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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the first quarter of 2006, the national economy continued to maintain steady and relatively rapid growth, with generally good performance. Domestic demand was strong, foreign trade continued to grow rapidly, household income, business profits, and fiscal revenues all increased by a large margin, while market prices were stable. GDP grew by 10.3 percent and the CPI increased by 1.2 percent on a year-on-year basis.

Under the guidance of the CPC Central Committee and the State Council, the People's Bank of China (PBC) continued to implement a sound monetary policy by appropriately controlling money and credit aggregates and enhancing the credit structure. Meanwhile, it steadily advanced the exchange rate regime reform, accelerated the reform of financial institutions and the construction of the financial market infrastructure, improved foreign exchange management, further developed the foreign exchange market, and continued to improve the monetary policy transmission mechanism. First, analysis and management of liquidity was strengthened and open market operations were conducted flexibly. Second, "window guidance" and credit policy guidance were strengthened to promote credit structure improvements by commercial banks. Third, supporting policy measures were adopted to improve the RMB exchange rate regime reform, the market-maker system and OTC transactions were introduced in the inter-bank spot foreign exchange market, RMB and foreign exchange swaps and RMB interest rate swaps were launched on a pilot basis, and a primary dealer system for foreign exchange transactions was introduced. Fourth, the joint-stock reform of state commercial banks was promoted forward steadily, and positive financial incentives of the central bank to support the pilot reform of rural credit cooperatives (RCCs) were strengthened to promote the healthy and sustainable development of the RCCs. Fifth, financial market institution building was accelerated and product innovation was fostered. Sixth, the foreign exchange management system reform was accelerated to promote the basic equilibrium of the BOP.

The financial industry performed soundly in the first quarter of 2006, and the growth of monetary and credit aggregates was higher than projected. At end-March, broad money M2 stood at 31 trillion yuan, increasing by 18.8 percent over the same period of the last year. Base money amounted to 6.3 trillion yuan, a year-on-year growth of 8.6 percent. In the first quarter, new RMB loans extended by financial institutions reached 1.26 trillion yuan, an increase of 519.3 billion yuan over the beginning of the year. Money market interest rates picked up to some extent. At end-March, foreign exchange reserves reached US$875.1 billion, US$56.2 billion more than that recorded at the end of 2005, and the central parity of the RMB against the US dollar stood at 8.0170 yuan per US dollar.

Although the economic situation remains favorable with sound performance of the financial industry, high priority should be given to monitoring the risks brought about by the excessively rapid growth of fixed-asset investment, structural imbalances in foreign trade, excess liquidity, and global economic imbalances.

In line with the guidelines of the Central Economic Work Conference and the Fourth Session of the Tenth National People's Congress, the PBC will continue to pursue a sound monetary policy, maintain the consistency and continuity of the policy, appropriately control money and credit aggregates, strengthen policy coordination between domestic and foreign currencies, and enhance the effectiveness of macroeconomic management so as to prevent an excessively rapid growth of money and credit and to provide a stable monetary and financial environment for the transformation of the economic growth pattern and economic restructuring. Steps will be taken in the following seven areas. First, the PBC will apply a mix of policy instruments to strengthen the preemptive nature of monetary policy. Second, continued efforts will be made to implement policies related to market-based interest rate reform. Third, the role of policy guidance will be enhanced to advise financial institutions to appropriately control credit expansion and improve the loan structure. Fourth, the rural financial reform will be accelerated and rural financial services will be improved to support the building of a socialist new countryside. Fifth, the development of financial markets will be actively promoted. Sixth, continued efforts will be made to deepen the reform of financial institutions. Seventh, steps will be taken to further improve the RMB exchange rate regime, to keep the RMB exchange rate basically stable at an adaptive and equilibrium level, and to deepen the reform of the foreign exchange management system so as to promote the equilibrium of the BOP.

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Part 1 Monetary and Credit Performance

In the first quarter of 2006, the national economy continued to grow steadily and relatively fast with sound performance in the financial industry. The growth of monetary and credit aggregates was higher than projected.

I. Monetary aggregates grew at a relatively rapid pace

Broad money M2 stood at 31 trillion yuan at end-March, increasing by 18.8 percent y-o-y, up 4.7 percentage points over the same period of the previous year. Narrow money M1 reached 10.7 trillion yuan, increasing by 12.7 percent y-o-y, up 2.8 percentage points over the same period of 2005. The relatively fast growth of M2 was caused mainly by higher growth of savings deposits and corporate time deposits. At end-March, cash in circulation grew by 10.5 percent y-o-y to 2.3 trillion yuan. Net cash withdrawals in the first quarter totaled 56 billion yuan, 33 billion yuan more than during the same period of the previous year.

II. Deposits of financial institutions increased steadily

At end-March, outstanding deposits of all financial institutions (including foreign-funded financial institutions) denominated in both RMB and foreign currencies increased by 18.4 percent y-o-y to 31.8 trillion yuan, 1.98 trillion yuan more than at the beginning of the year, an acceleration of 678.1 billion yuan compared with the same period of the previous year. In particular, RMB deposits rose by 19.6 percent y-o-y to 30.6 trillion yuan, a growth of 1.9 trillion yuan from the beginning of the year and accelerating by 699 billion yuan. Foreign currency deposits totaled US$158.9 billion, decreasing by 2.6 percent y-o-y but US$6.6 billion more than at the beginning of the year, a deceleration of US$1.3 billion.

Corporations and households continue to prefer time deposits. Outstanding corporate RMB deposits increased by 15.8 percent to 9.8 trillion yuan at end-March, representing a growth of 270.6 billion yuan from the beginning of the year and an acceleration of 244.6 billion yuan over the same period in 2005. In particular, corporate time deposits increased by 229.9 billion yuan from the beginning of the year, an acceleration of 115 billion yuan over the same period in 2005. Savings deposits increased by 18.2 percent y-o-y to 15.3 trillion yuan, increasing by 1.18 trillion yuan over the beginning of the year, 207.1 billion yuan more than growth in the same period of the previous year. In particular, time deposits increased by 846.3 billion yuan over the beginning of the year, 142.8 billion yuan more than the growth in the same period of 2005. Fiscal deposits increased by 24.3 percent y-o-y to 1 trillion yuan, representing an increase of 215.2 billion yuan over the beginning of the year, accelerating by 21.4 billion yuan compared with the previous year.

III. Loans of financial institutions expanded rapidly

Outstanding loans of financial institutions in both RMB and foreign currencies reached 21.9 trillion yuan at end-March, representing a growth of 14 percent y-o-y or an increase of 1.28 trillion yuan over the beginning of the year, accelerating by 455.4 billion yuan compared with the previous year. RMB loans grew by 14.7 percent y-o-y to 20.6 trillion yuan, an increase of 1.26 trillion yuan over the beginning of the year, accelerating by 519.3 billion yuan. Foreign currency loans rose by 6.5 percent y-o-y to US$154.6 billion, representing an increase of US$4.3 billion over the beginning of the year and a deceleration of US$6.5 billion.

RMB loans of financial institutions grew relatively fast in the first quarter due to the following factors. First, demand for credit continued to increase with the emergence of many new projects nationwide, accelerated growth of the total projected investment volume for the new projects, and the launching of important projects under the 11th "Five-year Program." Second, after share-holding reforms and going public, commercial banks increased their incentives to expand loans so as to increase the return on assets and shareholders' dividends with replenished capital and the strategy of "early lending gets the benefits." Third, increased inflow of foreign exchange and abundant liquidity in the money market enabled commercial banks to expand loans.

In terms of loan destinations, working capital loans and capital construction loans witnessed relatively stronger growth. In the first quarter, short-term RMB loans and commercial paper financing for corporate working capital increased by 749.6 billion yuan, accelerating by 341.6 billion yuan. In particular, commercial paper financing increased by 310.5 billion yuan over the beginning of the year, accelerating by 203.9 billion yuan. Long- and medium-term RMB loans grew by 490.8 billion yuan over the beginning of the year, accelerating by 175.3 billion yuan, among which, capital construction loans increased by 284.9 billion yuan, accelerating by 111.1 billion yuan. In the first quarter, long- and medium-term loans of major financial institutions (including policy banks, state-owned commercial banks, joint-stock commercial banks, and city commercial banks) mainly focused on the real estate, communication and transportation, energy, manufacturing, environment, and infrastructure industries. Additionally, the service industry witnessed relatively fast growth of credit, while the growth of consumer loans decelerated. In the first quarter, consumer loans increased by 43.4 billion yuan over the beginning of the year, 20.2 billion yuan less than growth during the same period in 2005, representing an increase of the outstanding balance by 9.1 percent y-o-y.

Broken down by institutions, RMB loans of all financial institutions grew rapidly. RMB loans of policy banks, the big four state-owned commercial banks, joint-stock commercial banks, city commercial banks, and rural financial institutions (including rural cooperative banks, rural commercial banks, and rural credit cooperatives) and foreign-funded financial institutions increased by 89.4 billion yuan, 600.5 billion yuan, 286.3 billion yuan, 41.5 billion yuan, 192.5 billion yuan, and 16 billion yuan respectively, representing an increase of 32.7 billion yuan, 275.2 billion yuan, 173.8 billion yuan, 9.5 billion yuan, 15.7 billion yuan, and 6.6 billion yuan over the same period of the previous year respectively.

IV. Base money grew at a stable pace, and the banking system had abundant liquidity

The outstanding balance of base money stood at 6.3 trillion yuan at end-March, representing an increase of 8.6 percent y-o-y but 179.2 billion yuan less than that at the beginning of the year. The excess reserve ratio of financial institutions stood at 3 percent at end-March, down 1.2 percentage points from the same period of 2005. In particular, the excess reserve ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives registered at 2.71 percent, 2.84 percent, and 5.91 percent respectively.

V. The interest rate for loans of financial institutions lowered somewhat

The weighted average interest rate of one-year RMB loans of commercial banks was 5.85 percent in the first quarter, which was 1.05 times the benchmark rate, down 0.22 percentage points from the previous quarter. In particular, the weighted average interest rate of fixed interest rate loans, which accounted for 86.03 percent of total loans, stood at 5.85 percent, down 0.23 percentage points from the previous quarter.

And the weighted average interest rate of floating interest rate loans, accounting for the other 13.97 percent, was 5.82 percent, down 0.2 percentage points from the previous quarter.

The statistical report of the PBC on the floating interest rate of financial institutions in the first quarter showed that, among the total loans of financial institutions, the proportion of loans charging the benchmark rate increased by 1.73 percentage points over the previous quarter, while the proportion of loans with the interest rate floating against the benchmark declined somewhat.

