



Chapter I

Macroeconomic Environment

In 2007, the world economy grew steadily, but the middle of the year witnessed outbreak of the subprime mortgage crisis in the US and its increasing spillover effect. The Chinese economy continued a steady and rapid growth supported by robust expansion of aggregate demand. The fiscal revenue, enterprise profits and household income all increased by a large margin, but there was growing inflation pressure. The international and domestic environment was favorable to financial stability in China, but there were still uncertain factors.

Economic and Financial Environment

In 2007, the global economic and financial performance could be summarized as the following. First, the world economy grew at a steady rate of 4.95%. Affected by the subprime mortgage crisis, the US economy slowed down to 2.2%, a decline of 1.1 percentage points over the previous year. Growth rates of the Euro area and the Japanese economy were 2.6% and 2.1%, respectively. The emerging market and developing economies registered a robust growth of 7.9%. Second, the spillover of subprime mortgage crisis deepened. In the US, the crisis spread to other categories of loans, and caused asset quality of financial institutions to worsen and credit cost to rise. Prices of real estate slumped further, weakening corporate and household consumption. The subprime mortgage crisis caused tur-

bulence in the international financial market, as reflected in wild fluctuations in the equity and exchange markets and tightening money market. Third, some central banks took measures to ease the impact of the crisis. The Fed, the European Central Bank, and Bank of England injected large amount of liquidity to the market. The Fed started a rate-cut cycle since September 2007. By the end of 2007, the federal fund rate had been lowered by 100 basis points. Fourth, the global inflation pressure intensified. Prices of bulk commodities such as grain and oil surged, with crude oil future price approaching USD 100 a barrel, gold price near USD 900 an ounce, and grain price hitting new record highs. Fifth, trade protectionism was on the rise. Since the beginning of 2007, trade disputes and frictions became more frequent. Some countries resorted more often to protectionist measures and investment protectionism emerged against emerging markets and developing countries.

The macroeconomic performance in China had the following features. First, the economic growth was steady and fairly rapid. GDP grew 11.9% to RMB 24.95 trillion yuan. The primary, secondary and tertiary industries grew 3.7%, 13.4% and 12.6%, respectively. Second, fiscal revenue, corporate profits and household income rose rapidly. The fiscal revenue grew 30.5% y-o-y to RMB 5.13 trillion yuan. The profitability of enterprises improved continuously and their general level of indebtedness declined. The household income increased significantly. The per capita disposable income of urban residents reached RMB 13,800 yuan, representing a real growth of

12.2% y-o-y and an increase of 1.8 percentage points over the previous year; the per capita net income of rural residents posted RMB 4,140 yuan, representing a real growth of 9.5% and an increase of 2.1 percentage points. Third, aggregate demand boomed. Investment growth remained rapid. The fixed asset investment posted a growth rate of 24.8% and totaled RMB 13.72 trillion yuan. Consumption expanded steadily, with the total retail volume increasing 16.8% y-o-y to RMB 8.92 trillion yuan. Export grew at a slower pace but trade surplus widened further. Total export reached USD 1.2 trillion, representing a growth of 23.5% and a decrease of 1.5 percentage points from 2006. Trade surplus totaled USD 262.2 billion, an increase of USD 84.7 billion from 2006. At the end of 2007, official foreign exchange reserves amounted to USD 1.53 trillion, a growth of 43.3%. Fourth, the general price level went up fairly quickly. In 2007, CPI growth accelerated by 3.3 percentage points y-o-y to 4.8%. Growth of industrial product prices had been stable in the first half of 2007 before entering an accelerated path in the second half. The factory prices of industrial products rose 3.1%, purchasing prices of raw materials, fuels, and power were up 4.4%. Soaring labour compensation pushed up labor cost. The GDP deflator was 5.6%, 2 percentage points higher than 2006.

In 2007, macroeconomic management was intensified. The reserve requirement ratio was raised 10 times by a total of 5.5 percentage points and the reserve requirement ratio for foreign exchange deposits was raised once.

