

China Monetary Policy Report Quarter Two, 2009

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

Executive Summary

As a result of the package of stimulus plans aimed at addressing the international financial crisis, China's economy saw more positive factors and an increasingly stronger momentum of stabilization and recovery in the first half of 2009. The agricultural sector developed in a sound manner, industrial production growth accelerated, consumption expanded rapidly, and investment increased at a more rapid pace. In the first six months of 2009, China's Gross Domestic Product (GDP) registered 14 trillion yuan, representing growth of 7.1 percent year on year, and the Consumer Price Index (CPI) declined 1.1 percent from the same period of the last year.

In accordance with the overall arrangements of the State Council, and to serve the primary task of supporting economic growth, expanding domestic demand, and restructuring the economy, the People's Bank of China (PBC) implemented a moderately loose monetary policy. The PBC guided financial institutions to step up support for economic development while making sure that risks remain under control, ensuring that aggregate money and credit supply meet the demands of economic development; properly conducted open market operations with appropriate timing to ensure ample liquidity in the banking system; guided financial institutions to optimize the credit structure, pursued differentiated credit policies, strengthened credit support to agriculture, rural areas, and farmers, small- and medium-sized enterprises (SMEs), employment, education, post-disaster reconstruction, consumption, and other programs aimed at improving social welfare, and provided greater financing support to industrial relocation, independent innovation, and programs designed to promote balanced regional economic development. The PBC also enhanced the coordination of monetary policy with fiscal policy and industrial policy to create a favorable monetary and financial environment for economic development.

In general, the moderately loose monetary policy has been transmitted effectively. From January to June 2009, aggregate money and credit grew rapidly and the credit structure was further optimized, playing an important role in reversing the economic slowdown and boosting market confidence, and effectively supporting sound and rapid economic development. At end-June 2009, broad money supply M2 stood at 56.9 trillion yuan, a year-on-year growth of 28.5 percent and an acceleration of 11.2 percentage points from the previous year. Corporate and household demand deposits increased substantially, while loans continued to expand rapidly, with medium- and long-term loans accounting for a larger share and consumer loans growing at a faster pace. In the first half of 2009, RMB lending increased 7.37 trillion yuan, 4.9 trillion yuan more than growth during the same period of the last year. At end-June, RMB lending totaled 37.7 trillion yuan, a year-on-year rise of 34.4 percent and an acceleration of 20.2 percentage points from the previous year. Lending rates offered by financial institutions continued to drop. In June, the weighted average interest rate

of loans to non-financial companies and other sectors was 4.98 percent, down 0.58 percentage point from the beginning of the year. The RMB exchange rate remained basically stable at an adaptive and equilibrium level, with the central parity of the RMB against the US dollar posting 6.8319 yuan per dollar at end-June.

China's economic development is now at a critical stage of stabilization and recovery. Difficulties and challenges remain, an economic recovery is yet to be firmly established, and there are still many unstable and uncertain factors both at home and abroad. However, as the package of plans aimed at addressing the financial crisis is further implemented, domestic demand is expected to expand further and the economy will continue to grow in a sound and relatively rapid manner.

In the next stage, in accordance with the overall arrangements of the State Council, the PBC will continue to take the task of promoting sound and relatively rapid economic development as the top priority of financial macro-management. It will ensure policy consistency and stability and will continue the moderately loose monetary policy to support economic stabilization and recovery. The PBC will properly manage policy priorities, pace, and intensity, pay attention to the support that money and credit growth extends to the real economy, balance the relationship between supporting economic development and preventing and resolving financial risks, and maintain proper money and credit growth. It will continue to guide financial institutions to optimize the credit structure, follow credit principles, and strike the right balance between supporting economic growth and restructuring the economy. It will also continue to advance the market-based interest rate reform and to improve the RMB exchange rate formation mechanism. It will press ahead with the reform of the financial system so as to improve the competitiveness of financial institutions and the efficiency of financial markets in resource allocation and to maintain financial stability.

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Part 1 Monetary and Credit Performance

In the first half of 2009, money supply and RMB lending grew rapidly and the moderately loose monetary policy was transmitted effectively, indicating that the financial sector was providing stronger support for economic development and was playing a key role in economic stabilization and recovery.

I. Money supply grew rapidly

At end-June, the outstanding balance of broad money M2 grew 28.5 percent year on year to 56.9 trillion yuan, an acceleration of 11.2 and 3.0 percentage points from the same period of 2008 and the first quarter respectively. The outstanding balance of narrow money M1 reached 19.3 trillion yuan, an increase of 24.8 percent year on year, representing an acceleration of 10.6 percentage points from the same period of 2008 and an acceleration of 7.8 percentage points from the first quarter. Cash in circulation M0 grew 11.5 percent year on year to 3.4 trillion yuan, a deceleration of 0.8 percentage point from the same period of 2008. Net cash withdrawals in the first half of 2009 totaled 57.8 billion yuan, whereas the first half of 2008 witnessed net cash injections of 6.1 billion yuan.

Growth of M2 and M1 maintained an accelerated momentum in the first half, indicating a general expansionary situation, and reached their highest levels since May 1996 and May 1995 respectively. In particular, the growth of M1 accelerated markedly, exceeding 20 percent at end-June.

II. Growth of deposits of financial institutions accelerated with increased in demand deposits

At end-June, the outstanding balance of deposits of all financial institutions (throughout this Report, “all financial institutions” includes foreign-funded financial institutions) denominated in RMB and foreign currencies increased by 28.7 percent year on year to 58.1 trillion yuan, 10.8 percentage points higher than the growth in the same period of 2008, representing an increase of 10.1 trillion yuan from the beginning of the year and an acceleration of 5.2 trillion yuan year on year. In particular, the outstanding balance of RMB deposits rose 29.0 percent year on year to 56.6 trillion yuan, an acceleration of 10.2 percentage points from the same period of 2008, representing an increase of 10.0 trillion yuan from the beginning of the year and an acceleration of 5.0 trillion yuan year on year. The outstanding balance of foreign currency deposits rose 16.0 percent to US\$208.1 billion, an acceleration of 17.8 percentage points from the first quarter of 2008, representing an increase of US\$15.4 billion from the beginning of the year and a deceleration of US\$3.3 billion year on

year.

Broken down by sectors and maturities of local currency deposits, the growth of household deposits remained relatively brisk, the growth of non-financial companies' deposits accelerated remarkably, and corporate demand deposits accelerated. Growth of the outstanding balance of household RMB deposits remained at above 28 percent since 2009, 28.3 percent at end-June in particular, and 13.7 percentage points higher than that in the same period of 2008. The outstanding balance of household RMB deposits posted 25.4 trillion yuan, representing an increase of 3.2 trillion yuan from the beginning of the year and an acceleration of 975.4 billion yuan year on year. The outstanding balance of non-financial corporate RMB deposits stood at 27.6 trillion yuan, an increase of 34.8 percent year on year, 14.7 percentage points higher than growth during the same period of 2008, representing an increase of 5.9 trillion yuan from the beginning of the year and an acceleration of 4.2 trillion yuan year on year. In the first half of 2009, growth of corporate demand deposits accelerated by 2.1 trillion yuan year on year, representing relatively sufficient working capital in the corporate sector and indicating that the expectation of corporate sector regarding the economic outlook had improved and that it might gradually increase investment in production and operations. At end-June, the outstanding balance of fiscal deposits had decreased 11.0 percent year on year to 2.5 trillion yuan, representing an increase of 688.3 billion yuan from the beginning of the year but a deceleration of 335.1 billion yuan year on year.

III. RMB loans issued by financial institutions grew rapidly, and the share of medium- and long-term loans rose by a large scale

At end-June, the outstanding balance of loans issued by all financial institutions in RMB and foreign currencies stood at 39.8 trillion yuan, a growth of 32.8 percent year on year, 17.5 and 5.8 percentage points higher than the growth during the same period of 2008 and the first quarter of 2009 respectively, representing an increase of 7.7 trillion yuan from the beginning of the year and an acceleration of 5.0 trillion yuan year on year. At end-June, the outstanding balance of RMB loans grew 34.4 percent year on year to 37.7 trillion yuan, 20.2 and 4.7 percentage points higher than the growth during the same period of 2008 and the first quarter of 2009 respectively, representing an increase of 7.37 trillion yuan from the beginning of the year and an acceleration of 4.9 trillion yuan year on year. Due to the gradual implementation of central government investment projects and the lowering of the minimum capital ratio for fixed-asset investment projects, the growth of RMB loans in the second quarter continued its relatively rapid momentum as new loans increased by 2.8 trillion yuan, representing an acceleration of 1.7 trillion yuan. Broken down by institutions, the share of state-owned commercial banks in aggregate credit decreased, while the share of joint-stock commercial banks and city commercial banks increased. In the second quarter, the share of new loans of state-owned commercial banks among the new

loans of all financial institutions declined by 16.6 percentage points from the first quarter, while the shares of loans of joint-stock commercial banks and city commercial banks increased by 4.5 and 3.7 percentage points respectively. At end-June, the outstanding balance of foreign currency loans stood at US\$295.4 billion, representing an increase of 8.1 percent year on year, down 40.6 percentage points from the growth during the same period of the previous year but up 19.8 percentage points from the first quarter, indicating a relatively rapid rebound. Foreign currency loans increased by US\$51.7 billion from the beginning of the year, representing a deceleration of US\$3.6 billion year on year. The deceleration was remarkably smaller than that during the first quarter due to the large increase in medium- and long-term loans and trade financing.

Table 1: RMB loans of financial institutions

Unit: 100 million yuan

	First Half of 2009		First Half of 2008	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Policy banks ^①	6445	3591	2853	589
State-owned commercial banks ^②	32561	23555	9005	-467
Joint-stock commercial banks	20212	14957	5255	-362
City commercial banks	5392	3649	1742	-283
Rural financial institutions ^③	7459	3429	4036	-525
Foreign-funded financial institutions	-327	-911	585	-70

Note: ① Policy banks include the China Development Bank, the Export-Import Bank of China and the Agricultural Development Bank of China. After undergoing reform, the China Development Bank has become a share-holding company and at present is in a transition period, so it is included among the policy banks in statistical terms.

② State-owned commercial banks include the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and the China Construction Bank.

③ Rural financial institutions include rural cooperative banks, rural commercial banks, and rural credit cooperatives.

Source: The People's Bank of China.

In terms of loan destinations, the growth of household loans accelerated steadily, whereas lending to non-financial institutions and other sectors continued its relatively rapid growth. At end-June, the outstanding balance of household loans grew 23.8 percent year on year, 2.7 percentage points and 6.9 percentage points higher than the growth during the same period of 2008 and the first quarter respectively, representing an increase of 1.1 trillion yuan from the beginning of the year and an acceleration of 599 billion yuan year on year. In particular, the outstanding balance of consumer loans

grew 650.6 billion yuan from the beginning of the year, representing an acceleration of 391.8 billion yuan year on year. The accelerated momentum is related to the recent rapid recovery of the real estate market. Individual housing loans increased by 466.2 billion yuan from the beginning of the year, representing an acceleration of 283.5 billion yuan. The outstanding balance of household business-oriented loans grew by 410.1 billion yuan from the beginning of the year, representing an acceleration of 207.1 billion yuan year on year. The outstanding balance of loans to non-financial companies and other sectors grew 37.0 percent year on year, an acceleration of 24.4 percentage points from the same period of 2008, representing an increase of 6.3 trillion yuan from the beginning of the year and an acceleration of 4.3 trillion yuan year on year. In particular, paper financing and medium- and long-term loans grew rapidly. Medium- and long-term loans accelerated by 2.0 trillion yuan year on year, and important infrastructure projects received supporting loans in a timely manner; paper financing accelerated by 1.7 trillion yuan year on year, but the share of the increment declined sharply month on month since the second quarter as financial institutions strengthened the restructuring of their assets.

The bulk of RMB medium- and long-term loans went to the infrastructure sector, the leasing and business services sector, and the real estate sector. In the first half of the year, new 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) to the infrastructure sector (transportation, warehousing and postal services, electricity, gas, water production and supply, water conservation, environmental protection, and public facility management), and to the leasing and business services sector stood at 1.6 trillion yuan and 424.6 billion yuan respectively, accounting for 51.6 percent and 13.7 percent of all new medium- and long-term RMB loans, 3.8 percentage points and 7.7 percentage points higher than the growth during the same period of 2008 respectively. New medium- and long-term loans to the real estate sector amounted to 350.1 billion yuan, accounting for 11.3 percent of all new medium- and long-term loans, down 7.9 percentage points from the same period of 2008.

Box 1: An Analysis of the Destination of Medium- and Long-term Loans

From 2009 on, medium- and long-term loans of financial institutions grew rapidly. At end-June, outstanding medium- and long-term loans of major financial institutions (i.e., policy banks, state-owned commercial banks, joint-stock commercial banks, the postal savings bank, and city commercial banks) posted 14.5 trillion yuan, representing a year-on-year growth of 36.3 percent and an acceleration of 19.1 percentage points from the corresponding period of the last year. In the first half of 2009, new medium- and long-term loans reached 3.1 trillion yuan, a year-on-year growth of 2 trillion yuan.

As for the destinations of the medium- and long-term loans, new loans to tertiary

industry grew rapidly and this was consistent with the objective of the industrial readjustment. At end-June, medium- and long-term loans to the primary, secondary and tertiary industries grew 17.0 percent, 23.4 percent, and 44.6 percent respectively, and registered an increase of 17.7 billion yuan, 680.3 billion yuan, and 2.4 trillion yuan respectively from the level at the beginning of 2009, accounting for 0.6 percent, 22.0 percent, and 77.5 percent respectively of the total medium- and long-term loans.