Table 1: The Shares of Loans with Rates Floating in Various Ranges in the First Quarter of 2006

Unit：%

	Total	Downward Adjustment	Bench Mark	Upward Adjustment				
		[0.9，1.0）	1.0	Sub-total	（1.0，1.3]	(1.3，1.5]	(1.5，2.0]	above 2.0
All Financial Institutions	100	22.96	28.20	48.84	29.78	6.40	10.24	2.41
State-owned commercial banks	100	28.26	31.83	39.92	36.80	2.62	0.47	0.02
Joint-stock commercial banks	100	30.57	34.36	35.07	34.07	0.88	0.10	0.01
Regional commercial banks	100	22.83	20.16	57.01	38.78	10.63	6.30	1.30
Urban and rural credit cooperatives	100	1.38	4.50	94.12	15.44	20.89	46.55	11.24
Policy banks	100	29.54	69.63	0.82	0.82	0	0	0

Note: The interest adjustment range for urban and rural credit cooperatives is (2，2.3]
Source: Reports of lending rates of commercial banks.

In the first quarter, the interest rate of negotiable RMB deposits (above 30 million yuan) increased slightly. In particular, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 3.71 percent, up 0.46 percentage points from the previous quarter; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 3.46 percent, up 0.39 percentage points from the previous quarter.

Affected by the persistent interest rate hikes of the US Fed and the interest rate rise in international financial markets, the interest rate of domestic foreign currency loans and large-value deposits (above US$ 3 million) continued to increase. In March 2006, the weighted average interest rate of large-value US dollar deposits (accounting for 86 percent of all large-value US dollar deposits of financial institutions) was 3.4 percent, an increase of 0.12 percentage points from the beginning of the year. The weighted average fixed interest rate of one-year US dollar loans was 5.58 percent and the weighted average floating interest rate of US dollar loans was 5.67 percent, up 0.14 and 0.15 percentage points respectively from the beginning of the year.

VI. The elasticity of the RMB exchange rate clearly strengthened

In the first quarter, the elasticity of the RMB exchange rate strengthened significantly and its interaction with other major currencies became evident. The central parity of the RMB against the US dollar at its highest topped 8.0170 yuan per US dollar, and at its lowest touched 8.0705 yuan per US dollar, accumulatively appreciating by 0.66 percent. In 58 trading days, the RMB saw an appreciation on 34 days, and a depreciation on 24 days. The largest fluctuation in a single business day was 0.12 percent. In the first quarter, the average daily volatility of the RMB exchange rate was 24 basis points, slightly larger than the average daily volatility of 17 basis points recorded in the period from July 21, 2005 to end-2005, representing an increased flexibility of the RMB exchange rate. On March 31, 2006, the central parity of the RMB against the US dollar was 8.0170 yuan per US dollar. After the exchange rate reform, the RMB exchange rate against the US dollar, the euro, and the Japanese yen appreciated cumulatively by 3.24 percent, 2.70 percent, and 7.02 percent respectively.

Part 2 Monetary Policy Conduct

In the first quarter of 2006, the PBC, under the leadership of the central government, pursued a scientific development approach in a comprehensive manner and continued to implement a sound monetary policy by appropriately controlling money and credit aggregates, strengthening liquidity management in the banking system, and enhancing the credit structure. It steadily advanced the exchange rate regime reform, accelerated the reform of financial enterprises and the construction of the financial market infrastructure, and improved foreign exchange management. Efforts were also made to perfect the monetary policy transmission mechanism and to ensure sound performance of the financial system and the overall economy.

I. Flexible open market operations (OMOs) were conducted

In the first quarter, the PBC closely monitored liquidity changes in the banking system during the periods of the New Year, the Spring Festival, and the post Spring Festival, by following and analyzing the contributing factors to liquidity such as the increase in foreign exchange reserves, the change in fiscal treasury balances, and currency in circulation. On that basis, the PBC continued strengthening liquidity management by making sound use of multiple OMO instruments with varying maturities to adjust the liquidity in the banking system duly and appropriately. Before the Spring Festival, the PBC mainly withdrew liquidity through issuance of one-year central bank bills, coupled with short-term reverse repo operations as appropriate, thus maintaining the necessary strength of sterilization on the one hand, and satisfying the commercial banks' liquidity needs for payment purposes before the Spring Festival on the other hand. After the Spring Festival, the PBC strengthened OMOs in response to a largely abundant liquidity situation in the banking system, mainly using a mix of instruments, including one-year central bank bills, three-month central banks bills, and 7-day repos, and issuing six-month central bank bills based on multi-level price bidding on a pilot basis, so as to appropriately adjust the liquidity in the banking system and effectively guide the money market interest rate. Satisfactory effects were achieved as expected.

In the first quarter, the PBC withdrew base money of 425 billion yuan in net terms through OMOs. During the period, it made 19 issuances of central bank bills, totaling 1.32 trillion yuan, including three-month central bank bills of 400 billion yuan, six-month central bank bills of 85 billion yuan, and one-year central bank bills of 835 billion yuan. By the end of March, the outstanding amount of central bank bills stood at 2.8002 trillion yuan.

II. The benchmark lending rate of financial institutions was raised

The PBC made a decision to raise the benchmark lending rates of financial institutions, effective on April 28. The benchmark interest rate of loans of financial institutions with a maturity of one-year was raised by 0.27 percentage points, from 5.58 percent to 5.85 percent, and the interest rates of loans with other maturities were adjusted accordingly.

The benchmark interest rate hike of RMB loans is conducive to containing over-investment, balancing the relationship between investment and consumption, and guiding a rational pricing of assets. The move also helps to optimize the economic structure, promote transformation of the economic growth pattern, and enhance financial institutions' capabilities in preventing risk, contributing to maintaining the sound momentum of sustained, rapid, coordinated, and healthy development of the national economy.

III. "Window guidance" and credit policy guidance were strengthened to promote improvement of the credit structure by commercial banks

Since the beginning of 2006, the PBC earnestly carried out the principle of "differentiating credit support to different sectors," strengthening coordination of credit policy and industrial policy and enhancing "window guidance" and risk warning toward commercial banks to guide them to optimize the credit structure and improve financial services. First, the PBC promoted commercial banks to strengthen early warning analysis on the loans and deposits maturity mismatch, to exercise reasonable control over medium- and long-term loans, and to expand working capital loans. Second, the PBC encouraged and guided financial institutions to further increase credits to the rural economy and improve financial services to rural migrant workers through novel mechanisms and institutional and product innovations. Third, the PBC actively guided financial institutions to strengthen credit support for job creation, education, the non-public sector, and the SMEs.

IV. The reform of financial institutions was steadily advanced

The joint-stock reform of state commercial banks was promoted steadily. With the advance of financial restructuring and internal reform, the Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of China significantly improved their financial positions and profitability, strengthened corporate governance, and basically put in place an independent internal control system and risk prevention system. The three banks saw performance indicators, such as the capital adequacy ratio, net profits, and net return on assets, improving steadily and the NPL ratio remained at a relatively low level. The shares of the China Construction Bank performed well in the stock market since its IPO, and were included in the Hang Seng China Enterprises Index on March 10, 2006. The Bank of China vigorously moved ahead with preparatory work for a listing in Hong Kong on June 1, 2006. The Industrial and Commercial Bank of China signed a strategic investment and cooperation agreement with strategic investors in January 2006, entering the concrete operational stage of strategic cooperation. The joint-stock reform program of the Agricultural Bank of China is being studied intensively.

Significant progress was made in the pilot reform of rural credit cooperatives. First, various supportive measures were carried out to solve historical problems. As of end-March 2006, the PBC, together with the China Banking Regulatory Commission (CBRC), following strict assessment and examination procedures, had made 9 issuances of special bills worth 164.9 billion yuan to RCCs in 2,355 counties (and cities), aimed at reforming the rural credit cooperatives on a pilot basis, and made special lending of 260 million yuan to the rural credit cooperatives in Jilin and Shaanxi, with special bills and special lending accounting for 99 percent of the total financial support earmarked for the reform project. Taking into account the exchange of special bills, the NPL ratio of the rural credit cooperatives stood at 13.5 percent, 23.4 percentage points lower than that at the end of 2002, according to statistics of the supervisory authority. The capital adequacy ratios of the rural credit cooperatives, rural cooperative banks, and rural commercial banks were raised to 7.43 percent, 12.32 percent, and 8.44 percent respectively. Second, agriculture-related credits were continuously increased to support development of the rural economy. At end-March 2006, the outstanding agricultural loans of the rural credit cooperatives stood at 1.1668 trillion yuan, accounting for 49 percent of the total loans issued by the RCCs, as opposed to the 40 percent recorded in 2002. Meanwhile, the agricultural loans of the rural credit cooperatives accounted for 91 percent of the agricultural loans issued by all financial institutions, compared with 81 percent in 2002. Third, property rights reform was promoted smoothly to transform operational mechanisms. Some rural credit cooperatives made valuable explorations into strengthening internal management, enhancing information disclosures, and improving corporate governance, accumulating good experience and practice. Fourth, the management and risk bearing responsibilities over the rural credit cooperatives were transferred to the provincial governments. So far, provincial management institutions, including the provincial level RCC associations in 25 provinces (including autonomous regions and municipalities), the Beijing Rural Commercial Bank, the Shanghai Rural Commercial Bank, and the Tianjin Rural Cooperative Bank have been established, and the Xinjiang Autonomous Region Association of Rural Credit Cooperatives is to be inaugurated, with management responsibilities of local governments preliminarily defined.

V. Supportive policy measures were adopted to improve the RMB exchange rate regime reform

On July 21, 2005, China began adopting a market-based managed floating exchange rate regime with reference to a basket of currencies. To support the implementation of the RMB exchange rate regime reform, the PBC continued to launch supporting reform measures to further improve and develop the foreign exchange market in a self-initiated, controllable, and gradual way. First, a market-maker system and OTC transactions were introduced in the inter-bank spot foreign exchange market, and the formation of the central parity of the RMB exchange rate was improved, with a view to perfecting the foreign exchange market system. Second, RMB and foreign exchange swaps and RMB interest rate swaps were launched on a pilot basis to enrich the variety of products in the foreign exchange market and to improve the pricing mechanism of financial derivatives in China. Third, more market participants were allowed access to the foreign exchange market to improve the market structure, with 64 member banks dealing in the inter-bank RMB forward market. Fourth, a primary dealer system for central bank foreign exchange transactions was introduced to ensure the security and effectiveness of the central bank's OMOs in the foreign exchange market. Fifth, the building of the foreign exchange market infrastructure was strengthened to provide more foreign exchange products to market participants and to encourage financial institutions to improve their capabilities in pricing and risk management.

Box 1: The Inter-bank Spot Foreign Exchange Market Improved Further

With a view to improving the managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies, promoting development of the foreign exchange market, diversifying the mode of foreign exchange transactions, and strengthening the pricing capabilities of financial institutions, the PBC issued the Public Announcement on Further Improving the Inter-Bank Spot Foreign Exchange Market (Public Announcement of the PBC No. 1[2006]), introducing the market-maker system and over the counter transactions (hereinafter referred to as OTC transactions) into the inter-bank spot foreign exchange market.

