Overview

In 2007, the Chinese economy continued to grow in a steady and rapid manner. Financial reform, financial management, financial supervision and regulation, and opening-up of financial sector all proceeded smoothly and the financial system remained stable. Meanwhile, the deep-rooted structural problems in the economy and financial sector remained yet to be resolved, and new problems emerged in the domestic and international financial systems, all posing new challenges for the financial stability work in the new circumstances.

The Chinese Financial System Remained Stable

The macroeconomic environment in China was generally favorable for maintaining financial stability, microeconomic foundation became even more solid, and the resilience of financial system continued to improve.

The Chinese Economy Registered Steady and Rapid Growth with Macroeconomic Management Further Strengthened and Improved

The GDP grew 11.9% y-o-y to RMB 24.95 trillion yuan in 2007. To address the problems in economic performance, the Chinese government adjusted policies promptly, focused on the pre-emptiveness, promptness and effectiveness of macroeconomic management, raised the reserve requirement ratio ten times and the benchmark lending and deposit rates six times, and abolished and lowered the export tax rebate of high energy-consuming, high-emission products and resource products. Macroeconomic management was strengthened and improved further to promote high-quality and rapid economic growth.

Reform of RMB Exchange Rate Regime Progressed Smoothly and the Flexibility of Exchange Rate Gradually Increased

The managed floating exchange rate regime was further improved, with the floating band of RMB to the US dollar trading price in the inter-bank spot market expanded from 0.3% to 0.5%. At the end of 2007, the central parity of the RMB against the US dollar was 7.3046 yuan per dollar, an appreciation of 6.90% from the beginning of 2007. The flexibility of yuan exchange rate gradually increased, and the exchange rate remained generally stable at an adaptive and equilibrium level.

Official Foreign Exchange Reserve Continued to Increase, Indicating Greater Resilience against External Shock

At the end of 2007, the official foreign exchange reserves grew 43.3% over the previous year to USD 1.53 trillion, indicating stronger external payment capability. At the end of 2007, total external debt outstanding increased 15.68% or by USD 50.63 billion over the previous year to USD 373.618 billion, including USD 153.534 billion of medium and long-term debt and USD 220.084 billion of short-term debt. The external debt service ratio, external debt/export ratio, external debt/GDP ratio, and the short-term external debt/official foreign exchange reserves ratio were 1.98%, 27.84%, 11.52% and 14.40%, respectively, all within the internationally accepted safety range, pointing to modest external debt risks.

Fiscal Revenue, Enterprise Profits and Household Income All Grew Considerably, and Solvency of Government, Enterprises and Households Became Increasingly Stronger

In 2007, fiscal revenue totaled RMB 5.13 trillion yuan, an increase of 30.5% y-o-y. Fiscal expenditure grew 23.3% y-o-y to RMB 4.96 trillion yuan. Supported by a good balance in revenue and expenditure, the government solvency improved. In general, profitability of enterprises was better than the previous year. In the first 11 months, profits of statistically-large industrial enterprises posted RMB 2.3 trillion yuan, an increase of 36.7%, indicating better solvency and financial strength of the enterprise sector. In 2007, the per capita disposable income of urban residents and per capita net income of rural residents were RMB 13,800 yuan and RMB 4,140 yuan respectively. People's livelihood improved further and resilience against risks was enhanced.

Microeconomic Foundation of Financial Stability Became Even More Solid as Financial Institutions Improved Their Competitiveness and Profitability

In 2007, the overall strength and profit-making ability of the banks, securities companies and insurance companies grew evidently. Total assets of banking institutions grew 19.7% to RMB 52.6 trillion yuan at the end of 2007. More banks reached the required level of CAR. The NPL ratio of major commercial banks posted a drop of almost one percentage point over the previous year. The institutional arrangements of securities companies were strengthened, and the intended objectives of comprehensive restructuring were achieved, with risk properly managed, and the third-party custodian system for clients' securities transactions and settlement funds put in place. The assets and profits of securities companies increased by a large margin. The fund management business developed quickly, with the scale of fund under management and net value rising almost 3 folds over the previous year and the sector became more influential in the financial market. The insurance sector was much stronger as its service area expanded and breakthrough was made in policy-related agriculture insurance. The total assets and premium income of insurance companies grew rapidly, and the rate of return of insurance fund investment rose 5.1 percentage points over the previous year.

