rate bonds issued by the China Development Bank in January was 3.5 percent, a rise of 0.35 percentage points from the fourth quarter of 2006. At present, there are stronger expectations in the market for a rising interest rate. The issue rates on short-term financing bills were basically stable, with a slight fall. The issue rates on 1-year financing bills ranged from 3.40 percent to 4.5 percent.

Box 3: The Inter-bank Bond Market Expanded Steadily

Since its inception in 1997, the inter-bank bond market has grown in a steady and sound manner. First, participants on the inter-bank market are diversified, including a large number of non-financial institution legal persons in addition to financial institutions such as commercial banks, insurance companies, and securities companies. At end-2006, there were 6,439 institutional investors on the inter-bank market, including 1,989 financial institutions and 4,450 non-financial institution legal persons. Second, the width and depth of the inter-bank bond market is continuing to expand. At end-2006, the volume of custodial bonds on the inter-bank market reached 8.4 trillion

yuan, accounting for 95.6 percent of the total stock of tradable bonds; in 2006, the cumulative turnover on the inter-bank market amounted to 36.6 trillion yuan, an increase of 68.5 percent from the previous year. Third, the inter-bank bond market has become the dominant channel for bond financing in China. A total of 5.6 trillion yuan of bonds was issued on the inter-bank bond market in 2006, accounting for 94.4 percent of the total in 2006, including 651.9 billion yuan of government securities, 954.4 billion yuan of policy financial bonds and financial bonds, and 292.0 billion yuan of enterprise short-term financing bills. Fourth, innovations in bond products are frequently launched. A series of products was introduced on the market such as commercial bank subordinate bonds, common financial bonds, international development institution bonds, hybrid capital bonds, and short-term financing bills; innovative bond trading instruments, including outright bond repo, forward, and interest rate swaps, were introduced to respond to the demand of the OTC market. Fifth, institutional building on the bond market proceeded smoothly, featuring the reform of the market-based bond issuance management mechanism, the adoption of an approval and filing system for bond issuance, and stronger information disclosure and credit rating management; the bond market infrastructure has been improved, due to the frequent upgrading of the bond transaction system and the registering and custodial system, and adoption of the international practice of delivery versus payment (DVP) and straight through processing (STP).

The deepening of the functions of the inter-bank bond market can be attributed to the choice of a correct development model. There are two types of bond markets. One is the exchange market model based on securities exchanges, and the other is the OTC market based on price inquiries. Generally, bonds are considered suitable for OTC transactions by institutional investors due to the following reasons. First, bond products are diversified in category, structure, and credit rating; investment decisions need to be supported by a tremendous amount of information collection and processing, which is beyond the ability of individual investors, but more suitable to institutional investors with a strong market analysis capacity and a risk tolerance capacity. Second, as a fixed-income instrument, bonds have certain future cash flows, stable returns, and low yields. Only bulk transactions can lower costs and produce returns of scale. So they are suitable for trading on the OTC market. The volume of a single transaction of bond repo on the inter-bank market averaged 430 million yuan in the first quarter of 2007. It is difficult for the centralized quotation system in the exchange market to find such a large value transaction order in the opposite direction and at the same price within a short time. Large price fluctuations would usually occur, while on the OTC market, a large market-maker or brokers can find a suitable counter party through a price inquiry to strike a smooth deal. Third, various elements such as

the issuer, the maturity, and the category make up a bond, and there are a large variety of bond products. Each bond needs a unique transaction code. A large number of codes would be needed if all bonds were to be listed on the securities exchanges. Furthermore, the code resources of the securities exchanges would be wasted given the bulk and wholesale nature and the low frequency of bond transactions, reducing the efficiency of the securities exchanges. According to the experience of development in the international bond market, the OTC market is the major form and developmental direction of the bond market. In those countries with advanced financial markets such as the United States and Japan, the majority of bonds are issued and traded on the OTC market, and the turnover on the OTC market accounts for over 95 percent of the total.

Given the major participants on the inter-bank bond market are institutional investors, the OTC market was specified at the advent of the inter-bank bond market in China, and the inter-bank bond market will be built into an OTC market featuring price inquiries by the two parties and will be suitable for bulk and wholesale transactions. In recent years, the functions of the inter-bank market have been enhanced and it has become a primary component of a multi-layered financial market, as part of the efforts of the PBC to implement and realize the requirements of the State Council on a market-based principle and to foster development of the inter-bank market.

3. Commercial paper business declined slightly

In the first quarter of 2007, a total of 1.4 trillion yuan of commercial bills was issued by the corporate sector, up 3.4 percent year on year; discount bills totaled 2.6 trillion yuan, up 13.9 percent from 2006; and rediscount bills reached 0.54 billion yuan, a year-on-year increase of 0.52 billion yuan. At end-March, the outstanding balance of commercial paper registered 2.3 trillion yuan, down 0.17 percent from the previous year; the outstanding balance of discount bills was 1.8 trillion yuan, down 6.6 percent from the previous year; and the outstanding balance of rediscount bills was 0.94 billion yuan, 0.8 billion yuan more than that in 2006.

Outstanding commercial bills declined on a year-on-year basis, and new discount loans decreased year on year. At end-March, discount loans accounted for 7.5 percent of all loans, down 2 percentage points from the previous year. New discount loans amounted to 81.9 billion yuan in the first quarter, 228.5 billion yuan less than in 2006, and accounted for 5.8 percent of all new loans, down 19 percentage points from the previous year. At present, commercial banks are making vigorous efforts to transform operation guidelines and to strengthen economic capital accounting. Commercial

banks are not as willing as before to accept commercial bills for they have a low premium against the risks they bear and cannot meet the requirements for economic capital accounting. In addition, commercial banks would make the discount the first choice when contracting credit aggregates given the higher yields of loans over discounts. As an important channel for commercial banks to adjust the credit aggregate and structure, the commercial bill business will face mixed impacts in its macro-economic management fluctuations, profit targets, and capital adequate ratios.

4. Both the turnover and index of the stock market reached a record high

The stock market continued to expand dynamically in 2007. Due to the rapid economic growth and the unfolding positive effects of the non-tradable shares reform, investors have a remarkably stronger willingness to invest on the stock and fund markets, as reflected in the 8.71 million yuan of new account openers in the first quarter, 1.7-fold of the total in 2006, and a record high in both the turnover and index. In the first quarter of 2007, the total turnover of the Shanghai and Shenzhen Stock Exchanges reached 7.5 trillion yuan, 6.4 trillion yuan more than 2006 and near the total of 2006; the average daily turnover increased 5.6-fold to 131.6 billion yuan. At end-March, the Shanghai Stock Exchange Composite Index closed at 3184 points, a rally of 509 points, or 19 percent, from end-2006. The Shenzhen Stock Exchange Composite Index closed at 826 points, a soar of 275 points, or 50 percent, from end-2006. At end-March, the total capitalization of the Shanghai and Shenzhen Stock Exchanges recorded 12.8 trillion yuan, up 43.2 percent from end-2006.

In the first quarter of 2007, a total of 86.5 billion yuan was raised by Chinese enterprises through IPOs, additional offerings, and rights issues on equity markets at home and abroad, 12-fold the amount during the same period of the previous year. In particular, a total of 84.6 billion yuan and US\$0.22 billion was raised on the A-share and H-share markets respectively.