In terms of the sectoral distribution of medium- and long-term loans, the bulk of new loans was channeled to expand domestic demand and support growth, facilitating the growth of investment demand and the national economy, and helping to create conditions for further expansion of consumption demand. Medium- and long-term loans to the infrastructure sectors surged. At end-June, medium- and long-term loans to the infrastructure sectors were up 42.4 percent, an acceleration of 23.2 percentage points from the corresponding period of the last year. In the first six months, new medium- and long-term loans to these sectors reached 1.6 trillion yuan, 1.1 trillion yuan more than that during the corresponding period of the last year and accounting for 51.6 percent of the total medium- and long-term loans. As for their sectoral distribution, medium- and long-term loans to water conservancy, environment and public facility management industries, and to transportation, storage, and post industries surged and new loans reached 892.1 billion yuan and 524.9 billion yuan respectively, accounting for 88.7 percent of medium- and long-term loans to the infrastructure sectors; medium- and long-term loans for the production and supply of power, fuel gas, and water increased relatively slowly, and new loans reached 180.7 billion yuan, accounting for 11.3 percent. Meanwhile, the growth of medium- and long-term loans to the housing industry picked up. At end-June, medium- and long-term loans to the housing industry increased by 22.7 percent, an acceleration of 6.8 percentage points from end-2008. In the first half of the year, new medium- and long-term loans to the housing industry totaled 350.1 billion yuan, 150 percent of the new loans to the housing industry in the entire year of 2008. In the first half of 2009, medium- and long-term loans on the local government financing and investment platform increased by a large margin.

The changes in the industrial and sectoral structure of medium- and long-term loans show that financial institutions had enhanced credit support to industries and sectors closely related to fiscal and monetary policies in line with the moderately loose monetary policy. According to the principle of differentiated lending treatment, financial institutions have intensified management over lending to various industries, providing easier loan access to major government projects and key industries and

sectors in line with the government's economic restructuring and industrial policies; and have implemented an exit strategy in lending to sectors with major potential risks. With the adjustment of the minimum capital ratio requirement for fixed-asset investment projects, capital for relevant projects was paid more promptly and medium- and long-term loans to the infrastructure industries subsequently increased.

In general, the rapid growth of medium- and long-term loans has helped expand domestic demand and promote economic restructuring, and is important for realizing comprehensive, balanced, and sustainable development of the national economy. Going forward, it is necessary to strengthen guidance to financial institutions, and to strike a balance between supporting economic development and preventing financial risks while maintaining the continuity and stability of monetary policy. In the medium and long term, it is necessary to deepen reform and speed up economic restructuring in order to achieve sustainable development.

IV. Liquidity in the banking system was sufficient

At end-June the outstanding balance of base money increased by 7.4 percent to 12.4 trillion yuan, representing a decline of 529.2 billion yuan from the beginning of the year. The money multiplier at end-June was 4.59, up 0.75 percentage point from the same period of 2008 and up 0.32 percentage point from the first quarter of 2008, representing a stronger capacity for money creation. At end-June, the excess reserve ratio of financial institutions registered 1.55 percent. In particular, the excess reserve ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 1.15 percent, 0.95 percent, and 4.26 percent respectively.

V. The lending rates of financial institutions declined continuously

Entering into 2009, the RMB lending rate of financial institutions declined continuously. In June, the weighted average lending rate to non-financial companies and other sectors stood at 4.98 percent, down 0.58 percentage point from the beginning of the year. In particular, the weighted average lending rate of loans and the weighted average paper financing rate stood at 5.70 percent and 1.95 percent respectively, down 0.53 and 0.94 percentage point from the beginning of the year respectively. The lending rate of individual housing loans continued to decline, with the weighted average interest rate for individual housing loans standing at 4.34 percent in June, down 0.6 percentage point from the beginning of the year.

The proportion of loans with an interest rate lower than or at the benchmark interest rate increased. In June, the share of loans to non-financial companies and other sectors with an interest rate lower than or at the benchmark registered 30.47 percent

and 33.70 percent respectively, up 4.91 and 3.57 percentage points from the beginning of the year; the share of loans with an interest rate higher than the benchmark accounted for 35.83 percent, down 8.48 percentage points from the beginning of the year.

Table 2: Shares of loans with rates floating at various ranges of the benchmark rate in the first half of 2009

Unit:
Percent

	Lower than Benchmark	At Benchmark	Higher than Benchmark					
		1	Sum	(1.0, 1.1]	(1.1, 1.3]	(1.3, 1.5]	(1.5, 2.0]	Above 2.0
January	23.52	34.27	42.21	14.62	12.79	4.97	6.98	2.86
February	28.82	33.56	37.62	12.29	10.36	4.82	6.98	3.18
March	28.39	35.18	36.43	12.21	10.46	4.37	6.64	2.75
April	26.72	33.48	39.8	12.18	11.07	5.46	7.97	3.12
May	27.34	32.4	40.26	13.03	11.46	5.18	7.49	3.1
June	30.47	33.7	35.83	12.66	10.24	4.7	5.82	2.41

Source: The People's Bank of China.

The domestic foreign currency deposit and lending rates declined continuously. Affected by the continued decline of the interest rate in international financial markets, the foreign currency lending rate went down month by month. In June, the domestic US dollar lending rate for within three-month maturity and for three-month to six-month maturity stood at 1.49 and 1.48 percent respectively, down 2.17 and 2.54 percentage points from the beginning of the year respectively. The domestic US dollar deposit rate declined slightly. In June, US dollar demand deposits and large volume US dollar deposits with a 3-month maturity stood at 0.11 and 0.31 percent respectively, down 0.74 and 0.90 percentage point from the beginning of the year. Several financial institutions also cut the interest rate for small-value foreign currency deposits (below US\$3 million). In particular, the 1-year US dollar deposit rate was cut to 0.75-0.85 percent.

Table 3: The average interest rate for large value deposits and loans denominated in US dollars in the first half of 2009

unit: %

	Large value deposits						Loans				
	Demand Deposits	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year
January	0.34	0.55	1.36	1.26	1.91	1.46	2.89	3.33	3.48	3.04	3.62
February	0.16	0.48	1.46	1.79	1.95	5.01	2.18	2.87	3.13	2.61	2.74

March	0.15	0.55	1.32	1.77	2.20	1.30	2.23	2.44	3.05	2.51	3.39
April	0.1	0.36	1.13	1.39	1.58	3.73	1.98	2.26	2.37	2.14	3.59
May	0.11	0.36	0.9	1.17	1.49	5.00	1.59	1.86	1.79	1.49	2.63
June	0.11	0.32	0.76	1.05	1.68	1.12	1.49	1.48	1.52	1.44	3.53

Source: The People's Bank of China.

Box 2: The Deposit Rates of Financial Institutions Became More Market-based

The market-based interest rate reform realized its preliminary goal of “controlling the ceiling of the deposit rate and the floor of the lending rate” in October 2004. Thereafter, constrained by the imperfect pricing mechanism of financial institutions, market competition, and other factors, financial institutions often offered the ceiling deposit rate to depositors. Since 2009, against the backdrop of generally sufficient liquidity, some commercial banks have offered rates lower than the RMB benchmark rate, indicating an enhanced market-based deposit rate of financial institutions.

At present, the downward adjustment against the benchmark deposit rate by financial institutions has the following features: First, the bulk of financial institutions that offered lower than the benchmark rates to depositors were foreign-funded commercial banks and joint-stock commercial banks, mostly foreign-funded commercial banks. Second, deposits with lower than the benchmark rates were concentrated in the medium- and long-term term deposits, call deposits and agreement deposits whose transaction volume is relatively small, especially time deposits with a maturity of 2 years and above. For example, the deposit rate for two-year maturity, three-year maturity, and five-year maturity deposits of a foreign-funded commercial bank was 1 percent, 1.1 percent, and 1.2 percent, down 1.79, 2.23, and 2.4 percentage points from the benchmark deposit rate with the same maturity announced by the PBC. Some joint-stock commercial banks also offered lower than the benchmark rate for RMB deposits, mostly for corporate time deposits. Third, the above-mentioned financial institutions usually compensate their clients' interest revenue through lending arrangements or wealth management services.

Offering a lower-than-benchmark deposit rate is the response of financial institutions to adapt to the changes in the market environment and to adjust their asset-liability structure, reflecting that deposit rates are more market-based. Since 2009, liquidity has been sufficient, so yields in the money market and bond market went down, placing strong pressures on commercial banks to use their funds. For some domestic foreign-funded commercial banks, the pressures were even stronger as their parent banks were affected by the financial crisis and continued negative credit growth. Financial institutions were able to reduce deposit interest payments by offering lower-than-benchmark deposit rates on the one hand, and by limiting the deposit increase on certain maturities on the other hand, so as to help adjust their liability structures and costs to match their assets business.

A relevant survey indicates that enterprises were generally fairly rational about the lower-than-benchmark deposit rate. In general, enterprises would consider the interest rate, the settlement convenience, and other factors when choosing a deposit bank. The bank side and corporate side normally decide on the deposit rate through negotiation and the bank's comprehensive sale pricing can make up for corporate losses in deposit interest revenue. Additionally, deposits of enterprises in banks are mostly demand deposits for daily production and operations, so the lower than benchmark deposit rate will impact their deposit interest revenue to a lesser extent.

VI. The RMB exchange rate remained broadly stable at an adaptive and equilibrium level

In the first half of 2009 the RMB exchange rate remained broadly stable at an equilibrium level. At end-June the central parity of the RMB against the US dollar was 6.8319 yuan per US dollar, an appreciation of 27 bps or 0.04 percent from the end of 2008; the central parity of the RMB against the euro and the Japanese yen was 9.6408 yuan per euro and 7.1117 yuan per Japanese yen, an appreciation of 0.19 and 6.37 percent respectively from the end of 2008. From the exchange rate regime reform in July 2007 to end-June 2009, the RMB appreciated by 21.14 percent against the US dollar, 3.87 percent against the euro, and 2.73 percent against the Japanese yen.

The RMB exchange rate fluctuated in both directions. In the first half of the year, the peak and trough central parities of the RMB against the US dollar were 6.8201 yuan per US dollar and 6.8399 yuan per US dollar respectively. The largest appreciation of the RMB central parity against the US dollar in a single business day was 0.07 percent (50 basis points) and the largest depreciation in a single business day was 0.07 percent (50 basis points). Among the 118 trading days, the inter-bank foreign exchange market saw RMB appreciations on 61 days and RMB depreciations on 57 days.

Part 2 Monetary Policy Conduct

Since the beginning of 2009, according to the State Council's overall arrangements and in order to serve the overall objective of supporting growth, expanding domestic demand, and restructuring the economy, the PBC implemented a moderately loose monetary policy, worked to keep sufficient liquidity in the banking system, and guided financial institutions to optimize the credit structure and to ward off risks, thus creating a good monetary and financial environment for economic development.

I. Open market operations were conducted with appropriate strength in a timely manner

Since the beginning of 2009, the PBC closely followed and responded to economic and financial developments at home and abroad, and conducted open market operations in a timely manner and with the proper strength to keep appropriately sufficient liquidity in the banking system and to stabilize market expectations. First, the PBC stepped up measures for liquidity management. Based on the dynamics of liquidity supply and demand in the banking system and in the market environment, the PBC managed the pace and strength of open market operations appropriately. In the first six months, a total of 2.29 trillion yuan of repo operations were conducted, and 1.41 trillion yuan of central bank bills were issued. At end-June, the volume of outstanding central bank bills was 4.15 trillion yuan. Second, the mix of instruments of open market operations was further optimized. On the one hand, the strength of short-term repo operations was maintained and 28-day repo operations were combined with 91-day repo operations to further enhance the resilience of the banking system to short-term liquidity fluctuations. On the other hand, issuances of 3-month and one-year central bank bills were resumed as a measure of monetary policy operations to optimize the mix of sterilization instruments. Third, the flexibility of open market operation interest rates was enhanced. Responding to the upward movements of the market interest rates after IPO resumption, open market operations served to increase interest rate flexibility, which effectively guided market expectations and gave more play to market interest rates in adjusting fund supply and demand. At end-July, the interest rate of 28-day repo operations, 91-day repo operations, and 3-month central bank bills were up 22 basis points, 14 basis points, and 28 basis points respectively from that at the beginning of 2009; the issuing interest rate of 1-year central bank bills was up almost 20 basis points from that on July 9 when the issuance was resumed. Fourth, central treasury cash management operations were conducted promptly to strengthen coordination between fiscal policy and monetary policy. In the first seven months, demand deposit business was conducted on six occasions, helping to enhance the return of treasury funds and to maintain the continuity of such operations.

II. Window guidance and credit policy guidance was enhanced

The PBC continued to follow the principle of differentiated lending treatment to support certain sectors and industries, guided financial institutions to further optimize the credit structure to support development of the real economy and restructuring and to ward off financial risks. First of all, coordination of credit policy with fiscal and industrial policies was improved. Measures were taken to increase input of matched lending to projects with central government investments, enhance financial support to the restructuring of ten key industries, provide financial services to programs including household electrical appliances to the countryside and automobiles to the countryside. Second, the PBC took concrete measures to provide credit to support the agricultural sector, the countryside, and farmers, SMEs, employment, student loans, post-disaster reconstruction, and consumer credit, to beef up credit support for industrial relocation, independent innovation, and balanced regional development, and to restrict lending to high-energy consuming, heavily polluting industries and industries with excess capacity. Third, the PBC urged financial institutions to follow the lending principles in order to control credit risks.

III. Financial enterprise reform was advanced

The reform of the large state-owned banks was deepened and their performance continued to improve. The Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications continued to improve corporate governance, deepen the reform of risk management and internal control mechanisms, speed up transformation of a services model, optimize the business structure, press ahead with basic institution and system building and product innovation, and to improve profitability and competitiveness. At the end of March, the capital adequacy ratio of the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications was 12.11 percent, 12.34 percent, 12.37 percent, and 12.77 percent respectively; the NPL ratio was 1.97 percent, 2.24 percent, 1.90 percent, and 1.62 percent; and pre-tax profits were 45.62 billion yuan, 25.29 billion yuan, 33.98 billion yuan, and 10.13 billion yuan respectively.