Generally adopted in mature international OTC markets, the market-maker system refers to market arrangement under which some capable market participants with good creditworthiness hold inventories of objects of transactions and hence commit to keeping both selling and buying in the market in the context of a regulatory framework, with those market participants that keep two-way transactions and undertake the obligation of market clearing referred to as market makers. The market-maker system serves to promote more active market activity and stabilize the market by ensuring the standardization and efficiency of transactions through an open, orderly, and competitive quotation-driven mechanism. An inevitable outcome of the development of the financial market at a certain stage, the market-maker system is an effective means to improve market liquidity, stabilize market performance, and standardize market development.

The OTC approach refers to transactions between market participants through independent bilateral price inquiry and bilateral settlements based on bilateral credit authorization. As a basic practice in the international foreign exchange market, OTC transactions account for most of the trading volume in spot foreign exchange markets. Given the international nature of foreign exchange transactions and the difference among market participants, the OTC approach has the advantages of lowering the costs and diversifying the credit risks.

Automatic price-matching transactions were adopted in China’s inter-bank foreign exchange market after the foreign exchange administration system reform in 1994, under which the weighted average rate of each business day was made the central parity of the RMB on the following business day. After the RMB exchange rate regime reform on July 21, 2005, automatic price-matching transactions remained in the inter-bank foreign exchange market, but the weighted average rate of the last five transactions of each business day served as the closing rate of the day and the central parity of the RMB for the next business day.

On January 4, 2006, the PBC introduced the market-maker system and OTC transactions in the inter-bank spot foreign exchange market. Taking into consideration the difficulties of small- and medium-sized financial institutions in securing credit authorization in the early days, the PBC decided to keep automatic price-matching transactions in the inter-bank spot foreign exchange market to meet the needs of small- and medium-sized financial institutions for foreign exchange transactions.

With diversified trading approaches, China's spot foreign exchange market is characterized by the coexistence of automatic price-matching transactions and OTC transactions, which means the trading price in price-matching transactions will no longer be a comprehensive price indicator, thus pointing to the need to improve the practice of using the closing rate of automatic price-matching transactions as the central parity of the following business day. Furthermore, to further reflect the fundamental role of market supply and demand in the RMB exchange rate formation mechanism and improve the pricing capabilities of financial institutions, the PBC decided to adjust the formation of the central parity of the RMB against the US dollar in line with international practice in deciding the benchmark interest rate and the exchange rate in the following way: the China Foreign Exchange Trade System (CFETS) inquires about the prices from all the market makers before the opening of the market on each business day, and then calculates the weighted average price as the central rate of the RMB against the US dollar for the day. The central parity of the RMB against the euro, the Japanese yen, and the HK dollar is determined by the cross rate based on the central rate of the RMB against the US dollar and the exchange rates of the euro, the Japanese yen, and the HK dollar in the international foreign exchange market before 9 am of each business day.

According to the new practice of determining the central parity of the RMB, the RMB exchange rate quotations of the market makers toward the CFETS are based on their comprehensive considerations of various factors, such as the purchase and sale of foreign exchange in the retail market, inter-bank market supply and demand, and their own positions and major currency trends in international markets; therefore the central parity calculated based on the quotations of the market makers reflects the nature of the RMB exchange rate regime "based on market supply and demand with reference to a basket of currencies." However, because market makers do not have to take into account credit risk and fees when quoting prices to the CFETS, and trends of major currencies change constantly in the international foreign exchange market during the trading period of China's inter-bank spot foreign exchange market, differences will arise between the RMB exchange rate in the inter-bank spot foreign exchange market and the central parity, manifested in upward and downward fluctuations of the RMB exchange rate in the inter-bank foreign exchange market around the central parity within a specified band.

Under the new market framework, the coexistence of OTC transactions and automatic price-matching transactions in the inter-bank foreign exchange market determines that there are three different, although linked, prices of the RMB in the RMB exchange rate regime: namely the central parity of the RMB, the OTC rate, and the price-matching rate. The relations among these three prices are as follows: first, the central parity plays a guiding role for the OTC rate and the price-matching rate, with the OTC rate and price-matching rate fluctuating within a specified band around the central parity as the benchmark rate in line with changes in market supply and demand. Second, there is a strong correlation between the OTC rate and the price-matching rate, as arbitrage across the two markets, which only differs in terms of trading approaches, resulting in obvious co-movements of the two rates. Third, due to other factors such as credit risk and fees, there is usually some difference between the OTC rate and the price-matching rat; but the substantial turnover in the OTC market decides that the OTC rate is able to better reflect changes in market supply and demand, and thus is a better price indicator compared to the price-matching rate.

Since the introduction of the new market framework, the inter-bank spot foreign exchange market performed stably, with trading in the OTC market increasingly expanding and the RMB exchange rate flexibility improving markedly. The turnover of the OTC market far exceeded that of the automatic price-matching market even at the outset of the functioning of the new market framework, and now stands at around 30 times that of the latter, showing the trend of the continuous rising share of the OTC market in the entire market. In terms of the price transmission mechanism, the quotations of the market makers are gradually converging, with a smooth price pass-through among the OTC market, the automatic price-matching market, and the retail market.

The new market structure has brought substantial dynamism to the inter-bank spot foreign exchange market, with market makers actively dealing in OTC transactions and automatic price-matching transactions, providing liquidity to the market and thus ensuring the effective clearing of the market. Today, the OTC market has become the backbone of China's inter-bank spot foreign exchange market, with OTC transactions serving as the major trading approach. The introduction of the market-maker system and OTC transactions marked another significant step in the process of advancing the RMB exchange rate regime reform, creating conditions for further integration of China's foreign exchange market into the international foreign exchange market.

Box 2: The Foreign Exchange Primary Dealer System

The PBC introduced the OTC transactions and market-maker system in the inter-bank spot foreign exchange market on January 4, 2006. Notwithstanding that price-matching transactions are retained under the new market structure, the OTC transactions account for most of the foreign exchange market, with market makers playing a major role in providing liquidity to the market. To adapt to the transformation of the trading approach in the foreign exchange market, the OMOs by the central bank in the foreign exchange market need to be adjusted accordingly.

In a foreign exchange market dominated by automatic price-matching transactions, market participants engage in transactions through anonymous centralized price biddings, with the CFETS undertaking settlement risk of market participants. At times of sharp fluctuation of the exchange rates, the central bank may conduct OMOs through automatic price-matching transactions in the foreign exchange market. In a foreign exchange market dominated by OTC transactions, market participants engage in foreign exchange transactions through an independent bilateral price inquiry and bilateral settlements based on bilateral credit authorization; therefore the central bank needs to take into consideration not only the trading counter party's capabilities in the passing-through price and collecting market information and giving feedback, but also its credit risk. The general practice of central banks in developed economies such as the Fed and the European Central Bank in conducting OMOs in the foreign exchange market is to select financial institutions with good creditworthiness and a commitment to keep the central bank as well informed as trading counter parties, which are also referred to as foreign exchange primary dealers, so as to ensure the security and efficiency of foreign exchange OMOs by the central bank. And for the purpose of the effectiveness of foreign exchange OMOs, no central bank publishes a list of primary dealers, although some central banks make public the criteria for designating the foreign exchange primary dealers. Drawing on the mature practices of foreign exchange OMOs by central banks in developed countries, and adapting to the foreign exchange market structural change in China, the PBC decided to introduce the foreign exchange primary dealer system and issued the Guidelines on Market Access by Foreign Exchange Primary Dealers.

Pursuant to the Guidelines on Designating Foreign Exchange Primary Dealers, foreign exchange designated banks that have capabilities in market making may apply to the PBC for authorization to be foreign exchange primary dealers, as long as they comply with the relevant economic and financial laws and regulations as well as the various rules of the PBC, and meet the indicator requirements of the regulatory agency and the criteria of the PBC in terms of creditworthiness. The PBC makes a decision on whether granting market access to the applicants to be the foreign exchange primary dealers based on their trading activity in the inter-bank foreign exchange market and their capabilities in collecting and analyzing market information. Foreign exchange primary dealers designated by the PBC have the right to conduct transactions with the central bank, and in the meanwhile need to undertake corresponding obligations including: active market making in the inter-bank foreign exchange market, maintaining price stability, conducting foreign exchange transactions with the central bank in line with the principles of honesty and integrity, offering the best quotation in the market, maintaining communications with the central bank, and reporting relevant information in a timely manner as required. The PBC will regularly review the performance of the foreign exchange primary dealers in undertaking obligations, and will suspend or revoke the licenses of those primary dealers found to be unfit during the review.

The introduction of the foreign exchange primary dealer system is conducive to transmit the central bank's policy stance in conducting OMOs in the foreign exchange market and promptly stabilizing the foreign exchange market with relatively low operational costs by influencing market expectations and promoting rational market trading behavior. As a result, the efficiency of foreign exchange OMOs by the central bank will be increased and the market will be allowed to play a larger role. As foreign exchange primary dealers serve as a hub of market supply and demand information, the central bank can grasp relatively complete market information and changes in expectations through the foreign exchange primary dealers, helping to understand the foreign exchange market dynamics in a comprehensive and timely manner and to stabilize the market. Foreign exchange primary dealers must undertake their obligations of market making, continuously offering two-way quotations to the market, maintaining market liquidity, ironing out exchange rate fluctuations, and promoting more active trading. Therefore, the introduction of the foreign exchange primary dealer system also helps to improve the efficiency of the foreign exchange market and promote development of the foreign exchange market.

At the early stage of the RMB exchange rate regime reform, the central bank still needs to iron out market fluctuations though OMOs and play the role of a filter. With the deepening of the RMB exchange rate regime reform, supply and demand in the foreign exchange market will tend to be more balanced and the behavior of the market participants will be more mature, allowing the central bank to reduce the frequency and strength of foreign exchange OMOs and gradually phase out market operations as the market forces play a greater role. As an international practice, the introduction of the foreign exchange primary dealer system will lay an effective institutional foundation for the central bank to carry out foreign exchange OMOs; however, the practice itself has nothing to do with the frequency and strength of the central bank's OMOs, nor does it mean persistent foreign exchange OMOs by the central bank.

VI. The foreign exchange management system reform was accelerated to promote the basic equilibrium of the BOP

In the first quarter, focusing on the task of promoting the basic equilibrium of the BOP, the foreign exchange management system reform was accelerated by launching a string of policy measures: first, the short-term external debt management approach and statistical coverage of domestic and foreign banks were unified to strictly curb the overly rapid growth momentum of short-term external debt. Second, the Qualified Foreign Institutional Investors (QFII) scheme was further improved. In the first quarter, an investment quota totaling US$325 million of QFII was approved. Third, six policies regarding the management of current accounts, such as current account foreign exchange accounts, were adjusted: prior approval for opening foreign exchange accounts for current account transactions was abolished and the limits for corporate foreign exchange accounts increased. Documents required for the sale and purchase of foreign exchange in the service trades were simplified with the examination and approval procedures relaxed, and the indicative limits on the purchase of foreign exchange by individuals were increased up to a yearly quota. The domestic banks' overseas foreign exchange investment services on behalf of their clients were expanded, with qualified banks allowed to collect RMB funds of domestic institutions and individuals and to convert them into foreign exchange within a specified limit to invest in overseas fixed income products. Qualified securities brokers such as fund management companies were allowed to collect self-owned foreign exchange of domestic institutions and individuals and use the funds for overseas portfolio investment. Overseas securities investment by insurance institutions was further expanded. Qualified insurance institutions were allowed to purchase foreign exchange for the purpose of investing in overseas fixed-income products and money market instruments, with the amount of the foreign exchange purchases subject to a limit in relation to the total assets of each insurance institution.