Fueled by the soaring index, higher returns, and wider recognition of fund products, investors have a rising demand for wealth management products in funds, as reflected in the pronounced increase of sales of funds. In the first quarter, a total of 18 securities investment funds were launched, 7 more than in 2006; the cumulative size and net value of the funds reached 822.5 billion yuan and 1.1216 trillion yuan, an increase of 72.5 percent and 123.6 percent respectively from the previous year, up 51

percentage points and 93.4 percentage points from 2006 respectively, both representing a large acceleration.

5. The insurance industry expanded briskly and assets grew at the highest pace since 2005

In the first quarter of 2007, total premium income in the insurance industry amounted to 196.5 billion yuan, up 22.7 percent year on year, with a large increase of income in life insurance and property insurance. With a large number of life insurance policies coming due, claim payments and benefits witnessed an 1.2-fold increase from the previous year to 69.6 billion yuan. In particular, life insurance payments grew 3.1-fold to 44.7 billion yuan. With the gradual expansion of insurance investment channels and favorable evolution of the financial market, the total assets of the insurance sector increased rapidly in the first quarter of 2007. At end-March, the total assets of insurance companies grew 37.1 percent to 2.24 trillion yuan, their highest growth rate since 2005. With strengthened management of insurance funds, investment assets swelled, with a year-on-year increase of 49 percent and a remarkable increase in shares in total assets.

Table 5: Use of Insurance Funds in Q1, 2007

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	Q1, 2007	Q1, 2006	Q1, 2007	Q1, 2006
Total assets	22440	16367	100.0	100.0
Of which, Bank deposits	6344	5488	28.3	33.5
Investment	14101	9463	62.8	57.8

Source: China Insurance Regulatory Commission.

6. The inter-bank foreign exchange market expanded at a rapid and sound pace

In the first quarter of 2007, the turnover on the inter-bank spot foreign exchange

market increased rapidly, with turnover on the OTC market accounting for over 99 percent of the total on the inter-bank foreign exchange market, reflecting its strengthened dominant role in the market. In the first quarter of 2007, a total of US\$5.32 billion was reached on the inter-bank forward market, up 55.8 percent from the previous year; a sum of US\$55.72 billion was reached on the RMB swap market, exceeding the total over the last nine months of 2006 (launched on April 2006). Most swap transactions were swap/forward swap transaction within 3 months, accounting for 81.3 percent of the total turnover of RMB and foreign exchange swap transactions. The foreign exchange market included more participants. At end-March, the number of members on the inter-bank foreign exchange spot market, forward market, and swap market hit 265, 80, and 71 respectively.

In the first quarter of 2007, the combined volume of 8 currency pairs trading on the inter-bank foreign exchange market amounted to US\$24.6 billion, with transactions in the major currency pairs of the USD/HKD, USD/JPY, and EUR/USD accounting for 74.1 percent of the total trading volume, down 14 percentage points from the previous year, mainly due to a large year-on-year decrease in the currency pairs of the USD/HKD.

II. Financial market institutional building

1. Liquidity in the bond market was enhanced through various channels

The market-maker system was further improved. The *Regulation on the Market-Maker System on the Inter-bank Bond Market* was issued in January to improve the present market-maker system framework through various channels, such as lowering market access, easing business requirements, and intensifying policy support and strengthening performance assessment, hence it has far-reaching significance for enhancing liquidity, facilitating price discovery, and promoting the development of the bond market. The issuance of the *Regulation* was well received, with trials of market-maker businesses by a large number of institutions and a large increase in bilateral quotes, quote volume, trade, and trading volume.

A net price transaction was realized for discount government securities. The *Circular of the Ministry of Finance, the People's Bank of China, and the China Securities*

Regulatory Commission on the Net Price Transaction of Discount Government Securities was released in March to improve net price transactions of government securities, facilitate fixed term revolving issuance of short-term government securities, address the levying of capital income tax on the accrued interest of discount government securities, further enhance the liquidity of the inter-bank bond market, and activate market transactions.

2. Risk management on the foreign exchange market was further intensified

Intensifying risk management on the foreign exchange market has become the top priority in the institution building on the foreign exchange market since 2007, given the deepening of the exchange rate regime reform and the enhanced flexibility of the RMB exchange rate. First, international advanced technology was introduced to establish a risk management platform for the exchange rate market in China. Second, a series of risk management instruments was launched through financial innovations to fortify risk management on the foreign exchange market. Third, a risk fund system was put in place in the China Foreign Exchange Trade System to forestall and mitigate any possible risks.

3. Reform of non-tradable shares in the listed companies was winding down, and the information disclosure system in the securities market was further improved

Reform of non-tradable shares in the listed companies was winding down. In line with the individual realities, since 2007 non-reformed companies can submit reform proposals to the stock exchanges at any time. For most non-reformed companies that are facing large deficits, frozen equity, fund seizures by large shareholders, and a low share of non-tradable shareholders, the non-tradable shares reform stalled. Accordingly, the China Securities Regulatory Commission and the Shanghai and Shenzhen Stock Exchanges intensified measures to guide and urge non-reformed companies, including requiring the non-reformed companies to release the proceedings of the non-tradable shares reform on a weekly basis.

In light of the new requirement of non-tradable shares reform on the information supervision of listed companies, the *Regulation on Information Disclosure of Listed Companies* was released on January 30 to further improve the rules and supervisory procedures of information disclosure, specify and regulate information disclosure, enhance the quality of information disclosure, the effectiveness of supervision, and

the transparency of the information disclosure of listed companies. The *Regulation on Securities Law Business by Law Offices* was issued to encourage market participants to strengthen self-restraint, facilitate a credit information system, fortify market discipline, and enhance the information disclosure of securities companies.

4. The futures market entered a new stage

The revised *Regulation on Futures Transactions* was released on March 6 and entered into force on April 15, ushering the futures market into a new stage. The *Regulation* expanded its validity to commodity futures and financial futures as well as option contracts from original commodity futures. It not only diversified the futures products and cleared the way for new products by financial futures exchanges, but also provided channels for investors to hedge risks and make profits. Also, the *Regulation* set a specific requirement for the establishment of a futures investor security fund as a component of an investor interest compensation mechanism, and for the introduction of a custodial supervisory system for futures deposits in addition to a futures deposit custodial regulatory institution. Based on the practical experience of the futures market supervisory institution since the rectification of the futures market, the *Regulation* specified the China Securities Regulatory Commission as the regulatory authority to supervise the futures market on a unified and comprehensive manner and to strengthen supervisory coordination on the market.

5. Institutional building was reinforced to enhance the competitiveness of insurance institutions

Four documents relating to regulating the governance structure of insurance companies, including the *Provisional Guidance on Risk Management of Insurance Companies*, were released to cement the foundation for policy supervision, define down the requirements on internal supervision mechanisms, facilitate the establishment of a modern enterprise system, and enhance the risk management capacity of insurance companies. The *Provisional Guidance on Credit Ratings of Bond Investments by Insurance Companies* was put in place to strengthen credit risk management of bond investments. Other regulatory documents such as the *Regulations on Actuarial Investment-based Insurance* were revised and issued to improve supervision and prevent risks.

Part 4 Macro-economic Analysis

I. Global Economic and Financial Development

Since the beginning of 2007, the global economy has been growing steadily and inflationary pressures have moderated. US growth continued but at a slower pace. The Euro zone and Japan saw steady growth. For most of the period, the international bond and foreign exchange markets were stable. In April 2007, the International Monetary Fund forecasted that global growth would reach 4.9 percent in 2007, 0.5 percentage point lower than that in 2006, and that US growth would slow down to 2.2 percent from 3.3 percent in 2006, the Euro zone 2.3 percent from 2.7 percent in 2006, and Japan would grow at 2.3 percent, the same level as that in 2006.