The joint-stock reform of the Agricultural Bank of China and the China Development Bank continued to make progress. Building on the improved arrangements of the board of directors, shareholders' meeting, board of supervisors, and the management team, the Agricultural Bank of China continued to deepen corporate governance, speed up reform of the internal auditing mechanism, and improve internal control. To

achieve the overall objectives of serving the agricultural sector, rural areas, and farmers, and operating on a commercial basis, the Agricultural Bank of China established an Agricultural Financial Operations Department, expanded the pilot reform of county-level operations to a wider area, and enhanced credit support to the agricultural sector, rural areas, farmers, and the countryside by increasing the quota of household micro-loans and loans for infrastructure building in the rural areas. The China Development Bank pressed ahead with building institutional arrangements, including risk management and internal control, expanded the range of business, and further improved operational mechanisms.

The reform of policy financial institutions is also making progress. In March 2009, the PBC, together with other relevant departments, established a working group for the reform of the Export-Import Bank of China and the China Export and Credit Insurance Corporation. The working group conducted in-depth studies to define the functions, business range, risk control, and corporate governance of policy financial institutions, and urged that the two institutions conduct an internal reform and improve policy financial services. Meanwhile, the PBC and other government agencies studied various matters regarding the reform of the Agricultural Development Bank of China to prepare for deliberation of the reform plan.

The reform of the rural credit cooperatives made important progress and produced some results. The financial support has basically reached its intended recipients. At end-June, a total of 159.6 billion yuan of special bills was redeemed for rural credit cooperatives in 2,296 counties and cities, accounting for over 95 percent of all the bills issued for this purpose; 1.5 billion yuan of ear-marked loans was disbursed. The smooth implementation of the financial support policy acted as a positive incentive to promote and support the rural credit cooperative reform. The asset quality of the rural credit cooperatives was significantly improved. At end-June, based on the four-category loan classification, the total volume and ratio of NPLs in the rural credit cooperatives were 320.3 billion yuan and 7.2 percent respectively, representing a reduction of 199.4 billion yuan and 30 percentage points from end-2002. Their lending ability increased by a large margin. At end-June, total deposits and outstanding loans of rural credit cooperatives posted 6.6 trillion and 4.5 trillion yuan respectively, the latter accounting for 11.9 percent of the outstanding loans of all financial institutions, 1.3 percentage points higher than that at end-2002. At end-June, agricultural lending of all rural credit cooperatives reached 2 trillion yuan, accounting for 45 percent of their total lending and 96 percent of the lending of all financial institutions, up 5 percentage points and 15 percentage points respectively from end-2002. The reform of the property rights system advanced. At end-June, 27 rural

commercial banks, 174 rural cooperative banks, and 2,009 institutions with legal person status at the county level had been established.

IV. Active participation in international cooperation to address the international financial crisis

To respond to the needs of neighboring countries and regions, the PBC signed bilateral domestic currency swap agreements with the monetary authorities of six economies, i.e., the Republic of Korea, Hong Kong, Malaysia, Belarus, Indonesia, and Argentina, to support bilateral trade and investment and to join forces in countering the ongoing international financial crisis. On April 8, the State Council approved a pilot program for renminbi settlement of cross-border trade in Shanghai and four cities in Guangdong province, i.e., Guangzhou, Shenzhen, Zhuhai, and Dongguan, which is expected to help manage exchange rate risks and thus bolster the stable growth of foreign trade. In order to meet the demands of the market, the PBC in concert with the relevant agencies formulated and released on July 1, 2009 the *Administrative Rules on the Pilot Program of Renminbi Settlement of Cross-border Trade Transactions* and the *Regulations on Implementing the Administrative Rules on the Pilot Program of Renminbi Settlement of Cross-border Trade Transactions* to regulate renminbi settlement of trade transactions, to promote the pilot program, to provide convenience to enterprises, and to support the development of normal trade relations with surrounding countries and regions.

V. Foreign exchange administration reform was deepened

First, measures were adopted to implement the decisions of the central government on stabilizing exports and to ease the difficulties of enterprises in receiving foreign exchange payments. The management of online verification of export-related foreign exchange collection and settlement to domestic currency was improved, the basic ratio of advance payments and deferred payments was raised to 30 percent, and small value advance payments and deferred payments were exempt from the ratio limit. Second, outbound direct investment related to foreign exchange administration was improved to help enterprises go global. Eligible enterprises, regardless of their ownership, were allowed to invest overseas with self-owned foreign currency funds and foreign currency funds converted from renminbi within the limit as approved by the relevant authority for outbound investments, in order to ease the difficulties in follow-up financing and the lack of working capital in enterprises that have conducted outward investment. Third, the foreign exchange-related administrative approval procedures were further simplified. Approval rights to open a capital account at a place other than the domicile of an enterprise, domestic entities providing guarantees for overseas entities, and other items were delegated to the SAFE branches. Fourth,

measures were taken to promote foreign exchange market development. A pilot project of net settlement of OTC transactions was carried out on the inter-bank foreign exchange market to reduce credit and settlement risks in foreign exchange trading. Five, monitoring of the foreign exchange liquidity of financial institutions was intensified to guide financial institutions to strike a balance in the safety, liquidity, and returns of their domestic and overseas investment, to readjust the structure of their overseas and domestic assets, and to provide more support for imports and exports.

VI. The renminbi exchange rate regime was improved

The managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies was further improved in a self-initiated, controllable, and gradual manner to enable market supply and demand to play a fundamental role in the yuan exchange rate formation and to keep the exchange rate basically stable at an adaptive and equilibrium level.

Part 3 Financial Market Analysis

In the first half of 2009 the financial market continued to perform in a sound and stable manner and market liquidity was adequate. Trading on the money market was active and interest rates edged up. Trading volume on the bond market continued to increase and bond indices fluctuated slightly. Trading volume on the stock market expanded significantly and stock indices registered remarkable growth. The total financing volume of the domestic non-financial sector (including households, non-financial enterprises, and the government sector) rose rapidly, up 186.1 percent over the same period of the last year. In terms of the financing structure, loans were still the major means of financing and the weight of treasury bonds (including municipal bonds) and enterprise bonds grew noticeably.

Table 4: Financing by domestic non-financial sectors

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	Q1 2009	Q1 2008	Q1 2009	Q1 2008
Financing by domestic non-financial sectors	88 915	31 081	100.0	100.0
Bank loans	77 230	27 341	86.9	88.0
Equities ¹	919	2 391	1.0	7.7
Government securities ²	4 902	246	5.5	0.8
Enterprise bonds ³	5 864	1 103	6.6	3.5

Notes: 1. Equity financing in this table does not include financing by financial institutions on the stock market.

2. The financing volume of government securities in 2009 includes municipal bonds issued by the Ministry of Finance on behalf of local governments.

3. Enterprise bonds include enterprise bonds, corporate bonds, short-term financing bills, and medium-term notes.

Source: The People's Bank of China.

I. Financial market analysis

1. Trading on the money market was brisk and interest rates edged up

Bond repos on the money market continued to expand significantly and inter-bank borrowing registered steady growth. In the first half of 2009, the turnover of bond repos on the inter-bank market totaled 35.6 trillion yuan, with the daily turnover averaging 292.1 billion yuan, representing year-on-year growth of 39.6 percent. The turnover of inter-bank borrowing reached 7.9 trillion yuan, with the daily turnover averaging 65

billion yuan, up 7.8 percent year on year. In terms of the maturity structure, overnight products were traded most frequently, accounting for 78.2 percent and 82 percent on the repo and inter-bank borrowing markets respectively, up 23.7 percentage points and 13.8 percentage points respectively year on year. The turnover of government bond repos on the stock exchanges increased 36.8 percent year on year to 1.32 trillion yuan.

The financing structure on the money market was characterized by the following: 1.) Against the backdrop of the sustained supply of abundant liquidity, state-owned commercial banks were the major lenders on the repo and inter-bank borrowing markets and their lending increased significantly over the same period of the last year; 2.) Due to the comparatively low returns of financing on the money market and the liquidity management strategy, other commercial banks reduced their lending volume; 3.) In the context of the continuous recovery of capital market securities, the demand for funds by fund management and insurance companies rose significantly. In the first half of 2009, funds borrowed by securities and fund management companies and insurance companies increased sevenfold and 85.7 percent year on year respectively.

Table 5: Fund flows among financial institutions in the first half of 2009

Unit: 100 million yuan

	Repo		Inter-bank borrowing	
	First Half of 2009	First Half of 2008	First Half of 2009	First Half of 2008
State-owned commercial banks	-151 343	-45 761	-12 349	17 672
Other commercial banks	-4 529	5 000	2 714	-21 822
Other financial institutions ¹	138 777	40 655	4 888	3 536
Of which: Securities and fund management companies	53 068	4 968	1 103	2 832
Insurance companies	21 500	11 575	—	—
Foreign financial institutions	17 095	16 667	4 746	3 446

Note: 1. Other financial institutions in this table include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies. A negative sign indicates net lending; a positive sign indicates net borrowing.

Source: The People's Bank of China.

The interest rate derivatives market operated in a sound manner. In the first half of 2009, bond forward and interest rate swap transactions steadily increased, among

which the 2-7 day bond forward and the interest rate swap with a maturity of one year or less than one year were traded most frequently. The trading volume of forward rate agreements was small and the value of the principal in nominal terms decreased slightly year on year. The Shibor played an increasingly greater role in the pricing of interest rate derivative products. The Shibor-based interest rate swap accounted for 30.7 percent of the total RMB interest rate swaps; forward rate agreements were all traded based on the Shibor.

Table 6: Transactions of interest rate derivatives

	Bond forward		Interest rate swaps		Forward rate forward	
	Transactions	Amount (100 million yuan)	Transactions	Nominal principal amount (100 million yuan)	Transactions	Nominal principal amount (100 million yuan)
2005	108	178	—	—	—	—
2006	398	665	103	356	—	—
2007	1 238	2 518	1 978	2 187	14	11
2008	1 327	5 008	4 040	4 122	137	114
Q1 2009	251	913	721	801	11	38
Q2 2009	406	1945	913	1068	6	10

Source: China Foreign Exchange Trading System.

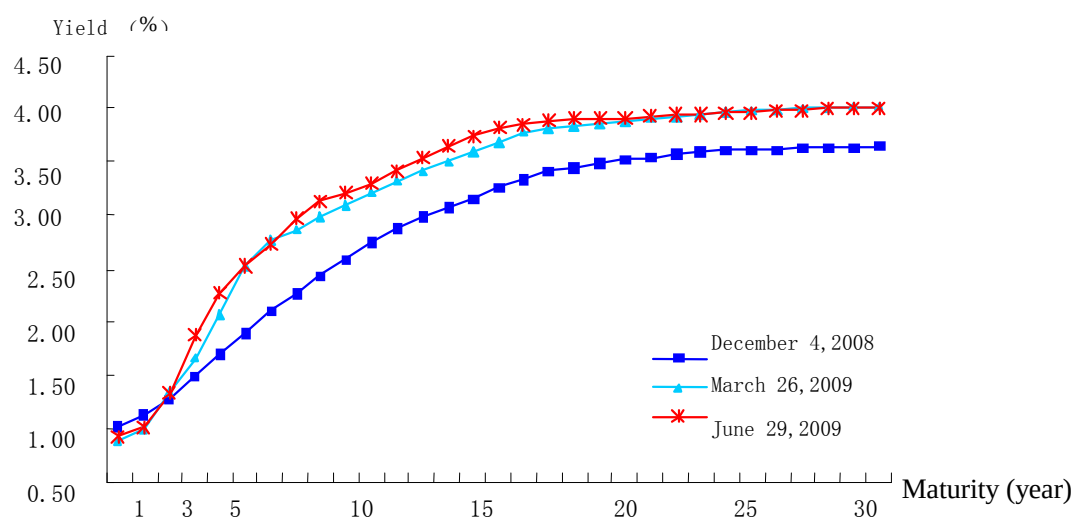
Money market interest rates edged up. In the first half of the year, the monthly weighted average interest rates of pledged bond repo and inter-bank borrowing basically remained at around 0.85 percent. In the second half of June, affected by the resumption of the IPO, the 14-day and below short-term interest rates rose. In June, the monthly weighted average interest rates of pledged bond repo and inter-bank borrowing both stood at 0.91 percent, which were both 0.06 percentage point more than that in the previous month. At the end of June, the overnight and 1-week Shibor stood at 1.09 percent and 1.2117 percent respectively, up 0.14 percentage point and 0.21 percentage point over the beginning of 2009, and 0.28 percentage point and 0.26 percentage point more than that in the previous month. The 3-month and 1-year Shibor registered 1.3179 percent and 1.8688 percent, down 0.46 percentage point and 0.49 percentage point over the beginning of 2009 but up 0.1 percentage point and 0.02 percentage point over the previous month.

2. Trading volume on the bond market continued to increase and bond indices fluctuated slightly

Spot bond trading was active on the inter-bank bond market. Affected by factors including adequate liquidity and the sustained recovery of the stock market, in the first half of 2009, the turnover of spot bond trading totaled 21.7 trillion yuan, with the average daily turnover reaching 177.9 billion yuan, up 34.8 percent year on year. Government bond spot trading on the stock exchanges registered 110.7 billion yuan, 34.4 billion yuan more than that during the same period of the last year. On the inter-bank spot bond market, the state-owned commercial banks conducted net purchases of 693.2 billion yuan, while the other commercial banks and financial institutions became net bond sellers, with net sales of 339.6 billion yuan and 321.3 billion yuan respectively.

Bond indices fluctuated within small margins. Though edging down since the middle of May, the bond index on the inter-bank market was generally stable in the first half of the year. The China Bond Composite Total Return Index fell 0.77 points from 132.22 points at the beginning of this year to 131.45 points at the end of June, representing a decrease of 0.59 percent.

The yield curve of government securities on the inter-bank market steepened. In the first half of the year, due to abundant liquidity in the market, the yields of short-term government bonds remained low while the yields of medium- and long-term government bonds edged up. Since June, affected by factors including market expectations and the “see-saw” effect of the stock market and the securities market, the yield curve of government bonds moved upward as a whole, among which the medium- and long-term yields of government bonds with maturities ranging from 3 to 15 years registered significant growth, with some increasing as much as about 20 basis points.