Part 3 Financial Market Performance

The first quarter of 2006 saw sound financial market performance, featuring brisk trading activities and sufficient liquidity in the money market, a recovery of the yields of the short-term debt instruments, and a steady decline of the yields of the medium- and long-term bonds. Financial market product innovation accelerated and great progress in institution building was achieved.

I. An overview of financial market performance

In the first quarter, the financing structure of domestic non-financial institutions, including households, enterprises, and government sectors, changed remarkably, with the share of debt financing by enterprises clearly rising and that of loans and equities declining to some extent, affected by the rapid expansion of debts, in particular the short-term financing bills issued by enterprises at the beginning of the year. The share of bank loans, equities, government securities, and corporate bonds in the total financing of the non-financial sectors was 91.3, 0.5, 2.5, and 5.7 percent respectively.

Table 2: Financing by Domestic Non-financial Sectors in the First Quarter of 2006

	Volume of Financing (100 million yuan)		As a percentage of total finaning (%)	
	2006Q1	2005Q1	2006Q1	2005Q1
Financing by Domestic Non-Financial Sectors	14048	8369	100	100
Bank loans	12822	8268	91.3	98.8
Equities	72	64	0.5	0.8
Government securities	349	17	2.5	0.2
Corporate bonds	805	20	5.7	0.2

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

1. Trading in the money market was brisk, and market interest rates edged up at the end of the quarter

In the first quarter, affected by factors like the relatively low market interests and the abundant liquidity of the financial institutions, the turnover of bond repo on the inter-bank market clearly grew by 2.54 trillion yuan over that of 2005 to 5.15 trillion yuan, a year-on-year growth of 97.3 percent. In particular, turnover of bond pledged transactions in March alone reached 2.37 trillion yuan, a growth of 110 percent from the same period of the last year, accounting for 46 percent of the total bond repo transactions. The accumulated turnover of government securities repo on organized exchanges was 0.32 trillion yuan, down 56.6 percent from the previous year.

In terms of the maturity structures of the bond pledged repo transactions, the market share of over-night products was more or less the same as that of the 7-day products in the first two months of the year, but the market share of over-night products jumped substantially in March to 50 percent, much higher than the 9.6 percentage points recorded for the 7-day products, reflecting a trend of shortening maturity in fund use.

In the first quarter, inter-bank borrowing totaled 381 billion yuan, up 62.2 billion yuan or 19.5 percent compared with that in 2005, registering positive growth for the first time since the second quarter of 2004. The lion's share was concentrated in two types of short-term instruments, i.e., 7-day and over-night products, with the market share of over-night products increasing by 11.5 percent year on year, and that of 7-day products declining by 17.9 percent.

Money market interest rates fluctuated due to factors like the Spring Festival and the strengthened intensity of open market operations by the central bank. Due to the Spring Festival, in January the monthly weighted average rates of inter-bank borrowing and bond pledged repo transactions rose to 1.88 percent and 1.74 percent respectively, before experiencing a slight fall in February. Starting from late March, with increased expectation of an interest rate hike combined with intensified open market operations and the lagging effect of large credit expansion by financial institutions in the previous periods, market interest rates rebounded to some extent. In March, the monthly average inter-bank borrowing rate and bond pledged repo rate moved up by 0.08 and 0.12 percentage points respectively from February, to 1.66 percent and 1.47 percent.

With respect to fund flows in the market, state-owned commercial banks were still the largest net fund providers through both bond pledged and outright bond repo transactions, with net lending in the first quarter increasing 1.16 trillion yuan to 2.52 trillion yuan over the same period of 2005. Net borrowing by other financial institutions6 increased rapidly, registering a year-on-year growth of 1.02 trillion yuan. In the inter-bank borrowing market, the four large state-owned banks and other commercial banks2 lent funds on a net basis totaling 60.2 billion yuan and 111.6

[6] Other financial institutions include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies.
[2] . Other commercial banks include joint-stock commercial banks and city commercial banks.

billion yuan respectively, with the amount lent by the former reduced by 24 billion yuan and that of the latter increased by 20.1 billion yuan compared with the previous year. Other financial institutions7 were the major fund receivers in the market, with borrowing funds totaling 123.2 billion yuan on a net basis. In particular, securities companies borrowed 73 billion yuan. Foreign financial institutions borrowed funds totaling 48.6 billion yuan on a net basis, an increase of 17.3 billion yuan from the previous year.

Table 3: Fund Flows of Financial Institutions in the First Quarter of 2006

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	2006Q1	2005Q1	2006Q1	2005Q1
Four State-owned Commercial Banks	-25221	-13651	-602	-842
Other Commercial Banks	8039	8215	-1116	-915
Othe Financial Institutions	14831	4657	1232	1445
Of which:securities and fund management companies	4193	1588	730	1147
Insurance companies	3913	1084	—	—
Foreign Financial Institutions	2351	779	486	313

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

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

2.The bond market grew larger

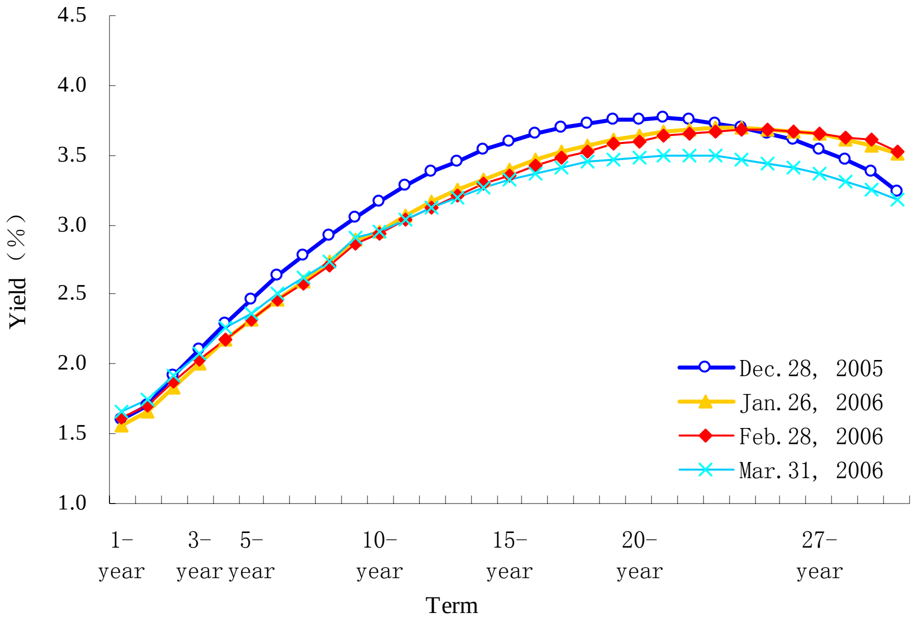
In the first quarter, the accumulated turnover of spot transactions in the inter-bank bond market increased by 1.33 trillion yuan over the same period of the last year to 2.3 trillion yuan, reaching a record high on a quarterly basis, while the daily average turnover soared by 1.4-fold year on year to 38.4 billion yuan. The turnover of government bond spot transactions on organized exchanges totaled 51.2 billion yuan, 19.8 billion yuan less than that recorded in the first quarter of 2005.

In the inter-bank spot market, the four state-owned commercial banks, as the net buyers, saw a large increase of net purchases by 23-fold over the same period of the previous year. Other commercial banks made a large net sale; securities companies, fund management companies, insurance companies, and foreign financial institutions as net buyers in 2005 became net sellers in the first quarter of 2006, due to their strong demand for funds.

[7] . Other financial institutions include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, and securities companies.

Bond indices on the inter-bank market and stock exchanges moved steadily upward. The bond index on the inter-bank market rose by 1.49 points, or 1.31 percent, from 113.42 points at the beginning of 2006 to 114.91 points at end-March. The government securities index on the organized exchanges rose by 0.92 points, or 0.84 percent, from 109.19 points at the beginning of the year to 110.11 points at the end of the first quarter.

Figure 1: Yield Curve of Government Securities in the Inter-bank Bond Market in the First Quarter of 2006



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

In the period under review, the yield curve of government securities displayed an obvious flattening trend. Yields of short-term bills on the inter-bank bond market witnessed a slight increase, while yields of medium- and long-term bonds dropped broadly. Performance of the yield curve can be grouped in two phases: first, an overall downward shift in January 2006. As the price in the bond market continued its rising trend since end-2005, yields to maturity of bonds with various terms experienced a broad fall, causing the yield curve to shift downward in general; second, the yield curve tended to flatten from February until the end of March. With the price of short-term debts falling steadily, yields of short-term bills increased, while the prices of medium- and long-term bonds continued to rise, leading to a steady fall of yields and thus causing the entire yield curve to flatten.

In the first quarter, a total of 316.2 billion yuan worth of bonds was issued, up 105.3 billion yuan or 49.9 percent year-on-year. In particular, a total of 160 billion yuan worth of government securities was issued, a year-on-year increase of 65 billion yuan or 68.4 percent. A total of 69.2 billion yuan worth of policy financial bonds was issued, a decrease of 10.8 billion yuan or 13.5 percent from the previous year. A total of 82 billion yuan worth of corporate bonds (including short-term corporate financing bills worth 60 billion yuan) was issued, representing an increase of 80 billion yuan from the same period of the last year.

2006 is the first year to introduce management of government securities based on the outstanding balance rather than on the amount of growth. Such a shift in the government securities management mode and the issuance of short-term government debts can lower fiscal expenditures related to interest payments and provide efficient instruments for the central bank to improve open market operations. It is also conducive to market pricing by the financial institutions and to fostering a complete and effective yield curve for short-term government securities.

Affected by lower expectations of inflation and abundant liquidity in the market, the issuing rates of bonds displayed an obvious declining trend in the first quarter. The 7-year book-entry treasury bonds issued in February (the 1st issue) offered an interest rate of 2.51 percent, 0.86 percentage points lower than that of the fifth issue book-entry treasury bonds issued in May of last year or 0.5 percentage points lower than that of the 13th issue book-entry treasury bonds issued in November of last year. The issuing rates of bearers' treasury bonds issued in March of this year (1st issue) were also markedly lower than that of the same period and the fourth quarter of the last year. The 10-year fixed-rate bonds issued by the China Development Bank in February (the 1st issue) had an interest rate of 3.01 percent, down 0.41 percentage points compared with that of the 19th issue fixed-rate bonds issued in September of 2005.