1. Development of the major economies

The US economy has been growing at a slower pace. In the first quarter real GDP grew at 1.3 percent,² 4.3 percentage points lower year on year. Inflation pressures receded as the month-on-month CPI for the first three months stood at 2.1 percent, 2.4 percent, and 2.8 percent, averaging 2.4 percent, which was 1.2 percentage point lower than that during the same period of the previous year. The development of employment was stable, with the unemployment rate in the first three months at 4.6 percent, 4.5 percent, and 4.4 percent, averaging 4.5 percent, slipping by 0.2 percentage points year on year. The goods and services trade deficit declined, reaching USD117.3 billion, USD12.1 billion lower than that in the previous year.

The Euro zone maintained steady growth. GDP grew at 2.7 percent in 2006, 1.3 percentage points higher than that in the previous year. The inflation pressures remained, as indicated by the HICP in the first three months of 2007, namely 1.8 percent, 1.8 percent, and 1.9 percent, averaging 1.8 percent, 0.5 percentage points lower year-on-year. The employment situation improved, with the unemployment rate at 7.4 percent, 7.3 percent, and 7.2 percent in the first three months respectively, noticeably lower than that during the same period of the previous year. In January and February, the trade deficit reached Euro 8.7 billion, down by Euro 4.6 billion year on year.

The recovery of the Japanese economy continued. In 2006 GDP grew at 2.2 percent, 0.3 percentage points faster than that in the previous year. There was no obvious change in inflation, the CPI rate stood at 0 percent, -0.2 percent, and -0.1 percent, averaging -0.1 percent, about the same level as that in the previous year. Employment improved further, with the unemployment rate lowered to 4 percent in the first three months. Exports continued to grow, with the trade surplus reaching Yen 2.6 trillion,

² Seasonally adjusted annualized rate. The first quarter GDP grew by 2.1 percent, 1.6 percentage points less than that during the same period of the previous year.

up by Yen 1.15 trillion.

The emerging economies and the developing countries maintained a momentum of rapid growth and inflation pressures were somewhat moderated. Driven by domestic demand and foreign trade, the emerging economies in Asia grew rapidly, while the economies in Latin America grew at a steady pace.

2. Financial market developments

Since the beginning of 2007, the Dollar depreciated against the Euro and the Yen. On March 30, 2007, the Euro/Dollar and Dollar/Yen rates closed at 1.34 and 117.78 respectively. The Dollar depreciated against the Euro and the Yen by 1.18 percent and 1.07 percent respectively since the beginning of the year.

The yields of major currency bonds showed moderate volatility. On March 30, 2007, the yields of 10-year US and Japan treasury bonds reached 4.65 percent and 1.65 percent, down 0.03 and 0.07 percentage points from the beginning of the year. The Euro zone 10-year treasury bond yield stood at 4.05 percent, up 0.12 percentage points.

The global equity indexes experienced drastic fluctuations. From the beginning of the year to February 26, 2007, the major indexes climbed rapidly. On February 27 and March 13, 2007 two major adjustments shook the market, which has since gradually recovered. On March 30, the Dow Jones Industrial Average reached 12354, down 0.97 percent from the beginning of the year; the NASDAQ remained unchanged at 2422; the Euro zone STOXX50 was 3709, down 1.01 percent, and the Nikkei index was 17288, down 0.38 percent.

In the first quarter, the London dollar Libor trended down as the market expected that US growth might slow down. On March 30, the one-year Dollar Libor was 5.22 percent, down 0.22 percentage point from the beginning of the year. In the first quarter, after the rate hike by the ECB, the Euro interest rate maintained a rising track. On March 30, the one-year Euribor climbed to 4.177 percent, or up 0.15 percentage points from the beginning of the year.

3. Monetary policy in the major economies

Since the beginning of 2007, the Fed Open Market Operations Committee kept the Fed fund rate unchanged at 5.25 percent. The ECB raised the refinancing rate by 25 basis points to 3.75 percent, the highest rate in the last three years. The Bank of Japan raised the non-guarantee overnight rate by 25 basis points to 0.5 percent. The Bank of England raised the official interest rate by 25 basis points on January 11 to 5.25 percent.

4. Major risks in the global economy

The major risks facing the global economy are the high and fluctuating oil prices, the resurgence of protectionism, and balance of payments imbalances. If the Middle East and other geopolitical uncertainties intensify, world oil prices may rebound. Since the beginning of 2007, oil prices have climbed. On March 30, WTI light oil closed at one of its historical highs of USD65.87. With the global imbalances becoming exacerbated and growing concern among the developed countries about competition from the emerging markets, protectionism resurged and trade frictions spread to the services trade and investment. As hedge funds continued to attract more fund inflows, the potential risks to financial stability grew. The large amount of OTC transactions of hedge funds can circumvent market discipline and financial regulations and supervision. The impacts of sub-prime mortgage lending on the US housing market, financial industry, and even the US economy warrant close monitoring. Uncertainties remain regarding the Yen carry trade and the balancing of this trade as well as its effects on the management of global financial markets.

II. Analysis of China's macro-economic performance

In the first quarter of 2007, the national economy maintained a momentum of steady and rapid growth. The growth of consumption accelerated, agricultural production remained stable, economic efficiency continued to be enhanced, and the consumer price index (CPI) increased slightly. In the first quarter, the GDP reached 5 trillion yuan, a growth of 11.1 percent and an acceleration of 0.7 percentage points on a year-on-year basis; the CPI rose by 2.7 percent year on year, an acceleration of 0.7 percentage points year on year; the trade surplus registered US\$46.44 billion, US\$23.14 billion more than that during the same period of the previous year.

1. Growth of consumption further accelerated, fixed-asset investment growth remained strong, and the trade surplus continued to widen

The growth of household income accelerated and domestic consumer demand was strong. In the first quarter, the per capita disposable income of urban residents stood at 3,935 yuan, a nominal growth of 19.5 percent, an inflation-adjusted real growth of 16.6 percent, and an acceleration of 5.8 percentage points on a year-on-year basis. The per capita cash income of rural residents amounted to 1,260 yuan, a nominal growth of 166 yuan or 15.2 percent, an inflation-adjusted real growth of 12.1 percent, and an acceleration of 0.6 percentage points on a year-on-year basis, the highest growth since 1997 during the same period. The steady increase in urban and rural household income supported sustained consumption growth. In the first quarter, the total volume of retail sales reached 2.1 trillion yuan, an inflation-adjusted real growth of 12.5 percent and an acceleration of 0.3 percentage points over the previous year. In particular, the volume of urban retail sales grew by 15.5 percent to 1.4 trillion yuan,

and the volume of retail sales at and below the county level grew 13.7 percent to 0.7 trillion yuan, resulting in a 0.1 percentage points narrowing of the growth gap of 1.8 percentage points between urban and rural retail sales.