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

Figure 1: Yield curves of government securities on the inter-bank bond market in 2009

In general, bond issuances grew rapidly. In the first half of 2009, a total of 2.08 trillion yuan of bonds (excluding central bank bills) was issued on the primary securities market, 995.7 billion yuan more year on year, representing growth of 92.2 percent. Among this total, the issuance of government bonds, bank subordinated bonds, hybrid capital bonds, and enterprise bonds rose rapidly, and the issuance of policy financial bonds declined significantly. In the first six months of 2009, the Ministry of Finance issued 165.9 billion yuan of municipal bonds on behalf of local governments. In terms of the maturity structure, the share of bonds issued with a maturity of less than 5 years was 69.9 percent, up 5.5 percentage points over the same period of the last year. As of end-June 2009, outstanding bonds deposited with the China Government Securities Depository Trust and Clearing Co. Ltd. totaled 15.8 trillion yuan, up 16.6 percent year on year. The issue rates of bonds went up, among which the interest rate for book-entry government bonds with a maturity of 10 years issued in June 2009 stood at 3.09 percent, up 0.19 percentage point over that of those issued in December 2008. The issue rate of other bonds also rose.

Table 7: Issuances of bonds in the first half of 2009

Types of bonds	Issuances (100 million yuan)	Year-on-year growth (%)
Government securities ¹	8678	122.4
Policy financial bonds	3207	-27.7
Bank subordinated bonds and hybrid capital bonds	1057	552.5
Bank ordinary bonds	50	—
Enterprise bonds ²	7692	281.5
Of which: Short-term financing bills	1499	-12.9
Medium-term notes	4357	492.8

Note: 1. Including 165.9 billion yuan of municipal bonds issued by the Ministry of Finance.

2. Including enterprise bonds, short-term financing bills, medium-term notes, and corporate bonds.

Source: The People's Bank of China.

The Shibor continued to play a role in the pricing of bonds. In the first half of 2009, 114 enterprise bonds were issued, totaling 183.7 billion yuan, which were all priced based on the Shibor rates; 43 short-term financing bills were issued based on the Shibor rates, totaling 57.1 billion yuan, accounting for 38 percent of the total issuance; and 15 medium-term notes were issued based on the Shibor rates, totaling 24.2 billion yuan, accounting for 6 percent of the total issuance.

3. The growth of paper financing declined quarter by quarter

From January through June, a total of 5.4 trillion yuan of commercial bills was issued by the corporate sector, up 72 percent year on year. Discounted bills totaled 12.8 trillion yuan, an increase of 134 percent over the same period of the last year. Rediscounted bills amounted to 1.41 billion yuan. By the end of June, outstanding commercial bills stood at 5.0 trillion yuan, up 74 percent year on year. Outstanding discounted bills totaled 3.6 trillion yuan, an increase of 182 percent over the same period of the previous year. Outstanding rediscounted bills amounted to 890 million yuan. With the reduction of bill issuances and enhanced measures by financial institutions to adjust the asset structure to meet the demand for medium- and long-term loans, bill financing accounted for a smaller share of new loans in Q2. With the influence of interest rates on the money market and the change in supply and demand on the bill market, the interest rates of bills remained at a stable low level since 2009, reducing the financing costs of enterprises, especially small- and medium-sized enterprises.

4. The stock indices surged amid fluctuations

Influenced by several factors such as the recovery of the national economy, the growth of the stock markets in the major economies, and the abundant liquidity, stock indices surged amid fluctuations and turnover on the stock market rose significantly. In the first half of 2009, the total turnover on the Shanghai and Shenzhen Stock Exchanges amounted to 22.18 trillion yuan, up 30.9 percent year on year; the daily turnover registered 188 billion yuan, an increase of 33.1 percent year on year. As of end-June, the market capitalization of tradable shares totaled 9.12 trillion yuan, up 101.6 percent over the end of 2008. At the end of June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 2959 points and 962 points respectively, up 62.5 percent and 73.9 percent over the end of 2008, basically reaching the level at the end of Q2 2008. The average P/E ratios of A-shares on the Shanghai and Shenzhen Stock Exchanges rallied 25 times and 36 times respectively as of end-June from 15 times and 17 times respectively at the end of 2008.

Stock market financing declined year on year. According to preliminary statistics, in the first half of 2009, a total of 91.9 billion yuan was raised by non-financial enterprises and financial institutions through IPOs, secondary offerings, rights issues, warrants, and the issuance of convertible bonds on equity markets both at home and abroad, a reduction of 147.2 billion yuan over the same period of the last year, representing a decrease of 61.6 percent. Among this total, 87.9 billion yuan was raised through IPO and rights issues on the A-share market, down 109.1 billion yuan year on year, representing a decrease of 55.4 percent.

5. The growth of total assets in the insurance industry recovered

The growth of premium income slowed down. In the first half of 2009, the premium income of the insurance industry registered 598.6 billion yuan, up 6.6 percent year on year, a deceleration of 44.5 percentage points. Among this total, the premium income of personal insurance grew 3.6 percent year on year, a deceleration of 60.3 percentage points over the same period of the previous year. The premium income of property insurance rose 16.4 percent, a deceleration of 3.4 percentage points. Claims and benefit payments in the insurance industry totaled 160.8 billion yuan, up 4.2 percent year on year.

Growth in the total assets of the insurance industry rallied. By the end of June, the total assets of the insurance industry amounted to 3.71 trillion yuan, up 22.6 percent year on year, an acceleration of 3.3 percentage points. In particular, investment-type assets grew 15.9 percent over the previous year, a deceleration of 13.4 percentage points; bank deposits increased 49.7 percent, an acceleration of 57.1 percentage points.

Table 8: Use of insurance funds

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-June 2009	End-June 2008	End-June 2009	End-June 2008
Total assets	37 072	30 236	100.0	100.0
Of which: Bank deposits	10 445	6 978	28.2	23.1
Investment	23 280	20 086	62.8	66.4

Source: The China Insurance Regulatory Commission.

6. The foreign exchange market developed in a stable manner

The foreign exchange market operated in a sound manner and the trading volume of swap transactions continued to rise. The trading volume of forward transactions and currency pairs dropped by a relatively large margin. RMB foreign exchange swap transactions were active, with a total turnover of US\$288.7 billion, and the daily

turnover grew 35.6 percent year on year. The US dollar was still the most frequently traded currency on the foreign exchange swap market and the turnover of overnight RMB/USD swaps accounted for 63.3 percent of the total turnover in swap transactions, up 9.2 percentage points over the end of 2008, showing a stronger trend of shortening maturities. The turnover on the RMB foreign exchange forward market totaled US\$3.2 billion and the daily turnover dropped 74 percent year on year. The turnover of the 8 currency pairs reached US\$16.4 billion, the daily turnover decreased 44.1 percent over the same period of the previous year, and the bulk of the transactions were USD/HKD and EUR/USD currency pairs, accounting for 74.3 percent of the total turnover.

7. The trading volume on the gold market increased

In the first half of the year, the Shanghai Gold Exchange operated in a generally stable manner, and its trading volume stood at 1999.8 tons, up 1.9 percent year on year; the turnover in gold transactions totaled 403.61 billion yuan, down 1.3 percent over the same period of the previous year. The trading volume of silver registered 3485.7 tons, an increase of 112.5 percent; the turnover in silver transactions reached 10.39 billion yuan, a rise of 49.9 percent year on year. The trading volume of platinum amounted to 30.8 tons, up 81.2 percent year on year; the turnover in platinum transactions stood at 7.94 billion yuan, an increase of 5.3 percent over the same period of the last year.

From January through June, the price movement of gold on the Shanghai Gold Exchange was consistent with that on the international market. The price of gold went up from January to the beginning of March and then fluctuated from March through June. In the first half of this year, the price of gold reached a peak and trough of 218 yuan/gram and 178 yuan/gram respectively and stood at 207 yuan/gram as of end-June, up 7.48 percent over the beginning of 2009.

II. Financial market institutional building

1. A new system for local currency-denominated transactions on the inter-bank market was successfully launched

The transaction system is a vital part of the infrastructure on the inter-bank market, and the stability, security, and usability of such a system affects the secure and efficient operations of the inter-bank market. In order to accelerate the development of the inter-bank market, the PBC launched a project to develop a new transaction system in 2006. After three years of efforts in design, development, and testing, the new system for local currency-denominated transactions on the inter-bank market (referred to as the “new transaction system” hereinafter) was officially launched on June 29, 2009. The new transaction system built on the strength of the original system and made significant improvements in structure, transaction functions, customer management, extended functions, and so on. Within the first month after its launch,

1,513 institutions had logged onto the new system, offering 52,249 quotes, among which 31,615 were successfully traded, and the turnover totaled 12.5 trillion yuan. The system facilitated frequent transactions of spot bond trading, pledged repos, and unsecured lending, as well as deals in bond forwards, outright repos, and interest rate swaps. The successful operation of the new transaction system has further improved the infrastructure of the inter-bank bond market.

2. Improvements in the institutional infrastructure of the securities market

First, the IPO system was reformed and improved. On June 10, the China Securities Regulatory Commission (CSRC) issued the *Guiding Opinions on Further Reforming and Improving the IPO System* in order to enhance the efficiency of offerings. Four major measures have been taken at the current stage: improving the bid and offer mechanism for book building and subscriptions to further establish a market-based pricing mechanism; optimizing an online IPO mechanism by separating online and offline subscribers; setting a ceiling for individual online subscription accounts; and promoting risk warnings for IPO subscriptions to keep all parties informed of market risks. The reform and improvement of the IPO system optimized the price discovery function of the IPO, and strengthened the check-and-balance between offerers and subscribers; enhanced the efficiency of the share allotment mechanism; increased the willingness of retail investors to participate as they are well informed of the risks; and significantly enhanced risk awareness on the primary market.

Second, the institutional arrangements concerning the growth enterprise board (GEB) were improved. In order to advance the development of the GEB in China and to improve the institutional arrangements, the CSRC issued the *Decision on Revising the Administrative Rules on the Offering and Listing of Securities* and the *Decision on Revising the Rules of the CSRC's IPO Review Committee*, which were enacted on June 14, 2009. The revision further adapted the sponsorship system and the IPO review committee to the characteristics of the GEB and put the professional review role of the IPO review committee into full play in a bid to ensure the quality of enterprises listed on the GEB and to strengthen market discipline and risk control.

Third, supervision over securities companies was reinforced. On April 3, the CSRC issued the *Regulations on Reinforcing Supervision over Securities Companies*, which urged listed securities companies to act in strict compliance with the regulatory rules for securities companies and listed companies and to improve corporate governance and management. On May 26, the CSRC released the *Provisions on Classification and Supervision of Securities Companies*, defining the classification standards and evaluation process of 11 classes in 5 categories of securities companies. By appropriately allocating regulatory resources and enhancing supervisory efficiency, these measures will promote effective regular supervision over securities companies and sustained development of the securities companies.

Fourth, the asset management business for specific multiple clients by fund

management companies was regulated. The *Provisions on Asset Management Business for Specific Multiple Clients by Fund Management Companies* were released on May 5 and took effect on June 1. This step helps protect the legitimate rights and interests of the concerned relevant parties.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In the first half of 2009, as the impact of the large-scale policy actions taken around the world was gradually felt, the global economic contraction showed initial signs of a slowdown, signaled by the rebound in the world stock markets, the resurgence of commodity prices, and the rise in the consumer confidence index. However, the recovery may still be slow and bumpy with many uncertainties in the future.

1. Economic development of the major economies

The U.S. economy showed signs of stabilization. In the second quarter of 2009, the seasonally adjusted annualized GDP was -1.0 percent, better than the -6.4 percent in the first quarter. The employment situation lagged behind economic development and the unemployment rate continued to climb, with the monthly rates for the three months of the second quarter registering 8.9 percent, 9.4 percent, and 9.5 percent (a record high in 26 years) respectively and the average standing at 9.3 percent, 1.2 percentage points higher than that during the first quarter. Foreign trade contracted sharply, but imports fell by a larger margin than exports, leading to a marked reduction in the trade deficit. In the first five months of the year, imports and exports dropped by 28.3 percent and 18.7 percent respectively and the trade deficit totaled US\$145.9 billion, much smaller than the US\$305.3 billion deficit during the same period of the last year. Fiscal conditions continued to deteriorate. In the first nine months of the 2009 fiscal year starting on October 1, 2008, the accumulated fiscal deficit soared to US\$1.086 trillion, a sharp rise compared with last fiscal year's total of US\$454.8 billion. Prices stabilized gradually, with the average monthly CPI for the second quarter declining by 0.9 percent year on year, and the month-on-month CPI for the three months of the second quarter increasing by 0.0 percent, 0.1 percent, and 0.7 percent respectively.

In the euro area, the pace of the decline began to moderate. In the first quarter of 2009, the seasonally adjusted GDP slid by 2.5 percent month on month, 0.7 percentage point lower than that during the fourth quarter of the last year. In May, seasonally adjusted industrial production increased by 0.5 percent month on month, the first positive reading in the past nine months. The employment situation was grave, with the unemployment rate registering 9.2 percent, 9.3 percent, and 9.4 percent respectively in the three months of the second quarter, averaging 9.3 percent, 0.5 percentage point higher than that in the first quarter. The trade deficit narrowed. From January to May, both imports and exports dropped by 23 percent and the accumulated trade deficit reached 6.5 billion euros, lower than the trade deficit of 13.4 billion euros in the same period of the last year. The price level remained subdued. The monthly average HICP

in the second quarter increased by 0.2 percent year on year, and the month-on-month HICP for the three months of the second quarter grew by 0.4 percent, 0.1 percent, and 0.2 percent respectively.

The Japanese economy remained weak. In the first quarter of 2009, the annualized quarter-on-quarter GDP growth after seasonal adjustments slumped by 14.2 percent, the steepest fall in the postwar period. The job market deteriorated further, with monthly unemployment rates in the second quarter at 5.0 percent, 5.2 percent, and 5.4 percent respectively (a six-year high), and an average of 0.8 percentage point higher than the 4.4 percent in the first quarter and 1.2 percentage points higher than that during the same period of the last year. Trade conditions were gloomy, with imports and exports plunging by 38.6 percent and 42.7 percent respectively and the cumulative trade surplus registering 8.3 billion yen, a drastic decrease from the 2.8 trillion yen surplus during the same period of the last year. In June, the pace of the decline in exports moderated, leading to a rapid increase in the trade surplus compared with the last year. Price levels fell steadily, with the monthly average for the second quarter dropping 1.0 percent year on year and the CPI for the three months of the second quarter increasing 0.1 percent, -0.2 percent, and -0.2 percent respectively.