3. The commercial paper market continued to expand quickly

In the first quarter, a total of 1.38 trillion yuan worth of bills was issued, up 35 percent year on year; the amount of discount bills totaled 2.28 trillion yuan, up 68 percent compared with the same period of 2005, while that of rediscount bills reached 10 million yuan, representing a year-on-year decrease of 1.473 billion yuan. At end-March, the outstanding balance of commercial paper stood at 2.34 trillion yuan, up 51 percent year on year; the outstanding balance of discount bills was 1.93 trillion yuan, up 72 percent; the outstanding balance of rediscount bills was 135 million yuan, 2.2 billion yuan less than that recorded in the previous year.

Box 3: The Rapid Expansion of the Commercial Paper Financing Business and Its Impact

During recent years, the bills financing business mainly conducted in the form of commercial paper has grown rapidly, with remarkable changes witnessed in terms of its size, participants, business formalities, and organizational structure. Commercial paper has already become an important credit instrument for short-term direct financing. Since 2000, the annual growth of the cumulative commercial papers issued and the outstanding balance was on average above 40 percent, while the annualized average growth of discount bills and the outstanding balance reached above 60 percent. The percentage of commercial paper financing in bank loans as well as that of commercial paper financing in new bank loans has increased steadily over the years. In terms of market share, the secondary market (bills discount and inter-bank discount) is dominated by the four large state-owned banks, while the small- and medium-sized banks and other depositary institutions take a relatively large share in the primary market (bills acceptance), due to differences among these commercial banks in terms of business strategy, balance sheet structure, and targeted customers.

With business expansion and an increase of shares in total financing, the role and impact of commercial paper financing have steadily improved. First, commercial paper has become an important instrument for short-term financing, increasingly replacing short-term loans. Commercial paper financing, featuring advantages like low costs and easy approvals has provided a short- term funding channel that is more convenient and flexible than bank loans for enterprises and has helped relieve the financing difficulties of the SMEs. Second, growth of commercial paper financing has facilitated asset structure adjustment and has strengthened liquidity management by the commercial banks. Through development of the commercial paper financing business, the commercial banks have been given incentives to restructure their assets in a more preemptive and flexible way, reducing the problems of the maturity mismatch between assets and liabilities. It has also lowered the requirement for excess reserves, contributing to improved liquidity management, fostered innovation in financial services, promoting growth of the relevant intermediary service business, and changed the business growth pattern of the commercial banks by basing profits too much on the interest spread income between loans and deposits, thus increasing the profitability and competitiveness of the commercial banks. Third, the expansion of commercial paper has enriched money market instruments. During recent years, the commercial paper market has evidently outgrown other sub-markets of the money market, with the volume of transactions steadily increasing as a percentage of the total amount recorded in the money market. Commercial paper financing has been playing a significant role in improving market efficiency, diversifying market products, and deepening the growth of the money market. In addition, based on a macro perspective, the development of commercial paper financing may help prevent systemic financial risks and reduce pressures on indirect financing.

The fast expansion of the commercial paper financing business is a result of wide participation and active exploration by market entities; it also reflects market needs for diversified financing. As a traditional and pragmatic financing instrument, commercial paper has some advantages, such as short maturity, quick turnover, low risk, and stable returns, which guarantee a solid market environment for its growth. Particularly at the present stage when direct financing channels are not smooth, money market interest rates are tending to move downward, and competition among the commercial banks is intensifying, it is quite necessary and reasonable for the enterprises and commercial banks to resort to commercial paper financing. First, the money market interest rate has fallen steadily in recent years, and when the market rate falls below the lower limit of the interest rate charged on ordinary loans, it is quite natural for people to shift to commercial paper financing with low interest in an open and competitive market. Second, facing pressures from market competition and service innovation, commercial banks have incentives to develop a commercial paper financing business so as to improve the balance sheet structure and liquidity management.

Some problems that emerged along with the rapid growth of the commercial paper financing business deserve serious attention. First, market instruments are still quite simple, concentrating mostly on bank acceptance bills, with business development mainly relying on support of bank credit. Second, banks have yet to improve their risk awareness and the fees charged are not sufficient to fully cover the inherent business risks. Third, transactions of commercial paper financing are mainly conducted in the form of paper vouchers with low efficiency, and the building of a market infrastructure needs to be accelerated. Fourth, relevant laws and regulations governing transactions and the market for commercial papers need to be further improved. In addition, with the credit expansion faster than desired, rapid growth of commercial paper financing may exert additional pressures on the conduct of monetary policy.

4. Stock market trading was brisk

Supported by favorable factors including sound economic growth and substantial progress in the reform of non-tradable state shares, investors' confidence in the stock market largely increased, as reflected by the brisk trading activities and the evident rise in the stock price index. In the first quarter, the total turnover of the Shanghai and Shenzhen Stock Exchanges reached 1.12 trillion yuan, 449.2 billion yuan more than that during the same period of the last year, with the daily average turnover up by 67 percent from that of 2005 to 20 billion yuan, the highest turnover in a single quarter since the second quarter of 2004.

In the first quarter, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index edged up to 1313 points and 327 points in March respectively, both registering their highest levels since April 2005. At end-March, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index closed at 1298 and 323 points respectively, up 11.8 percent and 16 percent from end-2005, indicating a visible recovery of market confidence.

In the first quarter, a total of 7.17 billion yuan (including IPOs, additional offerings, and rights issues) was raised on the equity market at home and abroad, 750 million yuan or 11.7 percent more than that in 2005. The funds were all raised in the H-share market, while fund raising in the first quarter of 2005 was done mostly in the A-share market.

Securities investment funds continued to grow rapidly. At end-March, the number of securities investment funds totaled 229, 11 more than at the end of 2005. The gross volume of the funds grew by 21.5 percent year on year from 476.8 billion yuan to 501.6 billion yuan, while net assets expanded by 30.2 percent compared with the previous year.

5. Insurance premium income steadily increased and the asset structure of the insurance industry further diversified

In the first quarter, the total premium income of the insurance industry reached 160.1 billion yuan, up 8.4 percent from that of 2005; accumulated insurance claim payments grew by 23.1 percent year-on-year to 31.9 billion yuan; total assets of the insurance companies grew by 24.7 percent year-on-year to 1.64 trillion yuan.

Assets of insurance companies further diversified with the expansion of investment channels and the rapid growth of the bond market. The shares of other investments (including investment in financial bonds, corporate bonds, and equities) in the total assets increased by 5.9 percentage points from the previous year to 28.2 percent, while the share of bank deposits declined by 4.4 percentage points to 33.5 percent.

Table 4: Use of Insurance Funds at end-March 2006

	Outstanding balance (100 million yuan)		As a percentage of total assets (%)	
	End-March 2006	End-March 2005	End-March 2006	End-March 2005
Total assets	16367	13121	100	100
Of which, Bank deposits	5488	4971	33.5	37.9
Investment	9464	6684	57.8	50.9
Governmnet securities	3711	2957	22.7	22.5
Securities investment funds	1134	798	6.9	6.1
Other Investment	4619	2929	28.2	22.3

Source: China Insurance Regulatory Commission.

6. Foreign currency pair trading was active

Foreign currency pair trading became increasingly active in the inter-bank foreign exchange market. In the first quarter, the combined turnover of all 8-currency pairs trading totaled US$18.1 billion, with most transactions done in currency pairs of USD/HKD, USD/JPY, and euro/USD, accounting for 88.1 percent of the volume of the total trading.

In the first quarter, the cumulative turnover of RMB forward transactions in the inter-bank foreign exchange market totaled 3.42 billion yuan. The 1-year RMB NDF in Hong Kong was priced at 7.705 yuan per US dollar on April 26, with a discount of 3170 points, down 1680 points from that recorded on July 21, 2005 when the exchange rate regime was reformed, indicating a narrowing of the discount. With the improvement in the RMB exchange regime and increased flexibility of the exchange rate, the single-sided expectation of a RMB appreciation was weakened.

II. Financial Market Institution Building

1. Promote the development of the financial market infrastructure

First of all, straight-through processing was officially introduced on January 17, 2006 for spot bond transactions, bond pledged repo transactions, outright bond repo transactions, as well as forward transactions in the inter-bank bond market to improve market efficiency and risk control. In the first quarter, completed bond transactions settlements based on straight-through processing amounted to 7485.6 billion yuan, accounting for 97 percent of the total settlement value. Second, in February 2006, the PBC authorized the National Inter-bank Funding Center to publish on a daily basis the fixing repo rate. The introduction of the fixed repo rate was conducive to strengthening the price finding capability of the inter-bank bond market, improving the market yield curve, and promoting the development of financial derivatives. Third, in March 2006, the PBC published the Guidelines on Credit Rating Management, in which the internal work and control procedures as well as the rating principles of the credit rating agencies are stipulated so as to improve market discipline.

2. Foster product innovation to enrich market products and trading instruments

First, an interest rate swap was introduced on a pilot basis to meet the urgent needs of market investors for interest rate risk control and balance sheet management. As of end-March 2006, 18 financial institutions had filed with the regulatory authorities their risk control systems and internal control procedures associated with the interest rate swap business in line with the Notice of the PBC on the Pilot RMB Interest Rate Swap Business. Transactions of RMB interest rate swaps involved nominal principals totaling 9.51 billion yuan. Second, corporate bonds and asset-backed securities were introduced for trading in the inter-bank market. In the first quarter, 28 corporate bonds were traded in the inter-bank bond market, involving the amount of 46.884 billion yuan. Third, the issuance of enterprise short-term financing bills and ordinary financial bonds was expanded to promote the growth of forward bond transactions. In the first quarter, the volume of forward bond transactions reached 34.09 billion yuan.

3. The non-tradable state share reform and securities company restructuring made steady progress

In the first quarter, a total of 347 companies, approved in 10 batches, were included in the non-tradable state share reform process, indicating a faster pace of reform. By end-March, 768 companies listed on the Shanghai and Shenzhen Stock Exchanges in 26 batches had either completed or started the reform procedures, accounting for 57 percent of the public companies subject to the required reform process in the A-share market.

The restructuring of securities firms with valuable potentials and great social significance was advanced by the joint efforts of the PBC and other relevant government agencies based on the principle of addressing both the root cause and the symptoms but focusing on the root cause. In the first quarter, the PBC and the China Securities Regulatory Commission, with the support of the People’s Government of Shandong Province and the People’s Government of Chongqing Municipality, completed the restructuring of Tiantong Securities and Southwest Securities respectively. While addressing problems such as inadequate capital and the liquidity difficulty of the securities companies, efforts were also made to promote the transformation of the operational mechanism, to advance the establishment of a corporate governance structure and a strict internal control system, and to encourage the institution building and innovation of the securities firms.