The size of fixed-asset investments was still relatively large and their growth remained strong. In the first quarter, total fixed-asset investment posted 1.8 trillion yuan, a growth of 23.7 percent on a year-on-year basis. In particular, urban fixed-asset investment reached 1.5 trillion yuan, a growth of 25.3 percent year on year and an acceleration of 0.9 percentage points compared with the growth in the first two months of the year; rural fixed-asset investment grew by 16.7 percent to 0.3 trillion yuan. In terms of the geographical distribution of fixed-asset investments, fixed-asset investment in central China grew at a relatively fast pace. Urban fixed-asset investment in central, eastern, and western China rose by 21.4 percent, 35.8 percent, and 26.8 percent respectively, with the proportion of fixed-asset investment in central and western China increasing by 1.6 percentage points and 0.2 percentage points respectively. In terms of industrial allocation, urban fixed-asset investment in the primary, secondary, and tertiary industries grew by 20.3 percent, 27 percent, and 24 percent respectively, with the investment growth of secondary industry remaining rapid. The investment size of new projects declined, while that of projects under construction still remained relatively large. In the first quarter of 2007, the number of new projects totaled 30,000, down 2,294 on a year-on-year basis. The total planned investment of new projects amounted to 1.3 trillion yuan, down 13.9 percent. The number of projects under construction was 93,000, up 5,827 from the same period of 2006. The total planned investment of projects under construction amounted to 14 trillion yuan, up 16 percent from the previous year.

The growth of exports and imports increased rapidly and the trade surplus further widened. In the first quarter of 2007, total trade volume reached US\$457.7 billion, an increase of 23.3 percent and a deceleration of 2.5 percentage points on a year-on-year basis. Specifically, exports posted US\$252.1 billion, up 27.8 percent, an acceleration of 1.2 percentage points on a year-on-year basis; imports registered US\$205.7 billion, up 18.2 percent, a deceleration of 6.6 percentage points. Driven by general trade and the processing trade, the trade surplus in the first quarter recorded US\$46.44 billion, up US\$23.1 billion over the previous year.

2. Output grew substantially, and enterprise operational profits continued to improve

The secondary industries continued to maintain rapid growth, and the growth of the tertiary industries accelerated. In the first quarter of 2007, the primary industries realized a value added of 0.4 trillion yuan, representing a growth of 4.4 percent and a deceleration of 0.1 percentage points year on year; the secondary industries realized a

value added of 2.6 trillion yuan, representing a growth of 13.2 percent and an acceleration of 0.5 percentage points year on year; the tertiary industries realized a value added of 2.1 trillion yuan, representing a growth of 9.9 percent and an acceleration of 1 percentage points year on year.

The situation for agricultural production was good. The sown area of grain increased slightly. The sample survey on plans for crop growing by the National Bureau of Statistics (NBS) indicated that, in 2007, the total sown area of grain was estimated to grow by 0.5 percent on a year-on-year basis to 1.59 billion mu, increasing for four consecutive years. The rise in the production prices of agricultural products (i.e., the prices at which producers of agricultural products directly sell their products) was higher than the rise in the prices of agricultural production materials, which is conducive to increasing the farmers' income.

Industrial production grew rapidly, and enterprise profits continued to improve. In the first quarter, the industrial value added of the statistically large enterprises grew 18.3 percent, accelerating by 1.6 percentage points on a year-on-year basis. In the first two months, profits of the statistically large enterprises posted 293.2 billion yuan, a growth of 43.8 percent and an acceleration of 22 percentage points. On the one hand, this indicated a continued improvement in the performance of enterprises. On the other hand, it should be noted that the new *Enterprise Accounting Rules* followed by listed companies since January 1, 2007 focused more on the fair value and added the changes in the fair value of more assets and liabilities to profits, which will probably increase the overall profits of enterprises. The 2007 First Quarter Survey on 5,000 Enterprises by the PBC indicated that the general business condition index reached 30.3 percent, up 6.1 percentage points over that recorded in the previous year.

3. The rise in the Consumer Price Index (CPI) accelerated

Since the beginning of 2007, the year-on-year growth of the CPI accelerated month by month. In the first quarter, the monthly CPI rose by 2.2 percent, 2.7 percent, and 3.3 percent respectively, with the growth of the CPI averaging at 2.7 percent, an acceleration of 1.5 percentage points on a year-on-year basis. New factors contributed 1.2 percentage points or 44 percent of the rise in the CPI, while basic factors contributed 1.5 percentage points, or 56 percent, of the rise in the CPI. Specifically, food prices rose by 6.2 percent, contributing 2.1 percentage points or 78 percent of the rise in the CPI, which were the main factors pushing up the CPI. Housing prices increased by 3.8 percent, also contributing to the CPI increase.

In the first quarter, the purchasing prices of industrial raw materials, fuels, and power decelerated gradually, while the factory prices of industrial products increased at a

steady pace, increasing by 4.1 percent and 2.9 percent respectively, down 1.9 percentage points and 0.1 percentage points respectively compared with those recorded in 2006. The production prices of agricultural products rose sharply by 7.3 percent year on year. In particular, grain production prices increased by 7.3 percent, prices of husbandry products rose by 13.8 percent, and the prices of agricultural production materials increased by 4.2 percent from the previous year, all lower than the rise in the production prices of agricultural products.

The year-on-year growth in the customs prices of imports accelerated and the customs prices of exports remained stable. In the first three months of 2007, the year-on-year growth of import prices was broadly stable, registering 4.7 percent, 4.8 percent, and 4.7 percent respectively; the year-on-year growth of export prices posted 5.4 percent, 4.6 percent, and 5.9 percent respectively.

Labor compensation grew rapidly. In the first quarter, the average monthly salary of employees in urban China was 5,516 yuan, 17.8 percent higher than that during the same period of the last year. In particular, the average monthly salary of employees in state-owned units posted 5,913 yuan, up 19.3 percent; that of employees in collectively-owned units was 3,251 yuan, up 17.1 percent; and that of employees in units of other ownership was 5,319 yuan, up 15.4 percent year on year.

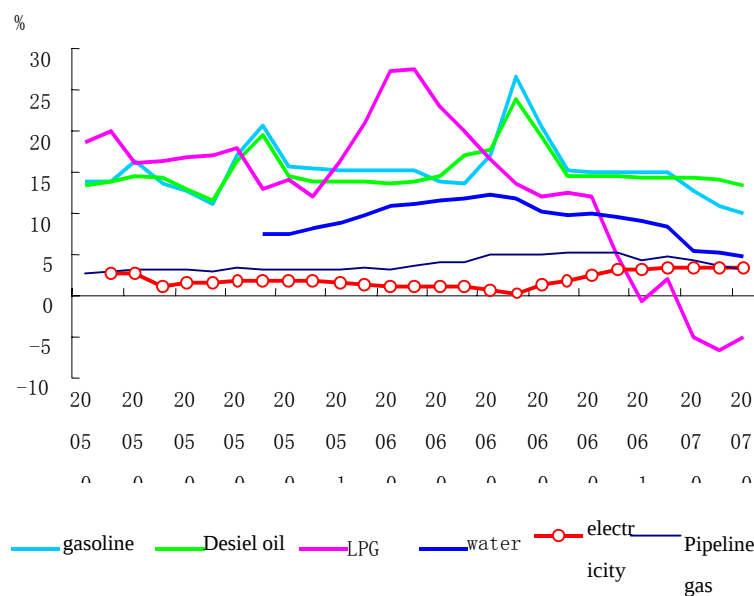
The GDP deflator increased evidently. In the first quarter, the nominal GDP growth rate was 14.7 percent and the real GDP growth rate was 11.1 percent, resulting in a 3.6 percent GDP deflator (the difference between the nominal GDP growth rate and the real GDP growth rate), up 1.1 percentage points on a year-on-year basis.