The issuance of special treasury bonds provided a good opportunity to step up sterilization. The benchmark lending and deposit interest rates were raised six times. While the control over aggregate was stepped up, credit policy was given a role in structural adjustment. Measures were taken to guide financial institutions to provide better service to energy conservation and environment protection, restrict lending to industries with over capacity, highly polluting enterprises, and those with high energy consumption, enhance credit support to the weak sectors and vulnerable groups, and guide the RCCs to provide more agriculture-supportive lending. Furthermore, macromanagement policies were adopted to regulate real estate credit. The floating range of RMB trading prices at the inter-bank market was expanded. The investment quota of QFIs and QDIs was raised further. The management over foreign exchange fund inflow and settlement was enhanced. The export tax rebate policy for selected goods was adjusted. Fiscal expenditures were increased to support weak sectors, social undertakings and reform.

Impact of Economic and Financial Environment on Financial Stability

In 2007, growing uncertainties and potential risks in the international economic environment and the salient problems and structural imbalances in the Chinese economy presented new challenges to financial stability in China.

Growing Uncertainties and Potential Risks in the International Economic Environment

Spillover of the subprime mortgage crisis continued to expand. The US dollar weakened and the international financial markets faced heightened risks. The US financial institutions incurred tremendous losses and its financial market experienced large-scale turbulence. Furthermore, some financial institutions and financial markets in the UK, Germany, Japan and Australia were also affected to varying degrees by the crisis. As a result, credit market tightened, and stock and foreign exchange markets saw even larger fluctuations. There were growing uncertainties in international financial market and downward trend in the global economy.

The impact of subprime mortgage crisis on China was not to be neglected. The absolute amount of securities related to subprime mortgage held by Chinese financial institutions and its share in assets were not big, and most of such holding was high-rated securities. Though the direct impact of the current crisis on China was limited, its potential risks in the long run were not to be neglected. First, a credit crunch in the US and slow-down of the US economy might lead to reduced demand for import, and subsequently less import from China. Second, rate cuts by the Fed increased the interest rate spread between the two countries, giving incentives to capital inflow into China to seek higher return rates, and thus making monetary policy conduct in China more difficult. Third, the subprime mortgage crisis exacerbated the turmoil in international

financial markets, and increased the market risks for those Chinese enterprises making outward investment.

Rising commodity prices intensified inflation pressure around the globe. Affected by a weakening dollar and speculation, prices of grain, crude oil, iron ore and other commodities became elevated and added to the inflation risks in the world. Developed economies such as the US and European countries faced the dual risks of recession and inflation. Rising commodity prices also heightened inflation pressure in China.

Global economic imbalances exacerbated trade protectionism. The US current account deficits were mirrored by the surplus in economies in East Asia and oil exporting countries. China's trade surplus with the US and European countries continued to grow, and the global imbalances were yet to be resolved. Due to the imbalances, trade frictions became more frequent, and there was a growing trend of trade protectionism spreading from trade of goods to investment and financial services.

Rapid Economic Growth and Structural Imbalances

Despite the sustained and rapid economic growth, the structural imbalances in the Chinese economy remained unresolved and the extensive growth pattern yet to be transformed, as reflected in reliance on investment and export, high savings rate, low consumption rate, the imbalance in the relative size of the primary, secondary and tertiary industries, and the development gap among regions and

between urban and rural areas. Other acute problems also undermined the sustainable development prospect of the Chinese economy, including heavy environmental cost, over consumption of energy and resources, environmental degradation, lack of enforcement of energy conservation and emission standards, over capacity in some industries, and the weak agricultural sector.

Imbalance of the BOP Account and Over Supply of Liquidity

In 2007, the BOP account continued to register a twin surplus, i. e. surplus in both current and capital accounts, which affected the sound performance of the economy and the financial sector in particular. First, rapid buildup of the official foreign exchange reserves and the subsequent increase in monetary base caused money and credit to expand, limited the forward-looking initiatives of monetary policy, and complicated measures of macroeconomic management. Second, there was the problem of over supply of liquidity, which was closely related to the imbalance between a high savings rate and low consumption rate and the export-driven economic growth pattern. Excess liquidity not only affected the stability of the stock and housing markets, but also had a potential impact on the consumer goods and capital goods markets, exacerbating inflation pressure. Third, it caused an over supply of foreign exchange and strengthened expectation of yuan appreciation. At the end of 2007, the central parity of yuan against US dollar exchange rate was 7.3046 yuan per dollar, representing an appreciation of 6.90% from the

beginning of 2007 and a cumulative appreciation of 11.67% from July 21, 2005 when the exchange rate regime reform was conducted. The expectation of a stronger yuan was likely to trigger hot money inflow. Once such expectation reversed, the subsequent sudden withdrawal of hot money would endanger domestic economic and financial security.