Financial Markets Expanded Rapidly and Functioned Smoothly

The capital market reform further deepened. With the market growing in size and institutional building making progress, the resource allocation function was further strengthened. At the end of 2007, a total of 1,550 companies were listed on the domestic capital market, 116 more than the previous year; the capitalization of Shanghai and Shenzhen stock exchanges totaled RMB 32.71 trillion yuan, and the stock market capitalization to GDP ratio rose to 132.65%; the tradable market capitalization reached RMB 9.31 trillion yuan, accounting for 28.5% of total market capitalization. The money market, bond market, foreign exchange market, futures market and gold market all kept the good momentum of sound performance.

The Work of Building a Financial Safety Net Made Further Progress and the Financial Infrastructure Was Improved

Financial supervision and regulation made further progress in terms of institutional arrangements, regulatory techniques and approaches. The risk disposal of financial institutions strengthened further, and the designing of a deposit insurance system started. The LVPS and RPS operated smoothly, and the function of payment system was enhanced. The account receivable collateral registration system, which was established on the basis of modern chattel guaranty mortgage registration system, was formally launched, further improving the credit environment. China became a full member of the FATF, and made breakthroughs in AML work. The legal system building registered major progress, with the promulgation and implementation of a number of important legislations including the *Property law* and *Enterprise Bankruptcy Law*. The securities, futures, insurance, fund management and other industries adopted the newly released *Enterprise Accounting Standards*.

The Strategy of "Going Out" Was Implemented Steadily and the Financial Sector Further Opened Up

In 2007, the financial sector implemented the "going out" strategy in a smooth manner. The China Investment Corporation was established and started its operation. The CDB, ICBC, and other institutions either made equity investments in or acquired foreign banks. The China Merchants Bank opened its branch in New York. Other institutions also made active exploration in expanding their overseas presence. The pilot QDII project moved ahead steadily. Meanwhile, the domestic financial markets opened up further to foreign participants. A larger group of foreign financial institutions opened offices and expanded business in China. According to relevant agreements, the examination and approval of joint-venture securities firms were resumed and the business range of this category of firms was enlarged step by step. The investment scale of QFIIs became larger and larger.

Comprehensive Measures to Safeguard Financial Stability

The Chinese financial sector faces a new situation in its reform and development while there were still some risk factors affecting financial stability. It is necessary to follow the guidance of the CPC's 17th National Congress decisions, implement the concept of scientific development in an in-depth manner, and put in practice the principles, policies and overall arrangements stipulated by the CPC Central Committee and State Council for the financial work. More efforts are needed to improve and strengthen macroeconomic management, promote financial reform, development and opening-up, encourage innovation and institutional development in the financial market, improve the quality of financial services, and further improve corporate governance and internal control with a focus on strengthening risk management, in order to preserve stability of the financial system.

Closely Watch Changes in International Economic and Financial Situation to Fend Off Contagious Risks Arising from International Financial Turbulence

In 2007, there were more uncertainties and potential risks in the economic and financial environment. The international economic and financial situation became increasingly complex, with the expanding spillover effect of US subprime mortgage loan crisis, the weakening of US dollar, soaring international oil and food prices, the persistent global imbalances and the subsequent intensification of trade protectionism, slow-down in global growth, and sporadic outbreak of political turmoil and conflicts in certain regions.