The economies of the major emerging markets and developing countries (regions) showed signs of recovery after a drastic worsening. Since the beginning of the year, capital outflows and a sharp plunge in exports severely dampened the growth of the emerging markets and developing countries, and some Central and Eastern European countries even fell into serious debt difficulties. But from the second quarter, as various sizable market supports and economic stimuli took hold, some emerging market economies showed tentative signs of recovery. In particular, in face of the slowed economic downturn, the risk appetite rose and capital flowed back into the emerging markets countries, promoting a rapid rebound of their stock markets. However, because the emerging markets and developing countries rely excessively on external demand, a firm recovery will not be in place until external conditions stabilize. Meanwhile, there was a discrepancy within the emerging markets and developing countries (regions). Due to their sound fiscal and balance of payments conditions and their low external debt level, the Asian countries might be the first to embrace a recovery, followed by Latin America. But the economic outlook for the Eastern European countries might be weighed down by the heavy external debts.

2. Global financial market development

The exchange rates of the major currencies saw large fluctuations and the US dollar first grew strong then dropped. At the beginning of the year, because economies such as that in the EU and Japan contracted more than expected, the US dollar firmed on risk aversion. Starting from March, against the backdrop that hedging needs waned

with the rising expectations for a global recovery and concerns about the long-term stability of the US dollar picked up due to the huge fiscal deficit and extremely loose monetary policy of the United States, the US dollar slipped. At end-June, the exchange rate of the dollar against the euro closed at 1.403 dollar per euro, a depreciation of the dollar by 0.4 percent from the beginning of 2009. And the exchange rate of the yen against the dollar closed at 96.3 yen per dollar, an appreciation of the dollar by 5.9 percent.

The US dollar Libor was low and fluctuating. On May 21, the 1-year US dollar Libor slumped to 1.49 percent, its bottom level for the first half of the year, but it later rebounded with the rising inflation expectations. The 1-year Libor posted 1.61 percent on June 30, 0.40 percentage point lower compared with that at the beginning of the year. Affected by the ECB's successive interest rate cuts, the Euribor moved continuously downwards. The 1-year Euribor posted 1.504 percent on June 30, down 1.545 percentage points from that at the beginning of the year.

The yields of government securities of the major countries generally climbed up. Although the yields of treasury bonds were once depressed by the treasury purchases programs announced in succession by the central banks of the major economies since March, yields picked up again with the market expectation that in the following several years, the issuance of government bonds would expand and inflation pressures would augment due to the sizable economic stimulus and the extremely loose monetary policies adopted by the major economies. At the end of June, the yield of 10-year treasury bonds of the United States, euro area, and Japan closed at 3.537 percent, 3.381 percent, and 1.352 percent respectively, a growth of 1.313, 0.437, and 0.184 percentage points respectively from the level at the beginning of the year.

The major stock indices rallied. Depressed by the deepening of the crisis and the economic slowdown, worldwide stock markets continued the downward trend of the beginning of the year. However, boosted by an arsenal of factors including forceful market support measures, comparatively eased economic and financial situations worldwide, improved market confidence, and an increased appetite for risk, the major stock indices rallied since mid-March and they all gained more than 10 percent in the single month of April. At end-June, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 8447.0, 1835.0, 2401.7, and 9958.4 respectively, up 11.0 percent, 20.0 percent, 16.0 percent, and 22.8 percent from end-March.

3. Housing market development in the major economies

There have been some signs of a modest improvement in U.S. housing market activity but house prices continued to slide. The national housing price index in the first quarter of 2009 declined by 0.55 percent month on month, a smaller fall compared

with the last quarter's 3.3 percent. After dipping by 0.3 percent in April month on month, house prices rebounded by 0.9 percent in May. In June, the start of new homes reached 583,000, up 3.6 percent month on month and a third consecutive month increase, but still 46 percent lower compared with the same period of the last year. New home sales registered 384,000, an increase by 11 percent month on month, which is the largest gain in eight years. New homes yet to be sold totaled 281,000, the lowest level in eleven years and a decrease of 4.1 percent month on month. Noticeably, mortgage rates were brought up by the rising long-term interest rates, and the average 30-year fixed-rate mortgage soared to around 5.20 percent by the end of June, a new high for the past six months, which might impair the recovery of the housing market.

The European housing market remained sluggish, with the Halifax housing index growing by 2.0 percent, -2.3 percent, -1.9 percent, -1.8 percent, 2.6 percent, and -0.5 percent for the first six months of 2009. With France as a representative, housing prices in the other European countries also spiraled downward and the start of new homes continuously shrank.

The Japanese housing market cooled down remarkably. Influenced by the outflow of capital and weak demand, house prices continued to decrease. At the same time, the start of new homes withered persistently, down 10.9 percent, 13.1 percent, 24.6 percent, 32.5 percent, and 34.0 percent respectively for the first five months of this year.

4. The monetary policy of the major economies

Since 2009, the Open Market Committee of the U.S. Federal Reserve has maintained the target range for the federal funds rate at 0 to 1/4 percent, while the Bank of Japan announced that it would keep its uncollateralized overnight call rate at around 0.1 percent. On January 15, the ECB reduced the major refinancing rate by 50 basis points to 2.0 percent, expanded the spread between deposit and marginal lending facilities from 100 to 200 basis points, and lowered the major refinancing rate by 50 basis points, 25 basis points, and 25 basis points on March 5, April 2, and May 7, respectively to 1.0 percent. The Bank of England cut its Bank Rate three times, on January 8, February 5, and March 5, lowering it by 150 basis points in all to 0.5 percent, a record low in the 300 years since its establishment.

When the benchmark rates fell to close to zero, the policy effect of the traditional price mechanism (interest rates) became quite limited. Therefore, a quantitative mechanism featuring a balance sheet size adjustment, or a so-called "unconventional" monetary policy, has become a necessary choice for the major banks to further ease their money stance and to influence financial markets.

Box 3 Effects and implications of the quantitative easing monetary policy of the foreign central banks in zero interest rate environments

Since September 2008, in order to deal with the financial crisis and to prevent the economy from sliding into a protracted recession, the Federal Reserve, the Bank of Japan, the Bank of England, the Swiss National Bank, and the European Central Bank cut their policy interest rates to near zero and adopted a quantitative easing monetary policy featuring balance-sheet expansion. On the basis of innovative instruments, the central banks pumped liquidity into the market through the purchase of government bonds and other medium- and long-term bonds. The purposes of a quantitative easing monetary policy under zero interest rate environments are on the one hand to keep money supply basically stable in the process of the rapid deleveraging in the financial system so as to lower medium- and long-term interest rates and to avoid serious deflation, and on the other hand to directly take over part of the markets' financing functions when credit markets are partially or tentatively dysfunctional so as to prevent the crisis from spreading into the real economy due to a credit crunch.

At present, paired with the massive fiscal spending, the quantitative easing monetary policy in zero rate environments has yielded preliminary results in that it has stabilized price expectations and avoided a recession similar to that during the Great Depression. In particular since the second quarter, as the financial market gradually stabilized, stock markets rebounded substantially, the credit squeeze was eased, commodity prices rose, the global economic recession slowed down markedly, the price decline gradually decelerated, and the risk appetite and confidence improved. A large number of national governments and international organizations judged that the worst was over, and predicted a recovery of the world economy around 2010.

However, the quantitative easing monetary policy under zero rate environments faces many constraints. At the current stage, despite improvements in the major advanced economies, deleveraging is still slowly under way in the private sector, the real economy remains fragile, and the recovery of consumption and employment is still uncertain. At the same time, with the burgeoning fiscal deficit of certain economies and the mounting pressures on government bond supplies, long-term government bond yields might climb further, posing threats to adjustments in the real estate market and to an economic recovery. A quantitative easing policy through the massive purchase of medium- and long-term treasury bonds helps to bring down long-term government bond yields in the short run; however, its impact on the long-term interest rate in the long run is not obvious, and if not handled appropriately might give rise to concerns about inflation and exchange rate stability in the medium and long term. The central banks of the major advanced economies are facing a dilemma between "maintaining low government bond yields to promote economic recovery" and "maintaining currency value to safeguard sovereign credit."

At present, the governments and central banks of some countries have started to study

exit strategies from the quantitative easing monetary policy and other response measures. First, in terms of timing and degree, in theory the exit policies should be preceded by the condition that the impacts of the crisis are over and the economic recovery has started. But in practice, an accurate judgment should be made on the timing and strength of the withdrawal of such policies. Otherwise, a policy withdrawal, if rushed, might put pressures on the economic recovery; and if too slow, it might trigger another round of asset price bubbles and hyperinflation. Second, in terms of the selection of withdrawal instruments, new instruments can be created in addition to scaling down quantitative instruments and occasionally applying conventional instruments to ensure that when the economy recovers, the liquidity can be withdrawn quickly without causing major fluctuations in the credit market. Third, in terms of coordination between monetary policy, fiscal policy, and other policies as well as communications among the major economies, it is necessary to avoid negative spillovers and policy compromises, and beggar-thy-neighbor policies so as not to hurt other economies. On June 25, the Federal Reserve announced that it would not scale up its balance sheet for the time being, and it suspended or halted some quantitative easing instruments. Chairman Bernanke of the Federal Reserve stated publicly on July 21 that the Fed had considered some issues concerning exit strategies.

In addition, the outbreak of the financial crisis has also revealed multifold problems on the part of the microeconomic players and poor supervision and regulation on the part of financial regulators in some areas. With a view to handling the spread of the financial crisis and mitigating and dissolving the financial risks, the major economies and international organizations have strengthened financial supervisory and regulatory reforms. On May 27, the European Commission issued the European Financial Supervision and proposed a pan-European financial regulatory system. On June 17, the U.S. administration promulgated a sweeping plan to overhaul financial supervision, proposing to promote robust regulation and supervision of financial firms, to establish comprehensive supervision of financial markets, to raise international regulatory standards, and to promote international cooperation, and so forth.

Box 4 Strengthen macro-prudential regulation and safeguard financial system stability

After the international financial crisis broke out, the roots of the crisis were subject to debate; however, after discussions at two international financial summits, the various parties had reached more of a consensus. As stated in the G20 London Summit Communiqué, major failures in the financial sector and in financial regulation and supervision were the fundamental causes of the crisis. To learn the lessons from the crisis and safeguard financial system stability, it is urgent that macro-prudential regulation be strengthened and improved, and counter-cyclical policies be adopted and comprehensive regulation and supervision be carried out over different markets and industries to overcome pro-cyclical fluctuations in the financial system, and to mitigate and dissolve systemic financial risks. Therefore, since the outbreak of the

financial crisis, the major economies and international organizations have been strengthening the financial regulatory reform, an important part of which is macro-prudential regulation. In January 2009, the Group of 30 issued a report entitled “Financial Reform: A Framework for Financial Stability,” in which it proposed that supervisory systems be improved by redefining the scope, boundaries, and the structure of prudential regulation, addressing pro-cyclicality via capital and provisioning requirements, and enhancing valuation and accounting standards. In April, the G20 London Summit proposed to push ahead with the international financial system, to rename the Financial Stability Forum the Financial Stability Board (FSB) and to expand its membership to all G20 economies and important international financial centers so as to coordinate the promulgation and implementation of global financial standards and codes, and to promote financial system stability at national and international levels. The FSB is now studying the launch of a complete set of plans to reinforce rules on banks’ capital adequacy ratios and liquidity and to improve loan loss provisions so as to reduce pro-cyclical and systemic risks in financial systems and financial regulation. In July, the Basel Committee on Banking Supervision made major adjustments to a series of important regulatory policies in accordance with the G20 Summit proposals and recommendations of the FSB, including strengthening the banks’ capital regulation, risk management, and risk supervision, pushing forward the implementation of the banks’ regulatory standards, revising accounting standards, and so forth, and established a working group on counter-cyclical capital regulation and a working group on macro-prudential analysis to strengthen counter-cyclical capital regulation and macro-prudential regulation.

Strengthening counter-cyclical capital regulation mainly aims at alleviating the pro-cyclical effects of the banking system and enhancing the quality of bank capital. The Basel Committee on Banking Supervision (BCBS) has put forward preliminary plans for implementing counter-cyclical capital regulation. First, a counter-cyclical supervisory framework on capital buffers should be established. Second, cyclical moves of the minimum capital requirement should be dampened. Third, banks’ provisioning of loan losses in a prudential manner, such as dynamic provisioning, should be encouraged. The BCBS meeting agreed that building up a counter-cyclical supervisory framework on capital buffers should take into account the excess cyclicity of the minimum capital requirement and attach great importance to the role of provisioning in mitigating cyclicity. In addition, the G20 Leaders’ Summit on the Financial Market and the World Economy and the FSB proposed to introduce a leverage ratio as a supplement to the CAR. The BCBS reviewed and agreed in principle to the *Design of a Stock-based Measure of Leverage* and specified the next priority to reduce the impact of discrepancies across accounting regimes and measuring quantitative effects worldwide to define the appropriate supervisory standards for the leverage ratio. A proper leverage ratio not only can be used as an indicator of potential excess risk-taking, but can also play a role in curbing the amplification of cyclical fluctuations.

In an effort to strengthen macro-prudential supervision, attention should also be given to preventing systemic risks that may be built up in cross-market and cross-sector financial development. In recent years, financial innovation has created new sources of systemic risks, as reflected in various OTC financial products, bank-like financial institutions (such as investment banks, hedge funds, and Special Purpose Entities) and cross-market speculation of capital flows. These bank-like financial institutions, with multifold problems, are closely related to traditional financial institutions, which may easily give rise to systemic risks. Systemic risks also come from the massive expansion of non-traditional financial products and businesses by some large traditional financial institutions with the aim of avoiding regulation. The BCBS suggested that the tools adopted for macro-prudential supervision should include horizontal reviews, supervisory stress tests, identification of systemically important financial institutions, products, and markets, and additional regulatory requirements. The FSB, IMF, and BIS are now working together to formulate guidance on assessing the system-wide importance of a financial institution, market, or instrument. With respect to the inefficient communication among supervisory authorities, central banks, and the Ministry of Finance in some developed countries since the outbreak of the recent financial crisis, which adversely affected the financial rescue and financial stability, the BCBS suggested an adequate sharing of information and a division of labor between the central banks and the supervisory authorities. Moreover, the BCBS meeting supported the international convergence on regulatory standards for liquidity risk raised by the G20 Summit and the FSB.