The Risk of the Structural Price Hike Evolving into Inflation

In 2007, the price hikes were driven by food price rises and had a structural nature. CPI was up 4.8% y-o-y, and food prices up 12.3%. In particular, grain price, that of egg, and that of meat, poultry and their products were up 6.3%, 21.8% and 31.7% respectively. Higher food prices were the major factor behind CPI growth and began to spread to non-food items, indicating a risk of structural price increases evolving into an inflationary process. Once the general public developed an inflationary expectation, it would push up the general price level, and high price level would be detrimental to the financial sector and economic performance and the quality of people's life.

Fluctuating Asset Prices Added to the Uncertainties in Economic and Financial Performance

Some cities had the problem of excessive and accelerated growth of housing prices. In 2007, the national housing price surged. In the four quarters of 2007, the national housing price grew 5.6%, 6.3%, 8.2% and 10.2% y-o-y respectively. In December 2007, the national housing price had a year-on-year

surge of 10.5% and a month-on-month growth of 0.2%. In 2007, uncertainties existed in the stock market as well. Stock price fluctuated by a very large margin. The Shanghai Composite Index surged from 2715.72 points at the beginning of the year to a peak of 6124 points, and closed at 5261.56 points at the end of 2007. The large swings in asset prices increased uncertainties in economic performance, and the financial sector's performance in particular.

Measures to Promote Financial Stability

Given the increasingly complex international and domestic economic and financial environment, the priority in 2008 should be to prevent the relatively fast economic growth from becoming over-heated, and prevent the structural price hikes from evolving into an inflation process. The developments in domestic and international economic and financial situation should be closely monitored, and the pace, focus and strength of macroeconomic management should be properly handled. A sound fiscal policy and a tight monetary policy should be adopted to contain inflation. Taking effective measures to adjust economic structure, ease the BOP imbalances, and maintain the stable and relatively rapid economic growth.

First, a sound fiscal policy and a tight monetary policy will be implemented to curb inflation. The sound fiscal policy will be continued

to give full play to fiscal policy's role of promoting structural adjustment and balanced development. Fiscal expenditure structure will be adjusted to increase outlay to weak sectors, in order to improve people's livelihood and deepen reform, and to encourage and increase input to social security, medical service, education, energy conservation and emission reduction. A tight monetary policy will be implemented to respond to the risk of over-heating and inflation, control money and credit supply at an aggregate level, contain the excessive expansion of aggregate demand, and prevent rebound of fixed asset investment, continued expansion of trade surplus and inflation. At the same time, a variety of measures will be adopted to increase effective supply, contain irrational demand, and prevent excessive increase of the general price level.

Second, structural adjustment will be intensified. To support the transformation of economic growth pattern, measures will be taken to expand domestic demand, improve the balance between investment and consumption, shift the economic growth from export and investment driven towards consumption, investment and export driven, from reliance on the secondary industry to reliance on all the three industries, and turn economic growth from based on resource and material consumption to based on technology and science, human capital and managerial innovation.

Third, efforts will be made to ease the BOP imbalances. Achieving BOP equilibrium will be a systemic project that requires more vigorous measures in both domestic and external

sectors. The role of exchange rate will be enhanced in adjusting BOP, and promoting structural adjustments and balanced growth. The RMB exchange rate regime will be improved and flexibility of yuan exchange rate will be enhanced. Foreign exchange market will be further developed, and efforts will be made to encourage outward investment and expand the channels and methods of foreign exchange reserve investment. BOP monitoring will be enhanced, and cross-border capital flow monitoring and early-warning system will be established and improved. The monitoring and examination of short-term and abnormal capital inflow will be intensified to crack down on illegal foreign exchange transactions and contain inflow of speculative capital.

Fourth, measures will be taken to prevent excessive asset price fluctuation. A variety of measures including taxation, credit and land control will be adopted to increase effective housing supply, refrain from irrational demand and promote sound development of the housing market. In addition, measures will be taken to deepen capital market reform and innovation, improve the institutional arrangements for capital market performance, demand and supply, information disclosure in the stock market, and corporate governance, further expand the base of institutional investors, enhance market regulation and law enforcement, suppress speculation and manipulation, and promote the long-term and sound development of the capital market.

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