Price reforms for natural resource products were carried out steadily. In January 2007, the National Development and Reform Commission announced that China will adopt a new refined oil pricing system based on the calculation of crude oil plus relevant costs and government subsidies on oil will be gradually abolished, indicating that the market-based reform of oil prices had entered a concrete operational stage. The new pricing system set the refined oil prices based on the crude oil prices in Brent, Dubai, and Minas, plus certain costs and profits of oil refineries. The introduction of the new refined oil pricing system will enhance the marketization of oil prices and the frequency of refined oil price adjustments, which will further promote the market-based reform of oil prices. The reform of the price of electricity was also underway. In June 2006, the National Development and Reform Commission raised on-line electricity prices in 25 provinces by an average of 1.174 fen/kwh and the selling prices of electricity by an average of 2.5 fen/kwh. Governments at provincial, municipal, as well as district levels all announced an increase in the price of

electricity used by industries and households.

Reforming the prices of natural resources is imperative to the efforts to build an energy-conserving society, to maintain sustainable economic growth, and to improve the effectiveness of the monetary policy. Since domestic resource prices were long been kept under control, most of the resources prices were lower than those in international markets, which stimulated the rapid growth of exports and widened the trade surpluses, leading to increasing pressures on foreign exchange surrender and expectations of an appreciation of the RMB exchange rate. As a result, international speculative capital flowed into China rapidly, which brought a surplus under the capital account and ultimately resulted in BOP imbalances and pressures for a RMB exchange rate appreciation. In the long run, the reforms will facilitate a transformation of the economic growth pattern, improve the environment for the conduct of monetary policy, and help bring the economy onto a path of sustainable growth. But in the short run, the reforms might cause certain increases in prices. Therefore, efforts should be made to appropriately control the pace of the reforms and to take into full account the impact of price rises and price-adjusting measures on the lives of low-income people.

Figure 4: Movements of major resource prices since 2005



Source: National Statistics Bureau

4. Fiscal revenue grew substantially

In the first quarter of 2006, fiscal revenues (excluding funding from the issuance of

bonds) amounted to 1.18 trillion yuan, growing 26.7 percent and accelerating by 7.2 percentage points over the same period of the last year; fiscal expenditures amounted to 0.73 trillion yuan, growing 15.8 percent and decelerating by 5 percentage points. Netting revenue and expenditure, fiscal revenues surpassed fiscal expenditures by 0.45 trillion yuan, up 0.15 trillion yuan on a year-on-year basis.

The main tax categories maintained rapid growth. In particular, both the corporate income tax and personal income tax saw growth of 25.2 percent. The value added tax and consumption tax for domestic products rose by 20.0 percent and 22.2 percent respectively, while the consumption tax and value added tax for imports increased by 27.8 percent. In the first quarter, due to the vibrant securities transactions, the stamp tax revenue registered 12.2 billion yuan, increasing by 515.9 percent on a year-on-year basis.

Fiscal expenditures increased sharply in agriculture, social security, and social development. Specifically, expenditures on social security and employment, education, urban and rural community affairs, and public security grew by 30.5 percent, 22.4 percent, 29.9 percent, and 16.5 percent respectively.

5. The balance of payments maintained a surplus

In the first quarter of 2007, China's BOP continued to maintain a pattern of "twin surpluses" under the current account and the capital account, and the official foreign exchange reserves grew briskly. At end-March, the official foreign exchange reserves reached US\$1202 billion, up US\$135.7 billion from the end of 2006 and US\$79.5 billion more than the growth recorded in the previous year. The reserves buildup was attributed to several reasons. First, the trade surplus and FDI grew at a rapid pace. In the first quarter, the trade surplus amounted to US\$46.44 billion, twice as much as in the same period of the last year. The actual utilization of FDI reached US\$15.9 billion, up 11.6 percent. Second, the surrender of foreign exchange funds raised by financial institutions and enterprises through IPOs in overseas markets also led to an increase in foreign exchange reserves.

The growth of external debt picked up slightly. At the end of 2006, the outstanding external debt stood at US\$323 billion, up US\$41.9 billion or 14.9 percent from the previous year, accelerating by 1.4 percentage points. In particular, short-term debt still maintained rapid growth, while the growth of medium- and long-term debt escalated by a large margin. At end-2006, short-term debt was US\$183.7 billion, up US\$27.5 billion or 17.6 percent from the end of 2005, and medium- and long-term debt registered US\$139.4 billion, up US\$14.5 billion or 11.6 percent.

Box 4: Analysis of the Balance of Payments

A country's international payments and receipts are reflected in its balance of payments account, which is a statistical statement that systematically records, within a specific time period (usually one year), all transactions between residents (those who have resided in the country for at least one year) and non-residents.

The balance of payments statement consists of four major components, i.e., the current account, the capital and financial account, reserve assets, and net errors and omissions. The current account is an important part of the balance of payments and transactions under the current account reflect the activities of entities in the real economy of a country. Specifically, current account transactions include trades in goods and services, net factor income, and current transfers. The capital and financial account has two major components—the capital account and the financial account. The financial account covers all transactions that result in changes in a country's claims on and liabilities to the rest of the world. It can be divided into three major categories based on the investment types, i.e., direct investment, portfolio investment, and other investment. Reserve assets refer to the external assets of the monetary authority, and are otherwise called official reserves or international reserves. Reserve assets include foreign exchange, monetary gold, SDRs, and the reserve position in the IMF. Foreign exchange reserves are the most important component. China began a balance of payments statistical compiling and reporting system in 1996, and compiled its balance of payments account in accordance with the fifth edition of the *Balance of Payments Manual* published by the IMF.

Since the reform and opening to the outside world, China's balance of payments have continued to expand. Before 1993, the current account surplus and capital and financial account surplus alternated. After 1994, the balance of payments has experienced a "twin surplus." In particular, since 2001, when China joined the WTO, the BOP surplus has grown rapidly. The cumulative current account surplus reached US\$328.2 billion and that of the capital and financial account reached US\$293.5 billion between 2001-2005, representing growth of 1.8 times and 3.7 times of the respective surpluses during the period from 1996 to 2000. Driven by the strong surpluses, the official foreign exchange reserves built up rapidly. At the end of 2006, foreign exchange reserves stood at US\$1066.3 billion, or 5.4 times the level at the end of 2000.

In recent years, the current account surplus has expanded by a large margin and has become the main source of the balance of payments surplus. In 2006, the current account surplus made up 96 percent of the balance of payments surplus, 24 percentage points higher than that in 2005. The share of the current account surplus in GDP has jumped from 2.9 percent in 2000 to 9.5 percent in 2006. The current account surplus mainly consists of a surplus of trade in goods. In 2006, the surplus in trade in goods

reached US\$217.7 billion, accounting for 84 percent of the total balance of payments surplus in the year. At the same time, the deficit in the trade in services became larger, mainly due to the increasing deficit in services related to transportation and insurance and the deceleration in tourism income. In 2006, the deficit in trade in services was US\$8.8 billion. With the growth of China's external assets and investment income, the net factor income deficit has been declining and in 2006 turned into a surplus of US\$11.8 billion, up 11 percent from the previous year. The surplus of current transfers has been expanding, reaching US\$29.2 billion, an increase of 15 percent year on year.

In 2006, the surplus of the capital and financial account accounted for 4 percent of the balance of payments surplus. A major contribution came from direct investment. In recent years, actual utilized foreign direct investment stabilized at around US\$60 billion. With the adoption of the "going overseas" strategy, overseas investment by domestic enterprises expanded significantly. However, as the base number was small, direct investment items still showed a fairly large net inflow. In 2006, the surplus in direct investment was 6 times the capital and financial account surplus. Given the asset allocations of domestic financial institutions, overseas listings, and changes in the external debt, inflows and outflows under portfolio and other investment items have grown rapidly in volume and have experienced large fluctuations, showing an alternating surplus and deficit.