Expanding the central banks' authority over systemic supervision through the reform of the financial supervisory framework served as an important way to strengthen macro-prudential supervision and as a key component in the recent financial regulation reform in the U.S. and Europe. In June, the U.S. administration announced a comprehensive overhaul of the U.S. financial regulatory system, and allowed the Federal Reserve to regulate large financial institutions as well as their subsidiaries whose failure could pose systemic risks to the whole economy. In May, the European Commission revealed a plan for establishing a new European Supervisory Framework according to two levels of supervision. At the macro-prudential level, the Commission proposed the creation of a European Systemic Risk Council (ESRC) in charge of monitoring the potential exposure of EU financial markets to systemic risks, and timely providing early warnings and, when necessary, recommendations for action to deal with these risks. At the micro-level, three European supervisory authorities, consisting of member-state supervisors, should be established and should be responsible for supervisory coordination in the banking, insurance, and securities sectors respectively. The three authorities should report to a Steering Committee to be created to strengthen the collaboration among these authorities. The EU Summit held in June supported the reform of the European financial supervisory framework, including equipping the EU with a European Systemic Risk Board (ESRB) in the course of 2010, which will monitor and assess market risks, and will have supervisory

powers for credit rating agencies. However, the decisions taken by the ESRB should not impinge in any way on the fiscal responsibilities of the member-states. The members of the General Council of the ECB will elect the chair of the ESRB.

In general, strengthening macro-prudential supervision is vital to preventing systemic risks and safeguarding financial stability. As a member-state of the FSB, China is exploring the way forward to establish and improve a macro-prudential supervisory framework, to develop macro-prudential supervision instruments, to promote the buildup of provisioning and capital requirements that “lean against the wind” and to strengthen cross-border and cross-sector supervision so as to safeguard financial stability and to promote the sound and sustainable development of the economy.

5. World economic outlook

In July 2009 the International Monetary Fund (IMF) projected that the world economy was beginning to pull out of a recession unprecedented in the post-World War II era, and the recovery was expected to be sluggish. The IMF forecast that world economic growth would sharply slow down from 3.1 percent in 2008 to -1.4 percent in 2009, about 0.1 percentage point lower from its April forecast; however, the world economy would register growth of 2.5 percent in 2010, up 0.6 percentage point from the April forecast. Growth in the United States, the euro area, and Japan would drop from 1.1 percent, 0.8 percent, and -0.7 percent in 2008 respectively to -2.6 percent, -4.8 percent, and -6.0 percent in 2009, and growth in the emerging market economies and developing economies would slow down from 6.0 percent in 2008 to 1.5 percent. At the same time, inflation in the developed economies and emerging market economies and developing economies will fall from 3.4 percent and 9.3 percent in 2008 to 0.1 percent and 5.3 percent respectively in 2009. World trade growth will decline from 2.9 percent in 2008 to -12.2 percent, and will register fractional growth of 0.1 percent in 2010.

Given the complicated roots, breadth, and depth of the global financial crisis, whether certain positive signals at the current stage indicate the end of the economic recession is yet to be determined. In light of the present situation, though the general trend of economic stabilization is basically established, the recovery process might be slow and tortuous. With regard to the real economy, consumption, investment, imports and exports, the real estate market, and the labor market have not formed a synergy that can achieve rapid recovery of the global economy; with regard to the financial sector, it will take a long time to repair the balance sheets, rebuild the profitability model of the financial system, and recover the financial markets. In addition, there are a lot of interwoven risk factors in the recovery process, including the US dollar exchange rate, the movements of commodity prices, the impact of non-conventional fiscal and monetary policy on inflationary expectations, and the rise of protectionism. These factors, coupled with the volatility in the economic and financial markets, will inevitably challenge market confidence during the recovery and influence the progress

of the recovery.

II. Analysis of China's macroeconomic performance

In the first half of 2009, positive factors in China's economic performance were on the rise, and the trend of economic stabilization was becoming more visible; the momentum of agricultural development was good, and industrial production growth sped up noticeably; consumption stabilized and continued growing at a relatively rapid pace, investment growth continued to accelerate, and the driving force of domestic demand for economic growth became stronger. At present, the macro economy is in a critical period of stabilization and recovery. In the first half of the year, the Gross Domestic Product (GDP) registered 14 trillion yuan, up 7.1 percent year on year, representing a deceleration of 3.3 percentage points from the same period of the last year and an acceleration of 1.0 percentage point from the first quarter. Final consumption, capital formation, and net exports of goods and services drove the GDP up by 3.8, 6.2, and -2.9 percentage points respectively. The Consumer Price Index (CPI) fell 1.1 percent year on year, representing an acceleration of 0.5 percentage point from the first quarter. The trade surplus posted US\$97.02 billion, representing a decrease of US\$1.21 billion from the same period of the last year and an increase of US\$34.73 billion from the first quarter.

1. Domestic demand steadily increased, while external demand shrank sharply

Urban and rural household income rose, and sales on the domestic market continued to grow steadily. In the first half of the year, the per capita disposable income of urban residents registered 8,856 yuan, up 9.8 percent year on year in nominal terms or 11.2 percent in real terms, an acceleration of 4.9 percentage points from the same period of the last year. The per capita cash income of farmers grew by 8.1 percent in nominal terms to 2,733 yuan, and the inflation-adjusted growth was 8.1 percent, representing a deceleration of 2.2 percentage points from the same period of the last year. Sales on the domestic market grew in a stable and relatively rapid manner. In the first half of the year, retail sales grew 15.0 percent in nominal terms year on year, or 16.6 percent in real terms, which was an acceleration of 3.7 percentage points from the same period of 2008 and represented a relatively high level in the recent decade.

Fixed-asset investments continued to increase rapidly. In the first half of the year, completed fixed-asset investments rose by 33.5 percent to 9.1 trillion yuan, an acceleration of 7.2 percentage points from the same period of the last year and an acceleration of 4.7 percentage points from the first quarter; the inflation-adjusted real growth posted 38.3 percent, representing an acceleration of 20.6 percentage points and an acceleration of 7.3 percentage points from the first quarter.

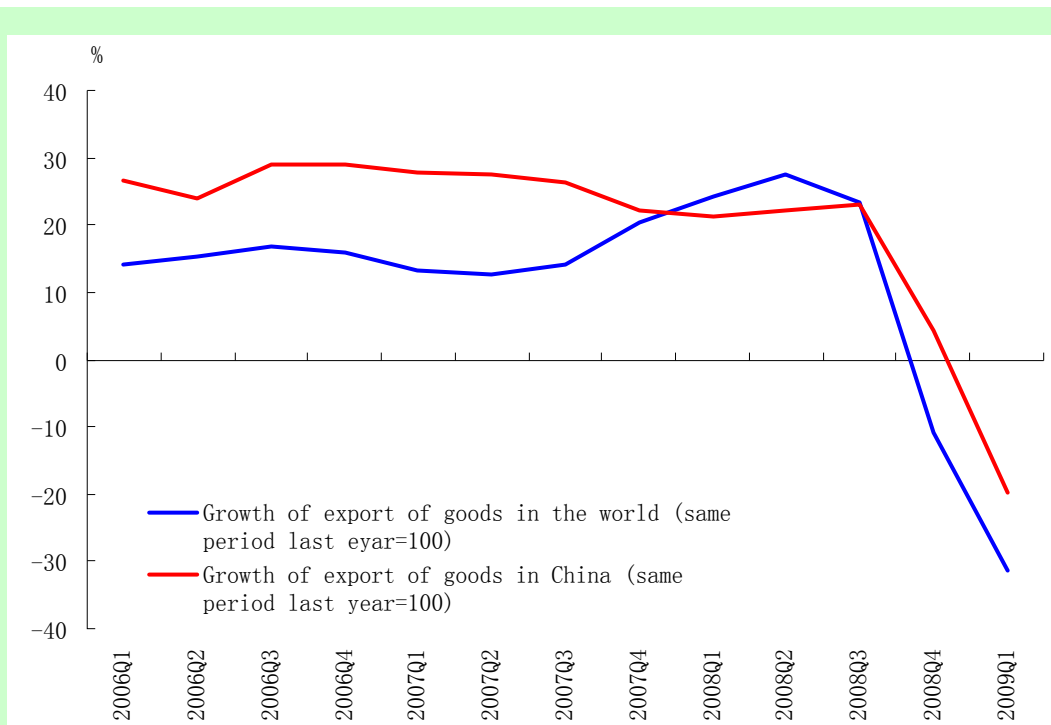
Foreign trade continued to fall steeply, and the trade surplus decreased. In the first half of the year, imports and exports totaled US\$946.24 billion, down 23.4 percent year on year and representing a deceleration of 1.6 percentage points from the first quarter. Among this total, exports posted US\$521.63 billion, representing a year-on-year decline of 21.8 percent and an acceleration of 2.0 percentage points from the first quarter; imports registered US\$424.61 billion, representing a decline of 25.4 percent and a deceleration of 5.6 percentage points from the first quarter. The trade surplus stood at US\$97.02 billion, a year-on-year decrease of US\$1.21 billion and an increase of US\$34.73 billion from the first quarter. In the first half of the year, actually utilized foreign direct investment posted US\$43 billion, down 17.9 percent year on year and representing a deceleration of 2.7 percentage points.

Box 5 Speed up economic restructuring to positively deal with the changes in external demand

Stimulated by the easing monetary policies and economic stimulus packages, the trend of a drastic slowdown in the developed economies is abating, and there are signs of economic stabilization. However, rising unemployment, weakening real estate markets, and shrinking global trade have shown that the impact of the financial crisis on the real economy remains, and it should be properly handled.

1. The main cause for the sharp decline in exports is weak demand in the international market

Affected by the international financial crisis, global trade has shrunk precipitously. The World Trade Organization (WTO) estimates that in the first quarter of 2009 the export value of goods fell by 31 percent year on year globally. It also predicts that global exports of goods will drop by 29 percent for the whole year, and by 10 percent in inflation-adjusted terms. China's export volume also shrank greatly, but less drastically compared to the rest of the world, and its share in the total exports of the world registered an increase rather than a decrease. In particular, the decline in the export of apparels, luggage, shoes, furniture, and other labor-intensive products was much smaller than the overall decline in exports, which shows that China's labor-intensive products enjoy great international competitiveness. In the first four months, China's exports accounted for 13.6 percent of the total imports of China's major trading partners (including the European Union, the United States, Japan, and some emerging market economies, and those economies combined imported 61.4 percent of China's total exports), an increase of 1.4 percentage points from the 12.2 percent in August 2008, continuing the trend of increasing market share since 2000. The PBC's survey of import and export enterprises for the second quarter of 2009 shows that 70 percent of the surveyed enterprises attribute the export decline to the weakening external demand.



Source: WTO, General Administration of Customs, PBC staff calculation.

Figure 2: Export growth in China and in the world

2. The impact of weakening external demand on China will persist

The recession triggered by the international financial crisis is the worst recession since World War II, and its breadth is unprecedented. At present, although in the major economies including the United States, Europe, and Japan there are signs of economic stabilization, the adjustments will not come to an end very soon, and the world economic recovery will be slow and full of twists. Moreover, the consumption pattern in some developed economies has changed, and there are signs that households' consumption philosophy is changing from "overconsumption" to "making ends meet," which might influence the expansion of the global consumer market. As international trade might enter a low-growth period, trade frictions will become more frequent, and the international trade environment might deteriorate. The WTO members launched 83 measures that might hurt international trade, doubling the number in the same period of the last year. In the first half of 2009, a total of 58 investigations were brought against China on grounds of anti-dumping, countervailing, safeguard measures, and special safeguard measures, involving about US\$8 billion. In the next period, exports from China are likely to continue their low growth.

Since the beginning of 2009, the export orders index has continued to rise, but there are many uncertainties in the future. A survey by the China Federation of Logistics and Purchasing shows that in June 2009, the new export orders index among the purchasing managers' indices in China's manufacturing sector posted 51.4 percent,

rising for the seventh consecutive month. The PBC's business survey for the second quarter of 2009 shows that the index showing the enterprises' expectations for export orders was 10.9 percent, up 13.2 percentage points from the previous quarter. Among this, 39.2 percent of the surveyed enterprises predicted a rise in export orders in the next quarter, up 3 percentage points from the previous quarter; those predicting a decline in export orders accounted for 28.3 percent of those surveyed, down 7 percentage points from the previous quarter. The survey also shows that at present export orders are dominated by small-size and short-term orders, so uncertainties still loom large and the situation is not optimistic.

3. Speed up restructuring to actively deal with the changes in external demand

Since the outbreak of the financial crisis, the Central Committee of the Communist Party of China and the State Council have adopted a series of policy measures that aim to support the development of external trade, including promoting trade facilitation, beefing up fiscal and taxation supporting measures, and improving financial services related to import and export activities. These measures have yielded good results, and have succeeded in maintaining China's market share. Going forward, in response to the possibility of weakening external demand, efforts should be made on the one hand to implement the policy measures, and, on the other hand, to pay attention to economic restructuring and to the shift in the pattern of foreign trade development. The product mix and market structure should be optimized to actively promote the transformation and upgrading of processing trade. Export enterprises should enhance their capability for independent innovation, improve the competitiveness of their products, and at the same time explore markets, especially the emerging markets with great growth prospects and potential.

2. The agricultural sector maintained a momentum of good development and industrial production growth accelerated

In the first half of the year, the added value of primary industry was up 3.8 percent year on year to 1.2 trillion yuan, contributing 4.0 percent to economic growth; the added value of secondary industry was up 6.6 percent year on year to 7.0 trillion yuan, driving up economic growth by 48.6 percent; the added value of tertiary industry grew 8.3 percent year on year to 5.8 trillion yuan, representing a 47.4 percent contribution to economic growth.