4. Promote development of the insurance market

More avenues were made available for insurance fund investment and the investment behavior was regulated. The China Insurance Regulatory Commission issued documents such as the Provisional Administrative Rules on Indirect Investment of Insurance Funds in Infrastructure Projects aimed to specify the formalities, scope, proportional limits, qualifications, and risk control concerning investment in infrastructure projects by insurance funds.

Relevant rules were improved to strengthen institution building in the insurance market. The China Insurance Regulatory Commission issued the Provisional Guidelines on Improving the Corporate Governance Structure of Insurance Companies to increase the accountability of the shareholders, strengthen the role of the board of directors and the board of supervisors, regulate management operations, and improve regulatory stipulations on connected trading and information disclosure. This will help to enhance the corporate governance structure of the entire industry, prevent business risks, and protect the legitimate interests of the policyholders, investors, and other stakeholders. In addition, the China Insurance Regulatory Commission issued the Provisional Procedures on Off-Site Surveillance of Life Insurance Companies in which regulatory rules, work procedures, and regulatory standards concerning off-site surveillance of life insurance companies were specified to improve regulatory efficiency and effectiveness as well as to strengthen the planning and integration of regulatory work.

Part 4 Analysis of Macroeconomic Developments

I. The global economic and financial situation

Since the start of 2006, the global economy continued to maintain a momentum of steady growth. The US economy witnessed strong growth. The economies in the euro zone saw sustained recovery. The Japanese economy picked up steadily. The major developing economies continued to maintain a momentum of robust growth. High international crude oil prices, rising trade protectionism, and imbalances in the global economy all remained major risks for global economic growth. According to the International Monetary Fund (IMF) forecast in April 2006, the global economy would grow 4.9 percent in 2006, up 0.6 percentage points compared with its forecast in September 2005; in particular, the US, the euro zone, and Japan would grow 3.4 percent, 2.0 percent, and 2.8 percent, up 0.2, 0.2, and 0.8 percentage points respectively compared with its forecast in September 2005.

1. Economic development of the major economies

The US economy saw strong growth. In the first quarter of 2006, the annualized quarter-on-quarter growth rate posted 5.3 percent. US employment continued to improve. The unemployment rate posted 4.7 percent, 4.8 percent, and 4.7 percent respectively in January, February, and March, markedly below that recorded in the corresponding months of 2005. Due to the impact of rising international oil prices, inflationary pressures built up. In the first quarter of 2006, the consumer price index (CPI) registered 3.7 percent, up 0.7 percentage points on a year-on-year basis. The US foreign trade deficit further increased to US$196.2 billion during January-March 2006, up US$24.11 billion over that recorded in the same period of 2005.

The economies in the euro zone continued to recover. In the first quarter of 2006, GDP grew by 2.0 percent over the same quarter in 2005. Employment improved, yet the unemployment rate was still at a high level, with the unemployment rate registering 8.2 percent, 8.2 percent, and 8.1 percent respectively in January, February, and March. The inflationary pressures persisted. The monthly average of the Harmonized Index of Consumer Prices (HICP) rose by 2.3 percent, higher than the 2.0 percent recorded in the same quarter of the previous year; in particular, the monthly HICP registered 2.4 percent, 2.3 percent, and 2.2 percent respectively in January, February, and March. In the first quarter of 2006, the trade deficits posted

EUR11.6 billion, compared with a surplus of EUR5.8 billion in the same quarter of 2005.

The Japanese economy picked up steadily. In the first quarter of 2006, the GDP grew by 3.1 percent on a year-on-year basis. The unemployment rate tended to be dropping, with the monthly average growth posting 4.2 percent, down 0.4 percentage points over the same quarter of 2005. In particular, the unemployment rate posted 4.5 percent, 4.1 percent, and 4.1 percent respectively in January, February, and March. In the first quarter of 2006, the CPI rose by 0.4 percent on a year-on-year basis, compared with a decrease of 0.2 percent in the same quarter of 2005. In particular, the CPI registered 0.5 percent, 0.4 percent, and 0.3 percent respectively in January, February, and March. In all three months the core CPI, excluding fresh food, posted 0.5 percent over the same month of the previous year. In the first quarter of 2006, the foreign trade surplus was JPY1.56 trillion.

The major economies in the emerging markets and developing countries or regions continued to maintain a momentum of robust growth. Such economies as Hong Kong (China), India, Singapore, and Indonesia in Asia and Argentina, Chile, Columbia, Peru, and Venezuela in Latin America attained rapid growth. Russia and some nations in the Middle East benefited from the rising prices of primary commodities.

Box 4: Analysis of the Global Economic Imbalances

In recent years, the issue of global economic imbalances has attracted extensive attention from nations all over the world. The Joint Communiqué of the Seventh G-20 Meeting of Finance Ministers and Central Bank Governors convened in October, 2005, emphasized that such problems as growing risks of global imbalances would intensify uncertainties and exacerbate weaknesses of the global economy, and that all parties concerned should shoulder their respective responsibilities, implement necessary policies, speed up structural reform, and mitigate the risks.

I. The symptoms of the unbalanced global economy

In February 2005, Mr. Rodrigo de Rato, managing director of the IMF, outlined the global imbalances in his speech “Correcting Global Imbalances—Avoiding the Blame Game”: The constellation of large deficits in one country, with counterpart surpluses being concentrated in a few others, is what we mean when we speak of global imbalances. The basic symptoms of current global economic imbalances are as follows: the US had a large trade deficit and rapidly rising debts, while Japan, China, and other major Asian emerging economies had substantial trade surpluses with the US.

On one side of the imbalance, the US had an unprecedented trade deficit of US$725.7 billion in 2005, with the ratio of the trade deficit to GDP soaring from 1.2 percent a decade ago to 5.8 percent in 2005. On the other side, Japan, China, and other Asian economies, major oil exporting countries, and some European countries had a trade surplus as large as US$100 billion. In particular, special attention was paid to China, with its trade surplus posting US$101.9 billion in 2005 and its trade surplus with the US reaching US$114.2 billion.

II. Analysis of the reasons for the global economic imbalances

As for the reasons for the global economic imbalances and for China's trade imbalance, we can proceed from two perspectives: one is the trade perspective and the other is the savings perspective.

From the trade perspective, one important reason for imbalances of international trade rests on cross-border outsourcing and the rapid development of supply chain reorganization in the process of adjustments in the global division of labor in recent years. Labor-intensive production and services are first outsourced to such countries as China and India with cheaper labor costs; developed countries feel the pressures and in turn provide high-grade products and services in a bid to create new opportunities for employment and new export advantages, yet the process often involves a time-lag. During the process, trade imbalances will expand. Furthermore, trade imbalances relate to various other factors such as trade and exchange rate policies across the countries.

The buildup of China's trade surplus to a great extent reflects the changes in the pattern of the international division of labor and international trade: First, the processing trade represents the major source of China's trade surplus. In 2005 the processing trade accounted for 49 percent of the total volume of foreign trade and a trade surplus of US$142.5. Second, foreign direct investment (FDI) contributed greatly to cross-border outsourcing and to changing the trade balance. China has formed bases of processing trade dominated by foreign-funded enterprises, with a continuously extending supply chain and rising value-added. Production and sales by enterprises with FDI have increased substantially, with their products partially substituting for China's imports. What should be noted is that while China has a large trade surplus with the US, China has substantial trade deficits with some countries or regions in Asia. The trade imbalances between China and the US in effect are the focal manifestation or the outcome of the trade imbalances between Asia and the US.

From the savings perspective, according to the macroeconomic equation "the savings gap = the trade gap," the global imbalances can be associated with the savings gap, i.e., the US trade deficits = the negative savings gap of the US = the savings gap in other areas = the trade surpluses of other areas, of which the savings gap refers to the differential between savings and investment and the trade gap refers to the differential between exports and imports.

China and some countries in Asia have very high savings rate, and yet excessive savings are not fully transformed into investment and are reflected as trade surpluses. There are probably various reasons for China's high savings rate. First, the transitional factors, including the reforms of the social safety net, the education system, and the housing system, etc. These factors result in temporary uncertainties in the society, dampening consumer confidence and hence increasing the current propensity to save. Second, the high savings rate is closely related to social and cultural traditions. The Asian countries (including China) are part of the Confucian culture that advocates thrift, leading to a high savings rate. Third, the demographic factors. For instance, due to the influences of the family planning policy and changes in conceptions of child-raising, the number of children in a family is generally decreasing. People have changed from the mode of "bringing up children as a form of pension" to that of "increasing their own savings as a means of pension." With the high domestic savings rate, and with the decreasing marginal returns of domestic investment, domestic savings tend to be invested overseas, including both official and private foreign investment overseas, to seek better investment opportunities. Japan and some European nations also encounter the problem of excessive savings as a result of long-term structural factors, and thus hold substantial trade surpluses with the US as well.

At the core of the global imbalances, the US has huge trade deficits, reflecting the unprecedented decrease in total domestic savings. Not only has the individual savings rate decreased to below zero, but also the fiscal deficits of the government have continuously expanded. The US economy features consumption as its main component, and this trend has been further strengthened due to the expansionary monetary policy in the past few years. The US interest rate was at a historical low of 1 percent in 2004, and the ratio of consumption to GDP increased from 68 percent in

2000 to over 70 percent in 2005, with consumption increasingly supported by borrowing. Meanwhile, US fiscal policy has also reinforced the trend of the decreasing savings rate. Since 2000, the US has maintained an expansionary fiscal policy, with the ratio of fiscal deficits to GDP reaching 4 percent in 2004. Due to the excessive consumption, the US has had to resort to excess foreign savings to finance domestic spending, hence leading to the huge trade deficits.

III. Policies and measures for adjusting the global economic imbalances

The global economic imbalances are not sustainable in the long term. In the event of disorderly adjustment, they will present a significant threat to global economic growth and to the stability of the global financial market. Therefore, resolving the global economic imbalances has become the consensus among the policy-makers of the major economies.

As global economic imbalances involve interactions of complicated structural multi-faceted factors, an adjustment of the global economic imbalances shall take into full consideration the responsibilities of all concerned parties. It is imperative to raise the US savings rate, to speed up the structural reform in Japan and Europe, as well as to improve the economic and financial systems in the developing countries, with each and every measure an indispensable task. In particular, it is most crucial that the necessary measures be taken to help raise the US savings rate.

The Chinese government has begun to implement a combination of policies and measures to promote an equilibrium in the international balance of payments, including expanding the domestic demand, reducing the domestic savings rate, increasing imports, opening up the domestic market, and reforming the exchange rate regime. In terms of expanding the domestic demand, China has taken measures such as tax cuts, increasing the income of residents, speeding up construction of the rural infrastructure, and encouraging financial institutions to develop credit businesses oriented toward individual residents. In terms of decreasing the domestic savings rate, China has stepped up the reforms of the pension system, the medical system, and the education system and has taken measures to develop housing mortgage loans, etc. With the combination of these measures, China’s economic development will rely more on domestic demand and less on exports, promoting a more balanced development of the Chinese economy and the world economy.