China's huge and persistent balance of payments surplus is the product of the combined effects of complicated domestic and foreign factors. The growing trade surplus has been the result of stronger export competitiveness from the deep industrialization, high labor productivity, strong manufacturing capacity, and low labor costs. In the process of opening to the outside world, the stable political and economic environment and excellent investment opportunities have attracted a large inflow of funds and relocation of production, making China one of the major manufacturing centers in the world. Domestic consumption has been growing slowly, leaving national savings higher than domestic investment and resulting in a continued current account surplus. At the same time, for a very long period of time, China has put great emphasis on expanding exports and attracting foreign direct investment, and has imposed limits on capital outflows. The favorable global economic development has also contributed to China's BOP surplus.

The massive BOP surplus and rapid growth in foreign exchange reserves are beneficial to building up China's ability for foreign payment and settlement, strengthening confidence in the Chinese economy, creating favorable conditions for domestic economic development and deeper reform. However, the continued large surplus has directly led to a passive supply of base money by the central bank in the form of purchasing foreign exchange, imposing some constraints on the independence and effectiveness of monetary adjustment and management. Meanwhile, the large balance of payments surplus means resources have flowed to the export-oriented

sectors in the coastal areas, undermining the industrial and regional structural adjustments.

Maintaining an equilibrium in the balance of payments is a long-term and complicated task, and it requires comprehensive measures to transform the growth pattern promptly, speed up the economic structural adjustment, and effectively boost domestic demand, especially consumption. Measures include the following: increasing fiscal support to social security, education, and the transfer of payments across different regions, allowing the fiscal and tax policies to play an important role in prompting structural adjustment and stimulating consumption; transforming the growth pattern of foreign trade, reducing excessive incentives for exports, increasing imports, and upgrading the processing trade; improving the investment and financing system, improving the quality of the utilization of foreign investment, strengthening law enforcement for labor protection, energy conservation, and environmental protection and removing differentiated treatments for domestic and foreign companies; applying a more balanced foreign exchange administrative policy with regard to foreign trade and foreign investment, further facilitating use of foreign exchange by enterprises, strongly supporting direct investment in the overseas market, especially important mergers and acquisitions, meeting the outward financial investment demand of market entities by strengthening management of external borrowing and foreign exchange sales.

6. Industrial analysis

In the first quarter of 2007, the major industries performed well, featuring rapid output growth, good sales performance, higher profits, and a keen interest in fixed-asset investments in many sectors, especially the high energy consuming sector that faced increasing pressures of a fixed-asset investment rebound. In terms of realized value added, of 39 industries, 15 industries registered growth of more than 20 percent in industrial added value. In particular, metallurgy, machinery, non-ferrous metal mining, construction materials, and chemical industries witnessed the fastest growth. In terms of exports, exports in the steel and ferroalloy industries grew by 1.2 times and 70 percent respectively. In terms of realized profits, most industries saw a substantial growth in profits in the first two months of 2007. Profits in the six major industries, including steel, chemicals, construction materials, oil processing, electricity, and non-ferrous metals, grew .7 times that recorded in the same period of the last year, contributing 70 percent of the growth of industrial profits. With regard to investment, in the first quarter, the growth of fixed-asset investment in the non-ferrous metal, metallurgy, and chemical industries all reached above 50 percent. It is worth noting that the high energy-consuming industries witnessed the fastest growth in terms of production, exports, profits, and investment during the first quarter.

Compatible with the economic growth, the growth in supplies of coal, electricity, and

transportation accelerated. In the first quarter, the output of crude coal grew by 14.8 percent, an acceleration of 2.8 percentage points year on year. Coal imports posted 2.89 million tons (net exports of coal stood at 7.86 million tons during the same period of 2006). Power generation rose by 15.5 percent, accelerating by 4.4 percentage points, and the short supply of electricity was steadily eased compared with the same period of the last year. The production and import of crude oil grew by 1.5 percent and 6.8 percent respectively. The volume of rail freight increased significantly and the turnover of sea freight grew at a rapid pace. In the first quarter, the daily loading of the national railways increased by 9 percent and the freight volume handled by the major seaports rose by 13 percent compared with the previous year.

(1) The real estate industry

In the first quarter of 2007, the investment in real estate development accelerated and the investment funds were sufficient due to the rapid growth of the domestic real estate loans and the use of foreign capital. The rise in housing prices stabilized, yet housing prices in some major cities still remained excessively high and increased rapidly.

Investment in real estate development posted faster growth while the investment structure improved. In the first quarter, real estate investment nationwide amounted to 354.4 billion yuan, up 26.9 percent and an acceleration of 6.7 percentage points over the previous year, 1.6 percentage points higher than the growth of fixed-asset investment during the same period. Specifically, investment in commercial residential housing grew 30.4 percent, accounting for 70 percent of overall real estate investment and accelerating by 2 percentage points on a year-on-year basis. Investment in office buildings and in commercial operations spaces rose by 23 percent and 17.7 percent respectively, with their shares in real estate investment declining. In terms of investment in commercial residential housing, investment in affordable housing grew by 41.6 percent, accounting for 2.5 percent of the overall investment in real estate development and increasing slightly from the last year. Investment in single houses and high-quality apartments increased 16.6 percent, accounting for 7.6 percent of total real estate investment, representing a deceleration from the previous year. In general, investment in common commercial housing with floor plans under 90 square meters accounted for a relatively small share of 11.2 percent. Small and medium-sized common commercial housing failed to play a dominant role in market supply.

The space of new commercial housing sales exceeded that of completed commercial housing and housing vacancies declined, indicating a strong market demand. In the first quarter, the space of new residential housing was 2.2 times that of completed housing, flat with that recorded a year earlier, and the growth of housing sales space

was 3.3 percentage points higher than that of completed housing space. At end-March, residential housing vacancies had decreased by 1.2 percent year on year to 69 million square meters.

The rise in housing sales prices stabilized, yet some major cities still saw steep rises. In the first quarter, housing prices in 70 large- and medium-sized cities rose 5.6 percent year on year, an acceleration of 0.1 percentage points on a year-on-year basis. In March, a number of cities registered a large hike in housing prices, including Beihai (13.7 percent), Shenzhen (10.7 percent), Changsha (10.1 percent), Beijing (9.9 percent), and Guangzhou (8.6 percent).

Investment funds in real estate development were sufficient and the use of foreign capital increased rapidly. According to statistics from the National Bureau of Statistics, in the first quarter, funds available for real estate investment increased year on year by 26.3 percent to 712.5 billion yuan, an acceleration of 1.5 percentage points. In particular, self-raised funds and other funds served as the main sources of the investment funds, growing by 23.2 percent and 30 percent respectively and accounting for 73 percent of the overall real estate investment. The use of foreign capital only accounted for 1.8 percent of the total, but grew 1 time from the previous year. The share of domestic real estate loans accounted for 25 percent of the total, up 20.9 percent and a deceleration of 27.6 percentage points on a year-on-year basis. According to the statistics of the PBC, at the end of March, outstanding real estate loans reached 1.6 trillion yuan, an increase of 159.7 billion yuan over that at the beginning of the year and 27.9 percent from the previous year, down by 5.54 percentage points and 1.83 percentage points respectively from end-January and end-February, which continued to decline month by month since August 2006.