Agricultural production maintained a momentum of good development, and the summer crop harvest grew for the sixth successive year. Summer crop production totaled 123.35 million tons, an increase of 2.2 percent year on year. In the first half of the year, meat (pork, beef, and mutton) production posted 35.8 million tons, up 6.3 percent year on year. The producer prices of agricultural products (the price at which farmers sell their products) fell 6.2 percent. The prices of agricultural capital goods posted year-on-year growth of 0.9 percent, representing a sharp decline of 18.8

percentage points from the same period of the last year, but still higher than the hike in the producer prices of agricultural products, implying difficulties for the income gains of farmers.

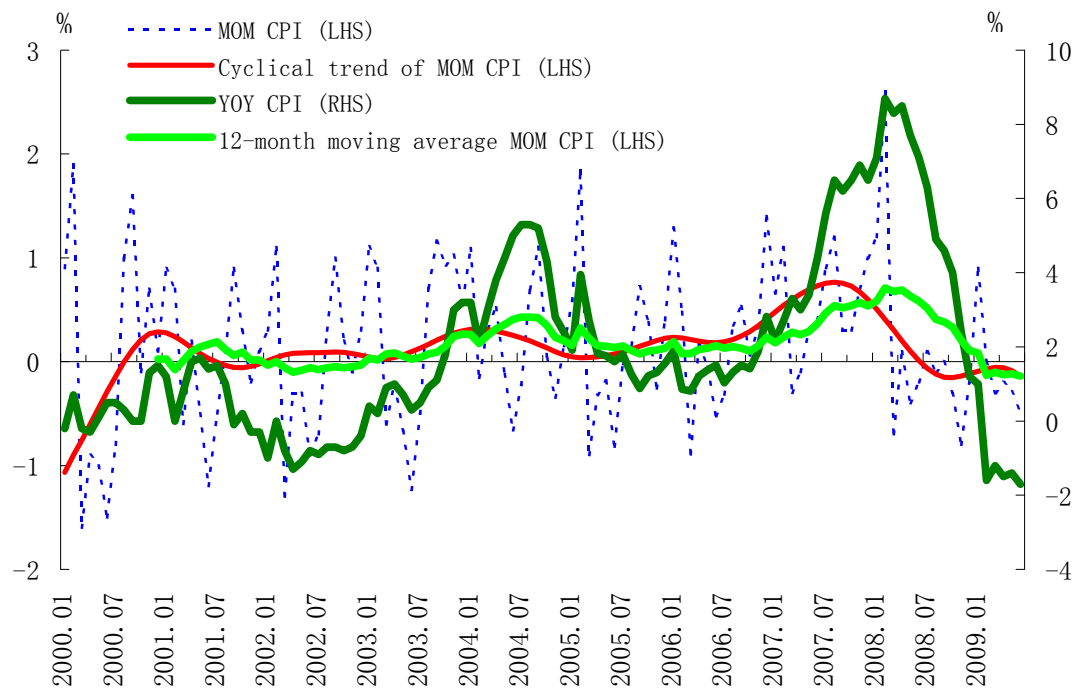
Industrial production rebounded more rapidly, and the decline in industrial profits decelerated. In the first half of the year, the added value of statistically large enterprises rose 7.0 percent year on year, representing a deceleration of 9.3 percentage points from the same period of the previous year; and growth registered 5.1 percent in the first quarter and 9.1 percent in the second quarter. The sales ratio of industrial products declined slightly by 0.5 percentage point from the same period of the last year to 97.2 percent. In the first five months, profits of statistically large enterprises posted 850.2 billion yuan, representing a year-on-year decrease of 22.9 percent and a deceleration of 43.8 percentage points from the same period of the last year, but an acceleration of 14.4 percentage points from January and February. According to the PBC's survey of 5,000 industrial enterprises, the business activity index in the second quarter rose 4.6 percentage points from the previous quarter to 12.1 percent, ending the declining trend since the third quarter of the last year.

3. General prices dropped year on year

The CPI dropped year on year, but the quarter-on-quarter CPI adjusted for seasonal and irregular factors showed signs of leveling. In the first half of the year, the year-on-year CPI dropped 1.1 percent, down by 0.6 percent and 1.5 percent in the first and second quarters respectively. The year-on-year CPI dent was mainly impacted by the base period factor. In the first half of the year, the base period factor stood at -1.5 percent, while the new price-rising factor was 0.4 percent. Since the beginning of 2009, the month-on-month CPI adjusted for seasonal and irregular factors edged up slightly; the 12-month moving average month-on-month CPI remained stable; the difference between the month-on-month CPI in the current month and the historical level of the same month in the past years started to climb from the second quarter of 2009; all of these figures show that general prices in China are going to stop their tumbling trend.

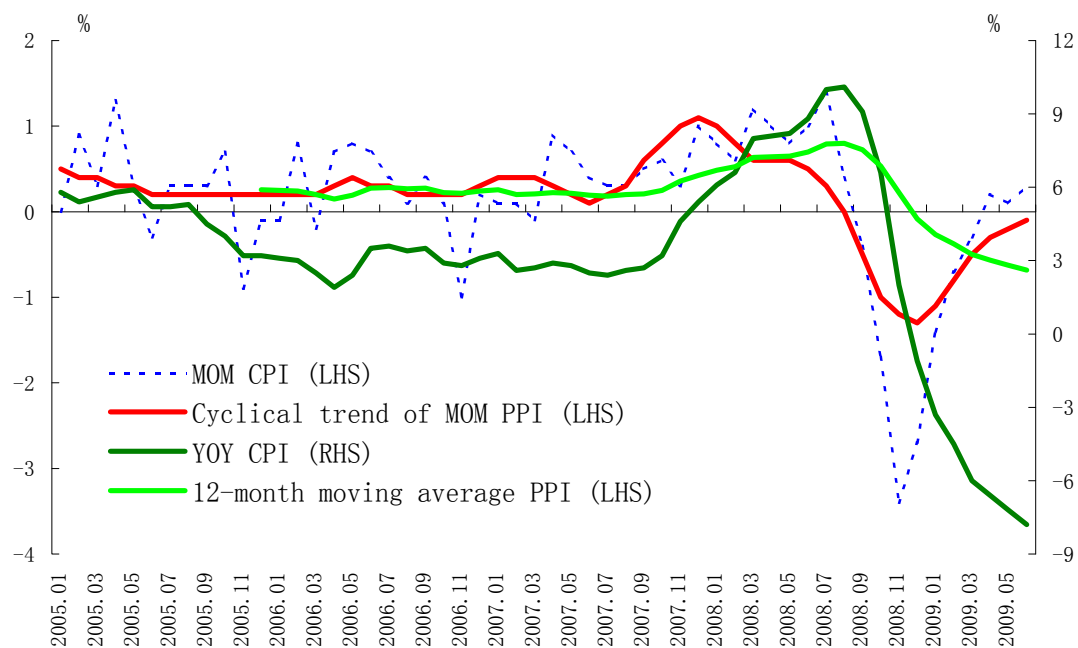
Producer prices continued to decline in year-on-year terms, but rebounded in month-on-month terms after adjusted for seasonal and irregular factors. The producer price of industrial products dropped by 5.9 percent year on year in the first half of the year, and was down by 4.6 percent and 7.2 percent respectively in the first two quarters respectively. The month-on-month producer prices of industrial products adjusted for seasonal and irregular factors started to rebound noticeably from December 2008. The purchasing prices of raw materials, fuel, and power registered an average year-on-year decrease of 8.7 percent in the first half of the year, and decreased by 7.1 percent and 10.4 percent respectively in the two quarters. The prices of agricultural capital goods grew 0.9 percent year on year in the first half of the year,

growing by 5.8 percent in the first quarter and decreasing by 3.7 percent in the second quarter.



Source: NBS and PBC staff calculation

Figure 3 Trend of y-o-y and m-o-m CPI movement



Source: NBS and PBC staff calculations.

Figure 4: Trend of y-o-y and m-o-m PPI movements

Commodity prices in the international market rose quickly. In the second quarter of the year, crude oil futures on the New York Mercantile Exchange and Brent Crude Oil stock price dropped by 51.7 percent and 51.6 percent respectively year on year, but rose 38.1 percent and 31.9 percent from the first quarter; the average stock prices of copper and aluminum on the London Metals Exchange fell by 44.7 percent and 49.4 percent respectively from the same period of the last year, but increased by 35.8 percent and 9.3 percent from the first quarter.

Import prices declined faster than before. In the second quarter, import prices fell by 18.6 percent year on year, representing an acceleration of 3.1 percentage points from the first quarter, with the monthly decline in the second quarter registering 19.2 percent, 20.4 percent, and 16.3 percent respectively in the three months; export prices declined by 7.0 percent year on year, representing an acceleration of 5.0 percentage points from the first quarter, with the monthly decrease posting 5.9 percent, 6.2 percent, and 8.8 percent respectively in the three months. The further acceleration of the decline in import prices was mainly due to the high commodity prices in the international market in the same period of the last year.

Labor compensation continued its year-on-year increase. In the first half of the year, the national average monthly salary of urban employees was 2,440 yuan, up 12.9 percent year on year. Broken down by entity, employees in state-owned entities, urban collectively owned entities, and other types of entities earned 2,626 yuan, 1,528 yuan, and 2,317.5 yuan per month respectively, up 14.2 percent, 17.7 percent, and 10.3 percent year on year.

The GDP deflator continued to decline. The GDP registered 14 trillion yuan in the first half of the year, representing real growth of 7.1 percent. The GDP deflator (as a ratio of nominal GDP versus real GDP) was -3.1 percent, down 11.6 and 0.7 percentage points respectively compared with that during the same period of the last year and the first quarter.

The pricing reform of resource goods advanced. Since the beginning of 2009, the National Development and Reform Commission (NDRC) has adjusted the prices of refined oil products on five occasions in accordance with the improved pricing mechanism for refined oil products and oil price movements in the international market. Starting from January 15, the prices of petrol and diesel per ton were reduced by 140 yuan and 160 yuan respectively; starting from March 25, the prices of petrol and diesel were adjusted upward by 290 yuan and 180 yuan respectively; starting from March 25, the prices of petrol and diesel were each increased by 400 yuan per

ton; starting from June 30, the prices were each raised by 600 yuan per ton; starting from July 29, the prices per ton were each cut by 220 yuan. In July, the NDRC and the Ministry of Housing and Urban-Rural Development clarified the general requirements for an adjustment in the price of tap water, which was to establish a water price formation mechanism conducive to water savings, reasonable allocation of water resources, and efficient use of water, and to promote sustainable consumption of water resources.

4. The decline in fiscal revenues narrowed, and fiscal expenditures continued to grow rapidly

In the first half of the year, fiscal revenues reached 3397.6 billion yuan, down 2.4 percent year on year, representing a deceleration of 35.7 percentage points from the same period of the last year and an acceleration of 5.9 percentage points from the first quarter; fiscal expenditures totaled 2890.3 billion yuan, up 26.3 percent year on year, representing a deceleration of 1.4 percentage points from the same period of the last year and a deceleration of 8.5 percent from the first quarter; as a result, expenditures exceeded revenues by 507.4 billion yuan, about 685.3 billion yuan less than that during the same period of the last year.

With regard to fiscal revenues, national fiscal revenues in the first four months of 2009 dropped 9.9 percent year on year, but May and June witnessed a year-on-year increase in fiscal revenues, with the increase in June posting 19.6 percent. The rebound of fiscal revenues since May was largely due to the modest increase in the transfer-type consumption tax and the effects of once-and-for-all revenues. The sustainable growth of fiscal revenues is not yet firmly established and the conflict between fiscal revenues and expenditures is still acute.

With regard to fiscal expenditures, the increase in fiscal expenditures was mainly related to the stimulus package that aims to expand domestic demand, stabilize external demand, and maintain economic growth. As of end-June, among the 4 trillion yuan stimulus plan, 591.5 billion yuan of the total of 1.18 trillion yuan in new public investment by the central government has been channeled. In addition, investment in science and technology, environmental protection, agriculture, forestry, and water conservancy increased. In the first half of the year, expenditures for agriculture, forestry, and water conservancy grew 75.5 percent, expenditures for transportation grew 67.8 percent, expenditures for environmental protection grew 63.4 percent and expenditures for science and technology grew 57.1 percent year on year.

5. The balance of payments (BOP) remained in a surplus position

In the first half of the year, the BOP continued its declining trend since the latter half of the year. However, since the beginning of the second quarter of this year, the

declining trend in net foreign exchange flows moderated. As of end-June, foreign exchange reserves reached US\$2131.6 billion, an increase of US\$185.6 billion from end-2008 and a deceleration of US\$95 billion from the same period of the last year.

Gross foreign debt fell in general with an improved maturity structure. As of end-March 2009, outstanding foreign debt posted US\$336.72 billion, US\$37.94 billion or 10.1 percent less over the end of the previous year. Among this total, the registered outstanding foreign debt was US\$252.6 billion, down US\$8 billion or 3.1 percent from end-2008; the outstanding short-term foreign debt stood at US\$173.47 billion, a decrease of US\$37.32 billion or 17.7 percent from end-2008, accounting for 51.5 percent of the total.

6. Industrial analysis

The decline in industrial profits slowed down, and industrial production recovered. In the first five months, 30 out of 39 major industries saw an increase or a narrowing of the decrease in profits compared to that in the first two months. The non-ferrous metals melting and rolling industry, the iron and steel industry, and the chemical fiber industry became profitable, even though they were in the red in January and February. The chemical engineering industry, the special equipment manufacturing industry, and the transport equipment manufacturing industry saw a marked slowdown in the decline of profits in year-on-year terms compared to the situation in January and February. In the first half of the year, industrial added value of statistically large enterprises in 36 out of 39 major industries experienced year-on-year growth. The supply of coal, electricity, oil, and transportation was generally adequate. In the first half of the year, crude coal production posted year-on-year growth of 8.7 percent, an acceleration of 2.4 percentage points from the first quarter; electricity generation and crude oil production fell 1.7 percent and 1.0 percent year on year respectively, representing a deceleration of 0.3 and 0.6 percentage point from the first quarter; freight volume grew 2.5 percent year on year, representing a deceleration of 1.9 percentage points from the first quarter.