Due to deepening financial and economic globalization, the economic and financial linkages and interactions between China and the rest of the world have become even stronger. It is necessary to closely monitor latest developments in the world economy and the global financial markets, better assess the challenges in maintaining financial stability in the new situation, put in place and improve a financial stability monitoring and assessment system, improve the contingency plans for various scenarios, make full preparation for possible changes in international environment and enhance risk mitigation abilities.

Improve Macroeconomic Management to Prevent Risks Arising from Structural Imbalances

The structural imbalances in Chinese economy and the extensive economy growth pattern need to be corrected. Salient problems in the economy include the imbalance between investment and consumption, persistently high investment ratio, over-consumption of resources and high environmental cost, excess capacity in some sectors, and a weak agricultural foundation. Structural imbalances are not conducive to sound and sustained economic growth, as they might lead to over supply of liquidity and higher inflationary pressure.

The macroeconomic management is to be improved, and a sound fiscal policy and a tight monetary policy will be adopted. The consistency and stability of fiscal policy will be maintained so that fiscal policy will play an important role in promoting structural adjustment and balanced development. The expenditure in weak sectors and for improving people's livelihood will be increased. The structure of fiscal expenditure will be adjusted to increase input in social security, medical service, educational and cultural development, energy conservation and emission reduction. A variety of monetary policy instruments will be adopted to intensify sterilization, optimize credit structure and prevent excessive growth of money supply and credit.

Improve Balance of Payments, Establish and Improve the Monitoring and Early-warning Mechanism of Cross-border Capital Flow

Surplus under both the current and capital accounts has resulted in rapid buildup of official foreign exchange reserves. This trend has accelerated in recent years. Due to large BOP surplus and strong growth of foreign exchange reserves, the central bank was in a passive condition in increasing monetary base and had limited room for monetary policy conduct. The oversupply of foreign exchange, pressure for a stronger yuan, increasing cross-border capital inflow, and greater potential shock posed by international capital to domestic market all had adverse impact on the economic and financial performance.

Persistent BOP surplus reflects the difference between domestic savings and investment, and is related to the rapid development of export-oriented economy and growing cross-border capital flow. A variety of measures would be needed to improve balance of payments. These measures include better monitoring and analysis of balance of payments, establishing and improving a cross-border capital flow monitoring and early-warning system, stricter examination of abnormal short-term capital inflow, crack-down on illegal foreign exchange transactions and effective control of speculative capital inflow.

Adopt Strong Measures to Prevent Excessive Hikes of the Price Level

In 2007, the CPI moved up by a large margin of 4.8%. In 2008, due to soaring prices of capital goods, stronger effect of imported-inflation and other factors, the prices are under fairly strong upward pressure, and there is a risk of structural price hikes evolving into a generalized inflation process. Once the public had an inflation expectation, it would push up the general price level, and high price level would be detrimental to economic performance, sound operation of financial institutions and healthy development of the capital market.

Effective measures are needed to increase supply, contain irrational demand, and prevent excessive hike of the general price level. Output of basic necessities including grain should be enhanced, import of important consumer goods in shortage should be increased, and the export of grain in general and that for industrial use should be restricted. The commodity reserve system should be improved, and the way of reserve adjustment as well as import and export adjustment should be fine-tuned; supply, demand, and price monitoring and early-warning mechanisms for bulk agricultural products and primary commodities as well as the contingency plan for market supply and price fluctuation should be improved. Market supervision and price inspection should be strengthened to prevent irrational price hikes.

Improve Capital Market Mechanism to Prevent Potential Fluctuations of Asset Prices

In recent years, the Chinese housing market and stock market developed rapidly, responding to the demand for property as a result of higher household income. Meanwhile, acute problems existed, including the distorted structure of housing supply, and accelerated growth and excessively high housing prices in some cities. There were also uncertainties in the stock market as reflected in the large swings of stock prices.