The growth of mortgage loans accelerated and displayed a rising trend. At end-March, outstanding mortgage loans grew by 142.4 billion yuan over those at the beginning of 2007 to 2.41 trillion yuan, representing a year-on-year growth of 19.9 percent and an acceleration of 3.7 percentage points. In particular, outstanding individual housing loans registered 2.40 trillion yuan, increasing by 147.1 billion yuan from the beginning of the year and 20.3 percent from the previous year.

(2) The construction materials industry

The construction materials industry is an important materials industry in China and the upstream sector of the national economy, which is closely related to the real estate industry. In recent years, the performance of the construction materials industry has maintained a momentum of good growth, with the growth of production and sales accelerating year after year, the overall economic efficiency enhanced, exports

continuing to grow at a rapid pace, and the industrial structure obviously improving. In 2006, the industrial value added of statistically large construction materials enterprises grew by 21.6 percent to 421 billion yuan, their ratio of sales to total output was 97.7 percent, and profits posted 60.3 billion yuan, a growth of 47.1 percent. The export of construction materials products continued to grow rapidly, and the total volume of exports rose year on year by 32.6 percent to US\$12.9 billion. Fixed-asset investment in the construction materials industry increased by 35.2 percent to 154.7 billion yuan, 10.7 percentage points higher than the growth of fixed-asset investment in the entire country.

Guided by the macro-economic management policies of the state, the structure of the construction materials industry was improved and developed in a energy-saving, low energy-consuming, and highly efficient way. In 2006, structural adjustments were introduced in cement, glass, and other construction materials industries to eliminate outdated capacities with high-energy consumption and high pollution, and large-scale mergers and restructuring of these industries were carried out.

The geographical distribution of the construction materials industry witnessed dramatic changes and the investment priority began to move to central and western China. Due to the differences in energy prices and labor costs between eastern China and central and western China, the growth of the construction materials industry in central and western China exceeded that of eastern China. In 2006, the industrial value added of the construction materials industry in central China and western China grew by 40.3 percent and 29.3 percent respectively, while that in eastern China only rose by 25.2 percent. The share of the construction materials industry in central and western China in the entire country increased from 34 percent in 2004 to 36.7 percent in 2006.

At present, the environment is favorable both at home and abroad for the development of the construction materials industry. International trade of construction materials has expanded steadily, and prospects for the construction materials market in the Middle East and Africa are particularly good. The engines for economic development in China remain strong, and the building of a new countryside, the acceleration of urbanization, and the implementation of some major programs will all promote the rapid development of the construction materials industry. However, with a great number of new construction materials product lines being put in place, capacity will be enhanced and market competition pressures will be aggravated. At the same time, building a resource-saving and environmentally friendly society and developing a cyclical economy pose new challenges and opportunities for the development of the construction materials industry. Therefore, efforts will be made to speed up the adjustment and improvement of the product structure, accelerate the application of modern technology, promote the upgrading of the industry, and enhance concentrated and collective production of the entire industry so as to promote the development of the construction materials industry toward low energy consumption, low

environmental pollution, and high energy efficiency.

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

I. Macro-economic outlook

The Chinese economy is expected to continue to develop relatively rapidly in the next period against the backdrop of strong economic growth, the still favorable global economic environment, and improvements in the income of domestic households, enterprise profits, and fiscal revenues. With a strong investment demand, the relatively rapid investment growth will be supported by economic fundamentals. Since China is at a stage of industrialization and urbanization, along with the continued breakthroughs in the reform of key sectors, a potential large domestic market and a favorable international economic environment, domestic investment will grow continuously. The launch of the “11th Five-Year Plan” and the establishment of a socialist new countryside, the vigorous development of the former industrial center in Northeast China, and advances in development in the central and western regions will further promote an industrial upgrading and movements among different regions. In recent years, due to the improvement in enterprise profits and strengths, enterprises have an increasingly stronger capacity to receive credit and there is high confidence in the market; therefore, investment willingness in general is strengthened. The Bankers Questionnaire Survey of the PBC indicated that, in the first quarter of 2007, the index of the loan demand climate surged close to the historical record registered in the first quarter of 2004, reflecting, to some extent, the relatively high investment demand of economic entities. The number of new projects and the projected total investment value moderated due to the effects of various earlier macro-economic adjustment policies, but with the strengthening of a willingness to invest, there is still a possibility that investment will rebound. Consumption demand climbed steadily. The income of urban households grew rapidly and a series of preferential policies boosted the income of rural households. A rise in the sentiment index of enterprises drove job creation and wage increases. As indicated by the PBC Quarterly Urban Depositors Survey in the first quarter of 2007, the proportion of households that believe that their income will be increased reached the highest in 6 years. Households have strong feelings about income growth, and the rise in the sentiment index was the highest since the launching of the survey. Although household income expectations in the second quarter fell somewhat due to seasonal factors, the relevant index still reached the highest since the launching of the survey. Meanwhile, the enhancement of social

security, especially social security for low-income residents, and the wealth effect from the boom in the capital market will help strengthen consumer confidence. In terms of external trade, despite the volatility in the international stock markets and the increasing uncertainties in the US economy, the global economy will continue to maintain relatively rapid growth due to the fairly optimistic economic performance in the Euro area, Japan, and other regions. External demand still remains strong. Given a series of restructuring policies, the increase in the trade surplus in China will possibly be moderated in the next period, but the surplus will remain relatively large.

Upward risks are expected to grow in domestic price movements and remain of concern. At present, factors including the speeding up of global market integration and technology advancements, the rapid growth of domestic productivity and supply, the ease in bottleneck constraints, and the effect of the greater economic size will all help to curb price increases. However, price upward pressures remain. First, on the one hand, the continued rapid economic growth has brought about high aggregate demand, including an increased demand for production materials, investment, and consumption goods; on the other hand, tight food supply and demand will build upward pressures. Second, with the advance in the reform of the factor price formation mechanism, the prices of major resources and factors will increase and some of the upward pressures will be transferred to downstream products. Additionally, due to the improvement in social security for employees, the price of labor is also on the increase. According to the PBC Urban Depositors Survey in the first quarter of 2007, 44.3 percent of surveyed households expect price increases in future, down 6.5 percentage points from the former quarter but up 15.6 percentage points from the previous year. Bankers hold the same expectation as the households: 65.3 percent of bankers expect the prices of consumption goods will rise, up 25.2 percentage points from the previous year. Enterprises also forecast that sales prices will continue to increase, with the relevant expectation index rising by 3.2 percent.

In general, the national economy will continue to maintain a momentum of steady and rapid growth. However, some prominent issues still remain in the economy, such as an acceleration in the economic growth trend, a rebound in the growth of fixed-assets investment, a continued increase in the trade surplus, and continued excessively abundant liquidity. These issues stem from deep-rooted economic structural problems. Moreover, the building up of pressures from the economic environment, including that of natural resources and the high demand to conserve energy and to reduce pollutant emissions may also inhibit sustainable economic development.

II. Main policy stance in the next stage

A scientific development approach should be followed in all areas of economic and social development to maintain a consistent and stable macro-adjustment policy; efforts should be made to speed up the economic restructuring and transformation of the economic growth patterns, to prevent the rapid economic development from becoming relatively overheated, and to avoid dramatic up-and-downs so as to maintain rapid and sound economic development.