(1) The real estate industry

In the first half of the year, sales of commercial property across the country grew rapidly, growth of investment in real estate development accelerated gradually, sale prices rebounded, and outstanding loans of commercial real estate increased by a large margin.

The growth of real estate development investment accelerated. In the first half of the year, completed real estate development investment registered 1.5 trillion yuan, up 9.9 percent year on year, an acceleration of 5.8 percentage points from the first quarter, representing ever-faster growth since the beginning of the year. Among this,

investment in residential housing posted 1.02 trillion yuan, representing year-on-year growth of 7.3 percent and an acceleration of 4.1 percentage points from the first quarter, accounting for 70.2 percent of the total. In the first half of the year, the acreage of completed land purchases nationwide reached 140 million square meters, down 26.5 percent year on year, an acceleration of 13.6 percentage points from the first quarter; the acreage for the start of new construction recorded 479 million square meters, representing a year-on-year decrease of 10.4 percent and an acceleration of 5.8 percentage points from the first quarter.

Sales of commercial real estate rebounded greatly, and growth surpassed the record high in the same period of 2007. In the first half of the year, the cumulative acreage of sold commercial real estate grew by 31.7 percent year on year to 340 million square meters, an acceleration of 23.5 percentage points from the previous quarter. Sales revenue of commercial housing posted 1.6 trillion yuan, up 53 percent year on year and an acceleration of 29.9 percentage points from the first quarter.

Sales prices bottomed out. In June, home sales prices in 70 large- and medium-sized cities grew by 0.2 percent year on year, representing the first month of positive growth since December 2008; sales prices were up 0.8 percent month on month, an acceleration of 0.2 percentage point from May, representing the fourth month of positive month-on-month growth. Among this total, sales prices of newly built housing fell by 0.6 percent year on year, but were up by 0.8 percent month on month; sales prices of pre-owned housing increased by 2.2 percent year on year, and were up by 1.1 percent month on month. In June, out of the 70 large- and medium-sized cities there were 63 cities whose newly built housing experienced a month-on-month sales price increase, and 57 cities that saw a month-on-month increase in sales prices of pre-owned housing.

Outstanding commercial real estate loans rebounded noticeably. As of end-June 2009, outstanding commercial real estate loans nationwide registered 6.21 trillion yuan, up 18.8 percent year on year and representing a deceleration of 3.7 percentage points from the same period of the last year, but an acceleration of 6.1 percentage points from the end of the first quarter. Among this total, outstanding real estate development loans posted 2.35 trillion yuan, a year-on-year increase of 20.5 percent and an acceleration of 4.2 percentage points from the first quarter; outstanding home purchase loans posted 3.86 trillion yuan, an increase of 17.8 percent year on year and an acceleration of 7.2 percentage points from the end of the first quarter. In the first half of the year, new commercial real estate loans grew by 486 billion yuan from the same period of the last year to 882.6 billion yuan. Among this total, new loans for real estate development recorded 403.9 billion yuan, up 221 billion yuan year on year; new loans for home purchases grew 263.3 billion yuan from the same period of the last year to 479.3 billion yuan.

(2) The high energy-consuming industries

High energy-consuming industries in general refer to six industries, including the iron and steel industry, the non-ferrous metals industry, the construction materials industry, the power industry, the oil processing industry, and the coking and chemical engineering industry. Given their sheer scale and close inter-connectedness, the high energy-consuming industries play an important role in the national economy. In addition, as the high energy-consuming industries account for around 63 percent of the total electricity consumption of statistically large industrial enterprises, it is of critical importance to reduce energy consumption and pollution discharges by the high energy-consuming industries. In recent years, the high energy-consuming industries have seen rapid investment growth and ever-growing capacity, which has resulted in a big increase in production and exports, exceeding the affordability of such external conditions as energy, resources, environment, and transport. Since the outbreak of the international financial crisis, affected by the shrinking external demand, the exports of the high energy-consuming industries have been declining sharply and the problem of over-capacity has heightened, production has slowed down, and investment has dropped. Since the second quarter, a recovery trend has become more obvious.

Production has slowed down and output has declined. In the first half of the year, the added value of the high energy-consuming industries grew 4.2 percent year on year, representing a deceleration of 10.3 percentage points from the same period of the last year and an acceleration of 1.9 percentage points from the first quarter. In the first half of the year, the output of cement and fertilizer grew 14.9 percent and 9.5 percent year on year respectively, representing an acceleration of 6.2 and 3.6 percentage points from the same period of the last year; steel production rose 5.7 percent year on year, representing a deceleration of 6.8 percentage points from the same period of the last year, but an acceleration of 2.9 percentage points from the first quarter; output of ten non-ferrous metals, soda, alkali, and ethylene fell 5.1 percent, 4.5 percent, 4.9 percent, and 6.8 percent in contrast to growth of 13.4 percent, 15.0 percent, 12.8 percent, and 2.1 percent in the same period of the last year, but the decline narrowed by 0.9, 6.6, 6.3, and 3.9 percentage points from the previous quarter.

Fixed-asset investment in the high energy-consuming industries slowed down noticeably. In the first half of the year, fixed-asset investment in the chemical fiber manufacturing industry dropped by 11.1 percent year on year, and the year-on-year increase of fixed-asset investment in oil processing, coking, and nuclear fuel processing, ferrous metal melting and rolling, and non-ferrous metal melting and rolling declined by 50.3, 18.4, and 20.9 percentage points from the same period of the last year.

Exports of high energy-consuming products fell precipitously. In the first half of the year, exports of steel products, copper products, aluminum products, and cement decreased by 65.4 percent, 28.6 percent, 44.3 percent, and 43.2 percent respectively in year-on-year terms, representing a deceleration of 45.2, 47.6, 38.6, and 24.8

percentage points from the same period of the last year. The decline of steel products registered a decline in exports of about 10.5 percentage points greater than that in the first quarter, while the decline of other products narrowed by 6.6, 4.8, and 11.3 percentage points from the first quarter.

Since the financial crisis, the high energy-consuming industries have sped up restructuring, scrapped outdated capacity, and vigorously pursued energy savings. Outdated capacity has been scrapped in all-out efforts through raising the threshold for energy savings and environmental protection. It is planned to phase out 15 million kilowatt of small thermal power units, 10 million tons of outdated iron melting capacity, 6 million tons of steel melting capacity, 500,000 tons of paper-making capacity, and 50 million tons of cement production capacity for the whole year in 2009. In the first half of the year, a total of 19.89 million kilowatt of small thermal power units was closed down, which meant that the objective of phasing out 50 million kilowatts of small thermal power units as outlined in the 11th Five-Year Plan had been achieved ahead of schedule by one and one-half years. Other industries also made progress in energy savings.

At present, China's economy is at a critical period for stabilization and development, and the high energy-consuming industries should base the target of maintaining growth on improving development quality, optimizing product structure, improving efficiency, reducing energy consumption, and protecting the environment; at the same time, the industries should enhance their capability for independent innovation and competitiveness. Efforts should be made to scrap outdated capacity, determinedly prevent low-quality redundant construction and blind development, and strictly control the exports of products that are heavily polluting, highly energy-consuming, and resource-dependent. Government departments should more rigorously pursue the differentiation of electricity tariffs by increasing the benchmark electricity tariff for products whose production processes are heavily polluting and highly energy-consuming. Financial institutions should stick to the credit policy featuring differentiated treatment to different sectors, strictly constrain new loans to heavily polluting, highly energy-consuming, and resources-dependent and over-capacity sectors, pay sufficient attention to financial services related to energy conservation and pollution reduction, make use of the financial market to encourage and guide industrial restructuring and optimization as well as the shift in the economic growth pattern.

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

I . Outlook for the Chinese economy

As a result of the effective coordination of the proactive fiscal policy and the moderately loose monetary policy, and due to the effect of the package of plans to address the global financial crisis, the Chinese economy has seen more positive factors and an increasingly stronger momentum for stabilization and recovery since the beginning of 2009. Deflation expectations have eased noticeably, and the risk that deflation and recession may become mutually reinforcing has been stemmed in a timely manner. China's economic development is now at a critical stage of stabilization and recovery. The external economic situation remains severe, the economic environment is still uncertain, and the recovery is yet to be firmly established. However, as the package of plans aimed at addressing the financial crisis is further implemented, domestic demand is expected to expand further, and the economy will continue to grow in a sound and relatively rapid manner.

There remain a host of factors that support domestic demand expansion and economic stabilization and recovery for the next period. First, investment is expected to keep growing at a fast speed. In terms of the increase in fixed-asset investment projects in the first six months of 2009, total planned investment for projects under construction grew 36.1 percent from the previous year, an acceleration of 18.8 percentage points; and total planned investment for newly started projects surged 87.3 percent year on year, which was 85.8 percentage points higher than the growth during the same period of the last year. In addition, as the inventory reaches a proper level after adjustments, willingness for corporate investment grows stronger, which will also play a positive role in supporting a recovery. As the business survey in the second quarter of 2009 suggests, the macroeconomic expectation index rose further by 7.8 percentage points after picking up by 1 percentage point in the previous quarter, the profitability index jumped 10.4 percentage points and 3.8 percentage points from the previous quarter and the fourth quarter of 2008 respectively, and the investment willingness index also witnessed an increase. Second, consumption is expected to continue to grow in a steady and rapid manner. The government has improved social security levels, advanced reform in the medical and healthcare system, and raised agricultural subsidies, which will contribute to a higher propensity for consumption and will boost consumption growth.

However, the risks and challenges that weigh on sound and relatively rapid economic development persist. First, since the global economic recovery still faces a range of difficulties and remains a protracted process, the Chinese economy will continue to be

affected by a severely contracted external demand. Second, the foundation for domestic demand recovery remains weak. In particular, willingness for private investment remains at a low level, some industries and enterprises face production and operational difficulties, and the structural problems and weak capability for independent innovation need to be addressed. Heightened employment pressures and unpromising expectations for future income may take a toll on consumption demand. The urban depositors' survey in the second quarter of 2009 indicates that while the future income confidence index has fallen, the savings and investment willingness has grown stronger and households are more cautious about spending.

Future price movements are still uncertain. External demand remains weak, and a domestic recovery is yet to be firmly established. Given the high uncertainties both at home and abroad, inadequate demands may pose downward pressures on prices. However, there are also upward pressures. Successive rounds of massive liquidity injections and stimulus plans by national governments have led to a relaxed global monetary condition. Commodity prices have already soared in the international market in the first half of 2009.

II . Monetary policy in the next stage

Since the Chinese economy is at a critical stage of stabilization and recovery, maintaining sound and relatively rapid economic development remains the primary task. In the next stage, in accordance with the overall arrangements of the State Council, the PBC will continue to implement a moderately loose monetary policy. It will conduct fine-tunings by using more market-based measures in line with domestic and international economic developments and price movements, and properly manage the priorities, intensity, and pace of the moderately loose monetary policy. It will identify and address problems before they are fully developed, properly handle the relationship between supporting economic development and preventing and resolving financial risks, and make macroeconomic management better targeted and more effective and sustainable, so as to maintain the stability of the financial system and to enhance the momentum of stabilization and recovery. In the medium- and long-term, efforts will be made to deepen the reforms and to accelerate the economic restructuring so as to improve the economic growth potential and to achieve sustainable development.

First, flexibly use monetary policy tools and guide money and credit to grow appropriately. The PBC will properly arrange the mix, term structure, and operation intensity of open market tools to keep liquidity in the banking system and interest rates on the money market at a proper level. Closely observing economic and financial developments and the policy effects, the PBC will innovate with policy tools and will regulate the supply and demand of funds in the market so as to provide funds to properly finance economic development.

Second, continue to guide financial institutions to optimize the credit structure. The PBC will guide financial institutions to follow credit principles to ensure loans to eligible projects invested by the central government are granted in a timely manner and to improve credit support to SMEs, agriculture, rural areas, and farmers, employment, students, post-disaster reconstruction, and other programs aimed at improving social welfare. The PBC will vigorously develop consumer credit, implement credit policies to the real estate industry, and step up financing support for restructuring, independent innovation, mergers and re-organization, industrial relocation, and programs to promote balanced regional economic development. It will rein in loans to high energy-consuming, heavily polluting industries and industries with excess capacity, and will curb lending to inefficient companies. Furthermore, the PBC will step up efforts to prevent systemic financial risks and to enhance macro-prudential regulation.

Third, continue the market-based interest rate reform, and improve the RMB exchange rate formation mechanism. The PBC will continue to develop a benchmark interest rate system on the money market, improve the capability of financial institutions for risk pricing, and allow the market to play a greater role in deciding interest rate levels. The PBC will closely follow the exchange rate movements of the major international currencies, and will make efforts to improve the RMB exchange rate formation mechanism in line with the principle of making it a self-initiated, controllable, and gradual process. It will make the RMB exchange rate more flexible, and keep it basically stable at an adaptive and equilibrium level. The PBC will continue to deepen the foreign exchange administration reform, further facilitate outbound investments, steadily open up the domestic capital market, promote the development of the foreign exchange market, and introduce more tools to manage exchange rate risks. It will steadily press ahead with the pilot program of renminbi settlement of cross-border trade transactions. It will use the foreign exchange reserves more efficiently to preserve and increase the value of the reserves.

In addition, as the Chinese economy improves, the PBC will use this opportunity to advance reform and restructuring programs in an effort to strengthen the inherent economic growth drive. While the protracted contraction of external demand will extend into the medium- and long-term period, the fundamental way to achieve sound and relatively rapid economic development is to accelerate reform and restructuring programs, with a priority on boosting consumption and domestic demand, and to shift the economic development pattern. Efforts will be made to further relax restrictions on investment and financing to jump-start private investment; improve the income distribution structure to increase the share of the household sector; substantially increase investments in human resources and adopt proactive employment promotion plans; and push forward the reform of the resources and energy-pricing mechanism to reduce market distortions.