A multiple of measures should be adopted to improve the institutional arrangements for capital market operation, strengthen adjustment and management, and prevent wild fluctuations of asset prices. The housing supply structure is to be adjusted to increase effective supply and promote sound growth of the housing market. The operational arrangements of stock market should also be improved to enhance corporate governance and information disclosure of listed companies, encourage product innovation, further expand the base of institutional investors, crack down on such illegal activities as insider trading and market manipulation, and establish an open, fair and equitable market order.

Make Efforts to Boost Bond Market and Improve Financing Structure

In recent years, stock, bond and other direct financing channels enjoyed rapid growth, but enterprises still relied heavily on bank loans, and the proportion of direct financing remained low. In 2007, the proportion of bank loans in total financing of the domestic non-financial sector was 78.9%, and that of direct financing was only 21.1%. Optimizing capital market structure and expanding the share of direct financing through various channels remained a priority in the reform and development of financial system.

Encouraging direct financing and improving financing structure are effective in expanding direct financing channels for enterprises, preventing them from overly relying on banking system and avoiding the excessive concentration of financial risks. The market mechanism should be improved and capital market structure optimized to promote stable and sound development of capital market. The growth of bond market will be accelerated to develop bond financing instruments including corporate bond, enterprise bond, enterprise short-term financing bill and medium-term notes and provide additional direct financing channels for enterprises.

Accelerate Financial Reform and Innovation to Enhance Risk Management Capability and Competitiveness of Financial Institutions

Reform and innovation were the key in building stronger financial institutions and providing a solid base for financial stability. Against the backdrop of economic and financial globalization, financial institutions improved their market competitiveness through reform, innovation, better corporate governance and operational mechanism, providing a diversity of products and services, transforming business growth pattern and better serving the financing need of the general public.

Promoting financial reform and innovation also served the need of improving macroeconomic management. Reform and innovation by financial institutions would help divert excessive liquidity to targeted sectors, areas and regions, change the situation of enterprises and households having only limited investment channels and improve macroeconomic management and risk management.

Financial institution reform shall be deepened, focusing on the joint-stock reform of ABC and the reform of CDB and cultivating market participants with innovative and risk management abilities. Unnecessary control shall be lifted to create a favorable regulatory environment for financial innovation. The fundamental standards for accounting and corporate governance and taxation policies shall be improved to build an external environment for financial reform and innovation. In addition, coordination among various financial regulatory authorities shall be enhanced to prevent potential systemic risk arising from innovation.

Strengthen Investment Risk Education to Increase Investors' Risk Awareness and Self-protection Ability

With rapid economic growth and improvement in people's livelihood, households were holding larger amount of financial assets. In recent years, households had a strong incentive for investment as a result of soaring housing and stock markets. As the mechanisms for investor protection remained to be improved and some investors lacked risk awareness, it was an urgent task to enhance investment risk education.

It is a systemic project and long-term task to improve investment risk education. Various levels of governments, departments, financial institutions and the general public should work together to adopt various measures to spread financial knowledge, signal financial risks, improve the public's financial IQ, encourage investors to have a proper investment philosophy and risk awareness, and increase their ability in self-protection.

Improve Coordination among Financial Regulatory Agencies and Build A Financial Safety Net

With the development of integrated financial business, the growing international nature of financial activities, expansion of financial transactions on the electronic platform, and diversification of financial products, cross-sector financial business and cross-sector, cross-market, cross-border financial risks became even more complex. Some financial institutions were yet to improve their risk prevention awareness and internal control mechanism, and regulatory agencies were yet to improve supervision and regulation over sophisticated financial business and their ability to fend off cross-sector, cross-market and cross border financial risks.

On the basis of summing up experiences in segregated operation and separate regulation, exploration would be made in building an effective coordination mechanism among various regulatory authorities. The building of a deposit insurance regime shall be accelerated to establish a deposit insurance agency with proper functions, balanced right and obligation, and effective operation. The financial stability assessment and financial risk early-warning mechanism shall be improved, and financial contingency mechanisms and plans established at various levels to enhance financial risk handling capacity.

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