2. Developments in international financial markets

In general, the US dollar weakened against other major currencies. On March 31, 2006, the euro and the Sterling pound closed against the US dollar at US$1.21 and US$1.74 respectively and the US dollar closed against the yen at JPY117.66. The dollar depreciated by 2.34 percent, 0.22 percent, and 0.98 percent against the euro, the yen, and the pound respectively over that recorded at end-2005.

The yields in major international bond markets generally rose but remained at a low level. On March 31, 2006, the yields of 10-year government bonds in the US, the euro zone, and Japan closed at 4.85 percent, 3.77 percent, and 1.77 percent respectively, up 0.46, 0.47, and 0.30 percentage points over that recorded at end-2005.

Global stock markets rose to varying degrees with intervals of fluctuation. On March 31, 2006, the Dow Jones Industrial Average and the Nasdaq Composite Index closed at 11,109.32 and 2,339.79 respectively, up 3.66 and 6.10 percent correspondingly over that recorded at end-2005; the Financial Times Stock Exchange 100 Index ended at 5,964.60, up 6.15 percent over that at end-2005; the Stoxx 50 in the euro zone closed at 3.507.13, up 2.0 percent over that at end-2005; and the Nikkei 225 Stock Average ended at 17,059.66, up 5.89 percent over that at end-2005.

3. Monetary policies of the major economies

The Federal Open Market Committee (FOMC) raised the federal-funds target rate to 5 percent by increments of 25 basis points respectively on January 31, March 28, and May 10, representing sixteen times the successive rate hikes by the Fed since June 2004. The European Central Bank (ECB) raised the interest rates of main refinancing operations, deposit facilities, and lending facilities by 25 basis points to 2.5 percent, 1.5 percent, and 3.5 percent respectively, the second hike since December 1, 2005. With the Japanese economy turning for the better, the Bank of Japan (BOJ) decided on March 9 to end the current ultra-loose “quantitative easing” monetary policy and changed the operational target of the monetary policy from the upper limit of the total current account balance held with the BOJ by commercial banks to the unsecured over-night call loan rate and to guide the rate near zero percent. The Bank of England’s Monetary Policy Committee decided to keep the repo rate at 4.5 percent.

II. Analysis of China’s macroeconomic performance

Since the start of 2006, the national economy continued to maintain steady and rapid growth, with generally good performance. Domestic demand was strong, foreign trade continued to grow rapidly, household income, business profits, and fiscal revenues all increased by a wide margin, while market prices were stable. And yet problems such as excessive rapid growth of fixed-asset investment and prominent structural contradictions in foreign trade persisted in economic performance. In the first quarter of 2006, the GDP realized 4.3 trillion yuan, up 10.3 percent, accelerating 0.4 percentage points on a year-on-year basis; the consumer price index (CPI) rose by 1.2 percent, decelerating by 1.6 percentage points on a year-on-year basis; the foreign trade surplus registered US$23.3 billion, up US$6.73 billion over the same quarter of 2005.

1. Domestic demand was strong and foreign trade grew rapidly

Household income continued to grow rapidly and consumption demand continued to accelerate. In the first quarter of 2006, the per capita disposable income of urban residents stood at 3,293 yuan, representing an inflation-adjusted real growth of 10.8 percent and an acceleration of 2.2 percentage points on a year-on-year basis. The per capita net cash earnings by rural residents came to 1,094 yuan, representing a real growth of 11.5 percent and a deceleration of 0.4 percentage points. In the first quarter of 2006, the total volume of retail sales was 1.8 trillion yuan, representing a nominal growth of 12.8 percent, an inflation-adjusted real growth of 12.2 percent, and an acceleration of 0.3 percentage points on a year-on-year basis. In particular, the total volume of urban retail sales was 1.24 trillion yuan, up 13.5 percent; the total volume of retail sales at and below county levels posted 0.6 trillion yuan, up 11.5 percent.

The growth of fixed-asset investment continued to accelerate. In the first quarter of 2006, total fixed-asset investment posted 1.4 trillion yuan, representing a growth of 27.7 percent and an acceleration of 4.9 percentage points on a year-on-year basis. In particular, urban fixed-asset investment posted 1.2 trillion yuan, representing a growth of 29.8 percent and an acceleration of 4.5 percentage points on a year-on-year basis; rural fixed-asset investment registered 0.2 trillion yuan, growing by 18.1 percent and accelerating by 5.4 percentage points over the same quarter of the previous year. The size of fixed-asset investment under construction continued to expand, with the number of projects under construction and new projects increasing considerably. In the first quarter of 2006, the number of projects under construction totaled 87,000, up 22,000 on a year-on-year basis. The total planned investment in projects under construction amounted to 12.2 trillion yuan, up 30.1 percent. The cumulative number of new projects was 33,000, up 11,000. The total planned investment in new projects amounted to 1.5 trillion yuan, up 42 percent. Generally, the size of fixed-asset investment still remained excessively large, with some sectors and some areas having a strong impetus for fixed-asset investments and pressures persisting in terms of excessive expansion of fixed-asset investment.

The growth of exports fell from a high level while that of imports accelerated. In the first quarter of 2006, the total volume of exports and imports reached US$371.3 billion, increasing by 25.8 percent and accelerating by 2.7 percentage points on a year-on-year basis. Specifically, exports posted US$197.3 billion, up 26.6 percent, a deceleration of 8.3 percentage points on a year-on-year basis; imports registered US$174.0 billion, up 24.8 percent, an acceleration of 12.6 percentage points. Netting exports and imports, China had a trade surplus of US$23.3 billion, up US$6.73 billion over that recorded in the same quarter of 2005. The growth of exports fell from the high level mainly because exports of some high energy-consuming and resources products apparently slowed down or even dropped; the growth of imports accelerated mainly because large amounts of imports of such products as crude oil, refined oil products, automobiles, and airplanes grew substantially. In the first quarter of 2006, actual utilization of FDI amounted to US$14.2 billion, an increase of 6.4 percent on a year-on-year basis.

2. Output increased considerably, enterprise profits improved

In the first quarter of 2006, the value-added of the primary industries posted 0.3 trillion yuan, growing 4.5 percent and decelerating by 0.1 percentage points over the same quarter of the previous year; the value-added of the secondary industries registered 2.2 trillion yuan, growing 12.5 percent and accelerating by 1.4 percentage points; the value-added of the tertiary industries reached 1.9 trillion yuan, growing 8.9 percent and decelerating by 0.8 percentage points.

Agricultural production had a good beginning. Spring plowing and production proceeded smoothly nationwide. The sown area of grain increased steadily. The sample survey on plans for crop growing by the National Bureau of Statistics (NBS) indicated that, in 2006, the total sown area of grain was estimated to be 105 million hectares, up 0.7 percent on a year-on-year basis. The enthusiasm of the farmers for investment in agricultural production remained high. In the first quarter of 2006, the fixed-asset investment by farmers grew 12.6 percent, accelerating by 1 percentage point over the same quarter of the previous year; yet the rise in prices of agricultural produce was small and grain prices continued to decline, presenting difficulties for farmers to further increase their income. In the first quarter of 2006, the production prices of agricultural products (i.e., the prices at which producers of agricultural products directly sell their products) increased by 2.4 percent, while the production prices of grain decreased by 1.4 percent on a year-on-year basis; the price index of agricultural production materials rose by 2.2 percent.

The growth of industrial production accelerated, and enterprise profits improved. In the first quarter of 2006, the statistically large enterprises realized a value-added of 1.8 trillion yuan, representing growth of 16.7 percent and an acceleration of 0.5 percentage points on a year-on-year basis. The ratio of sales to total output by the statistically large enterprises was 97.1 percent, down slightly over the same quarter of the previous year. The level of returns of industrial enterprises continued to improve. The statistically large industrial enterprises realized a total profit of 336.3 billion yuan, increasing by 21.3 percent and accelerating by 4.1 percentage points on a year-on-year basis. The 2006 First Quarter Survey on 5,000 Enterprises by the PBC indicated that enterprises' expectations of future economic trends and industrial development were optimistic and the business confidence index rose for 7 consecutive quarters to a record-high level.

3. Various price indices dropped steadily

(1) The rise of the Consumer Price Index (CPI) decelerated steadily on a year-on-year basis. In the first quarter of 2006, the CPI grew 1.2 percent, a deceleration of 1.6 percentage points on a year-on-year basis. The prices of services rose by 1.8 percent. In terms of product segmentation, food prices rose by 1.9 percent, and non-food prices increased by 0.8 percent, both contributing 0.6 percentage points, or 50 percent, to the rise in the CPI. With respect to non-food prices, the prices of gasoline, diesel oil, and liquefied petroleum gas saw the greatest increases, registering 14.9 percent, 13.9 percent, and 26 percent respectively. Generally, the deceleration in the rise of the CPI was mainly related to the fact that rises in food prices, especially rises in grain prices, eased.

(2) The rise of the Producer Price Index (PPI)[4] decelerated. In the first quarter of 2006, the purchasing prices for industrial raw materials, fuels, and power increased by 6.5 percent and decelerated by 3.6 percentage points over the same quarter of the preceding year. In particular, in March 2006, the PPI for fuels and power, non-ferrous metal materials, and chemical materials rose by 16.7 percent, 19.8 percent, and 0.2

[4] The PPI can be divided into input PPI and output PPI. In China, input PPI is the purchasing price index for industrial raw materials, fuels, and power; output PPI is the factory price index for industrial products.

percent respectively, while the PPI for ferrous metal materials dropped by 3 percent on a year-on-year basis. In the first quarter of 2006, the factory prices of industrial products increased by 2.9 percent, decelerating by 2.7 percentage points over the same quarter of the previous year. In particular, in March 2006, the factory prices of crude coal, gasoline, kerosene, diesel oil, and crude oil rose by 33.5 percent, 24.1 percent, 24.9 percent, 20.5 percent, and 7.6 percent respectively. The drops in the factory prices of various steel products ranged from 6.6 percent to 18.3 percent, while the rises in the factory prices of copper, aluminum, lead, and zinc ranged from 10.5 percent to 38.4 percent. In the first quarter of 2006, the differential between the rise in the purchasing price of industrial raw materials, fuels, and power and the rise in the factory prices for industrial products was 3.6 percentage points, down 0.9 percentage points on a year-on-year basis, indicating that pressures had eased for enterprises to absorb the rises in the prices of upstream products.

(3) Price indices of both imports and exports declined. In the first quarter of 2006, the rise in the customs prices of exports posted 0.8 percent, a deceleration of 6.8 percentage points on a year-on-year basis. The increase in the customs prices of imports registered 1 percent, a deceleration of 9.1 percentage points on a year-on-year basis. The trade terms posted 99.8 percent, an improvement of 2.1 percentage points over the same period of the previous year.