The key to addressing the economic structural imbalances is to earnestly transform the economic growth patterns in line with a scientific development approach, to promote economic structural adjustments, balanced savings, consumption, investment, and structural relationships among the different industries, to promote a shift in the economic growth pattern from one driven by exports and investment to one mainly driven by consumption and investment and by internal and external demands, which is also the necessary path to promote a balanced BOP and to ease the excessive liquidity. A strengthening of liquidity management will create a sound money and financial environment for the economic restructuring. At the current juncture, efforts should be made to intensify coordination among monetary policy, fiscal policy, tax policy, and trade policy as well as to further strengthen liquidity management. A basket of structural policies aimed at boosting internal demand should be carried out so as to promote a rebalancing of the BOP with the support of the exchange rate policy.

According to the State Council's overall arrangements, the PBC will further improve the financial macro-management and the forward-looking and scientific nature of monetary policy and its effectiveness in macro-economic management. The PBC will continue to carry out a sound monetary policy, strengthen liquidity management, apply a mix of measures including open market operations and a reserve requirement ratio to drain the excessive liquidity, and maintain an appropriate sterilization through coordinated use of different liquidity management tools to guide money and credit to grow at an appropriate pace and to maintain balanced aggregates. Coordination of the interest rate and exchange rate policy will be further strengthened. The market-based interest rate reform will be further advanced, and the establishment of a benchmark interest rate system will be promoted to strengthen the leveraging role of prices in macro-economic adjustments. The reform of the RMB exchange rate regime will be promoted in a self-initiated, controllable, and gradual manner to keep the RMB

exchange rate basically stable at an adaptive and equilibrium level. Efforts will be made to promote the reform of the foreign exchange management system, improve the multi-layered external investment system, and accelerate the pace of “going out.” A management model for official foreign exchange reserves should be diversified to improve reserve operations and management. Endeavors should be made to improve the credit structure, strengthen financial support to key areas and weak sectors including the agricultural economy, consumption, small- and medium-sized enterprises, autonomous innovation, energy-conservation, environmental protection, job creation, and aid to students, and strictly control credit to high energy consuming and heavily polluting industries and industries with an excessive production capacity. The scale and structure of direct financing and indirect financing should be coordinated to promote the healthy development of the capital market.

The effects of the structural policy will not be felt in the short run, but it should be implemented as soon as possible. Currently, efforts should be made to clarify and revise the trade policy to “encourage exports while restricting imports” the foreign exchange and investment management policy that “relaxes capital inflows but controls outflows,” and the industrial policy that aims at import substitution and to close the gap between China and the advanced nations, maintaining a favorable international and domestic environment and implementing a mix of structural adjustment measures to boost consumption demand, such as boosting domestic demand, reducing the savings rate, opening markets, and expanding imports. Efforts should be made to raise the income of households, strengthen social security, increase the supply of public goods, and fully take advantage of the role of fiscal policy and tax policy to promote an economic structural adjustment.

Appendix 1:

Highlights of China's Monetary Policy in the First Quarter of 2007

On January 4, the Shanghai Inter-bank Offered Rate (Shibor) was officially launched. The released Shibor products include overnight, 1-week, 2-week, 1-month, 3-month, 6-month, 9-month, and 1-year.

On January 5 and February 16, with the approval of the State Council, the People's Bank of China announced, effective January 15 and February 25 respectively, a rise in the RMB reserve requirement ratio of depository institutions by 0.5 percentage points.

On January 11, the People's Bank of China, jointly with the China Banking Regulatory Commission, issued the *Guidance on Implementation of the Financial Support Policy through Special Central Bank Bills and Transformation of the Operational Mechanism for Rural Credit Cooperatives* (PBC Document [2007] No. 11) to further strengthen the positive role of financial support for the pilot reform of rural credit cooperatives (RCC), to intensify the reform of RCCs, to transform the operational mechanism, and to promote stable and sound development.

On January 14, *Announcement of the People's Bank of China* ([2007] No. 3) was released to allow domestic financial institutions, with approval, to issue RMB financial bonds in Hong Kong, which further expanded the RMB business in Hong Kong, helped to maintain Hong Kong's status as an international financial hub, and created a channel for RMB held by Hong Kong residents and enterprises to be returned to Mainland China.

On February 1, the *Administrative Rules on the Foreign Exchange of Individuals* (PBC Decree [2006] No. 3) became effective, and the *Rules for Implementing the Administrative Rules on the Foreign Exchange of Individuals* took effect.

On February 5, the People's Bank of China reported to the Committee of Finance and Economy of the National People's Congress on the implementation of monetary policy in 2006.

On February 9, the *China Monetary Policy Report, 2006*, was released.

On February 26, the Examination and Appraisal Committee of the People's Bank of China on the Issuance and Redemption of Special Central Bank Bills for the Pilot Reform of Rural Credit Cooperatives (RCCs) decided at its eighth regular meeting to redeem special central bank bills totaling 9.3 billion yuan to RCCs in 125 counties (cities) in 8 provinces and municipalities, including Jiangsu province.

On March 14, the PBC held a "window guidance" meeting to request commercial banks to comprehensively, correctly, and actively implement the macro-adjustment policies formulated by the central government, to extend loans in a reasonable and balanced manner, and to strengthen the role of finance in improving macro-economic management.

On March 18, the benchmark deposit and lending rates of financial institutions were raised. The one-year benchmark deposit rate was raised by 0.27 percentage points from 2.52 percent to 2.79 percent; the one-year benchmark lending rate was raised by 0.27 percentage points from 6.12 percent to 6.39 percent; and the deposit and lending rates of other maturities were adjusted accordingly.

On March 29, the Monetary Policy Committee of the People's Bank of China held its first quarterly meeting of 2007.

Appendix 2:

Monetary Policy of the Central Banks of the Major Economies in the First Quarter of 2007

I. The Federal Reserve of the U.S.

At its meetings on January 31 and March 21, the Federal Open Market Committee (FOMC) decided to keep the target of the federal funds rate unchanged at 5.25 percent. According to the FOMC, core inflation has been somewhat elevated. Although inflation pressures seem likely to moderate over time, the high level of resource utilization has the potential to sustain these pressures. Under these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

II. The European Central Bank (ECB)

On March 8, the ECB Governing Council increased by 25 basis points the interest rate on deposit facilities, the main refinancing operations minimum bid rate, and the interest rate on marginal lending facilities to 2.75 percent, 3.75 percent, and 4.75 percent respectively. In the ECB's opinion, even with the rate hikes, there is ample liquidity and strong growth of money and credit in the Euro area, and the monetary policy continues to be accommodative. Therefore, looking ahead, acting in a firm and timely manner to ensure price stability in the medium term is warranted. The ECB reports it will continue to monitor closely all developments to ensure that the objective of mid-term price stability can be achieved.

III. The Bank of Japan

On February 21, the Bank of Japan decided to raise the uncollateralized overnight call rate by 25 percentage points to 0.5 percent. In the opinion of the Bank of Japan, the increase in the policy rate to 0.5 percent will contribute to maintaining a lax monetary environment, ensuring price stability in the medium and long term, and promoting sustainable growth. The Bank of Japan reports it will adjust the level of the policy interest rate gradually in light of developments in economic activities and prices.

IV. The Bank of England

On January 11, the Committee of the Bank of England decided to raise the official bank rate by 25 basis points to 5.25 percent due to the firm and steady growth of output and domestic demand, the rapid growth of broad money and credit, and the continued strong growth of the international economy. In the opinion of the Committee, it was likely that inflation would rise further. Against that background, the Committee judged that an increase in the bank rate of 0.25 percentage points to 5.25 percent was necessary to bring the CPI inflation back to the target of 2 percent in the medium term.