(4) Labor compensation grew rapidly. In the first quarter of 2006, the monthly average salary of employees in urban units was 1,657 yuan, up 15 percent on a year-on-year basis. In particular, the monthly average salary of employees in state-owned units posted 1,653 yuan, up 15.5 percent; that of employees in collectively-owned units was 925 yuan, up 15 percent; and that of employees in other units was 1,554 yuan, up 13.4 percent.

Box 5: Survey on Compensation for Migrant Workers

In recent years, there has been a widespread shortage of migrant workers in some areas of China where there are labor-intensive enterprises that employ migrant workers as their main workforce. Compensation for migrant workers tends to be rising. From the macroeconomic perspective, the rising compensation of migrant workers is an indispensable outcome of the rapid growth of the national economy, yet to some extent it will push up the general prices as a result of the rising costs. Therefore, we should have a correct understanding of and pay full attention to this phenomenon. At end-2005, the PBC chose the five provinces of Henan, Jiangxi, Anhui, Sichuan, and Guizhou that supplied the most migrant workers and conducted a survey on the compensation of migrant workers. The survey involved 1,999 rural households and obtained 1,999 valid responses. The survey indicated that migrant workers mainly worked in the Yangtze River Delta area, the Pearl River Delta area, and their respective provinces, and were mainly engaged in the manufacturing, construction, hotels and catering, transportation, and mining industries. In the recent two years, compensation of migrant workers has increased. In the first half of 2005, the monthly average salary of migrant workers grew 8.3 percent on a year-on-year basis. Geographically, the salary of the migrant workers in the area of the Bohai Rim was relatively higher, reaching 985 yuan; that for the migrant workers in the Yangtze River Delta area and the Pearl River Delta area posted 979 yuan and 958 yuan respectively; that for the migrant workers working in their own provinces was the lowest at 934 yuan, 51 yuan lower than that for the migrant workers in the area of the Bohai Rim. In the first half of 2005, the number of migrant workers choosing to work in the Pearl River Delta area was the largest, accounting for 33 percent of the total, followed by that in the Yangtze River Delta area, accounting for 30 percent. In terms of sector segmentation, the migrant workers who had the highest salary of around 990 yuan were in the manufacturing and mining sectors; the greatest number of migrant workers worked in manufacturing, accounting for 40 percent, followed by those in construction.

Table 5: Geographical Distribution and Average Salary of Migrant Workers in the First Half of 2005

	Bohai Rim	Yangtze River Delta	Pearl River Delta	Home Province
Geographical Segmentation	6%	30%	33%	22%
Monthly Average Salary (yuan)	985	979	958	934

Source: Financial Survey and Statistics Department of the PBC.

Table 6: Sector Segmentation and Average Salary of Migrant Workersin the First Half of 2005

	Mining	Manufacturing	Construction	Hotel, catering and beverages, and entertainment	Transportation	Agriculture, Forestry, Husbandry, and Fishery	Other Sectors
Sector Segmentation	2%	39%	25%	13%	6%	1%	14%
Monthly Average Salary (yuan)	991	990	987	962	944	936	880

Source: Financial Survey and Statistics Department of the PBC.

Migrant workers are generally engaged in “heavy, dirty, hard, tiring, and risky” work, with longer working hours, inadequate social security, and lower compensation. The survey indicated that those with 41-60 weekly working hours accounted for one-half of the total migrant workers, those with over 61 weekly working hours accounted for one-third. That is to say, about 85 percent of the migrant workers worked longer than the legal working hours. In addition, those who had signed employment contracts only accounted for one-third, and those who did not have any social protection or did not know about social security accounted for 75 percent. The main reason for these problems is that there is a large surplus labor force in the rural areas; in the course of urbanization a large amount of rural laborers are transferred to the cities, thus creating a large supply of labor for a long period of time. In recent years, with increasing attention paid to the issue of migrant workers in the whole society, their employment environment has improved, defaults of salary payments have decreased, and attention has been paid to their living conditions. There are, however, still grave problems in terms of employment contracts and social protection and their compensation is still too low. The survey also indicated that 70 percent of those surveyed would choose to work outside of their hometowns and had stable and optimistic expectations about future income despite difficult working conditions and low compensation.

Recently, there has been a structural shortage in the supply of migrant workers, in particular, of skilled migrant workers in some areas. To some extent, that will help promote the growth of the income of migrant workers, improve their working and living conditions, and raise their capacity for consumption. It is expected that increasing the income of migrant workers will be a long but inevitable process.

(5) The GDP deflator was lower than that in the same quarter of the previous year.

In the first quarter of 2006, the nominal GDP growth rate was 14.1 percent, while the real GDP growth rate was 10.3 percent. The GDP deflator was 3.9 percent, down 2.2 percentage points on a year-on-year basis.

4. Fiscal revenues and expenditures were in a good position

In the first quarter of 2006, fiscal revenues amounted to 930 billion yuan, growing 19.5 percent and accelerating by 7.4 percentage points over the same period of the last year; fiscal expenditures amounted to 629.2 billion yuan, growing 20.8 percent and accelerating by 5.1 percentage points. Netting revenue and expenditures, fiscal revenues surpassed fiscal expenditures by 300.8 billion yuan, up 43.4 billion yuan on a year-on-year basis.

5. The international balance of payments maintained a surplus

China's BOP continued to maintain a pattern of "twin surpluses" under the current account and the capital account. The surplus under the current account apparently expanded, with that in 2005 reaching US$160.8 billion and growing 134 percent over that recorded in 2004. The increase in the current account surplus was mainly attributed to the surge in the surplus in goods trade. The surplus under the capital and financial account declined, with that in 2005 amounting to US$63 billion, down 43 percent over that recorded in 2004; the decline of the surplus under the capital and financial account was mainly due to the fact that securities investment and other investments posted a deficit, compared with a surplus in the previous year. In the first quarter of 2006, China's BOP continued to maintain a pattern of twin surpluses and forex reserves increased rapidly. At end-March 2006, China's forex reserves reached US$875.1 billion, growing US$56.2 billion and accelerating by US$7.0 billion over that recorded at end-2005.

6. Industrial analysis

In the first quarter of 2006, major industries performed well. In terms of realized value-added, production of most industries grew rapidly, in particular, the value-added of non-ferrous metal smelting and pressing, agricultural and non-staple food processing, general equipment manufacturing, and communications and transportation equipment manufacturing all grew more than 20 percent on a year-on-year basis. In terms of realized profits, of the 39 industries, most industries saw increasing profits over the same period of the previous year. In particular, the top-five industries with the highest profits were oil exploration, communications and transportation equipment, non-ferrous metals, telecommunications, and power. The industries with the highest year-on-year growth rates of profits were non-ferrous metal smelting and pressing, communications and transportation equipment manufacturing, oil and natural gas exploration, special-purpose equipment manufacturing, and non-metal mineral mining and washing, with the growth rates ranging from 60.1 percent to 96.5 percent. The iron and steel and chemicals and chemical fiber industries witnessed a decelerating growth of profits. Oil processing and coking incurred a net loss of 9.8 billion yuan.

The supplies of coal, power, oil, and transportation grew steadily, and their shortages eased. In the first quarter of 2006, output of crude coal posted 430 million tons, up 12 percent on a year-on-year basis. Power generation reached 606.8 billion kilowatt-hours, up 11.1 percent. Output of crude oil posted 45.45 million tons, up 1.7 percent. In terms of transport capacity, construction of infrastructure continued to be strengthened. The volume of rail freight increased 4.1 percent to 670 million tons, the turnover of water freight increased by 10.4 percent to 1.1856 trillion ton-kilometers, and the volume of freight handled by major ports rose by 17.0 percent to 780 million tons.

(1) Labor-intensive industries

The labor-intensive industries contrast with capital-intensive or technology-intensive industries. It refers to industries where the weight of labor input is relatively high in the process of production or services. Labor-intensive industries can be divided into the following three categories: First, the manufacturing of labor-intensive products, e.g., production of light industrial products such as textiles, garments, footwear, leather products, furniture, toys, luggage, etc.; second, labor-intensive links in the production of capital- and technology- intensive products, e.g., assembly of electronic products; third, labor-intensive services industries, e.g., commerce, trade, catering, transportation, etc.

China is the richest country in the world in terms of labor resources. In 2005 China had a population of 940 million between the ages of 15 and 64 years, accounting for 72 percent of the total population. Of the adults between 15 and 64 years old, those with an education above the level of junior middle school accounted for 72 percent, thus constituting a relatively high quality labor force. However, the monthly average salary in the manufacturing industry in China was less than 1,000 yuan, about one twenty-fourth of that in the US. Due to its rich labor resources and low labor costs, China's labor-intensive industries boast of strong competitiveness in the international market and have attracted the developed countries in succession to establish factories or to outsource their production to China.

Since the reform and opening up in China, FDI has been increasing rapidly. In 2005 the actual utilization of FDI amounted to US$60.3 billion, 66 times that recorded in 1983. In terms of industry segmentation, FDI was mainly concentrated in manufacturing, in particular, manufacturing of electronic products, and textiles. Most of the products of the foreign-funded enterprises were for export. In 2005 exports and imports by foreign-funded enterprises accounted for 59 percent of China's total exports and imports, while the trade surplus attributed to the foreign-funded enterprises accounted for 56 percent of China's total trade surplus.

Cross-border outsourcing means that multinational companies (MNCs) transfer a part of their production or services to other countries or regions with lower labor costs, duties and taxation, and other costs incurred by the companies. Typical outsourcing includes processing with the customers' materials in the manufacturing sector as well as project outsourcing in the high-tech supporting industries such as software development, management of IT telecommunications systems, product research and design, project design and molding, customer services and internal business operations, and third-party logistics, etc. At present, domestic enterprises only take up low-level outsourcing projects like "processing with customers' materials" which are mainly focused on manufacturing or processing. By doing so, the domestic enterprises only earn low-level processing fees and remain at the low end of the international economic chain. In 2005 exports of the processing trade amounted to US$416.5 billion, accounting for 55 percent of total exports.

The FDI and cross-border outsourcing in the labor-intensive industries contributed greatly to China's exports, yet they had the effect of import substitution in the domestic market and thus curtailed Chinese imports of corresponding products. In 2005 imports of labor-intensive products accounted for only 5 percent of total imports.

Generally, transferring production and services from one country to another country is the law of industrial upgrading in the process of economic development. The development of the labor-intensive industries in China is the result of the industrial upgrading in the developed countries; the development also increases China's demand for imports of capital- and technology-intensive products from the developed countries and in turn promotes the industrial upgrading of the developed countries and facilitates the balance of world trade at a higher level.

(2) The real estate industry

With the implementation of macro control policies in the real estate market in 2005, the excessive growth of real estate development investment and the excessively rapid rise in housing sales prices were initially restrained. Some issues in the field of real estate, however, have not been fundamentally resolved, the housing sales prices in a small number of large cities are still rising excessively rapidly, and the contradictions in the irrational housing supply structure is still prominent. In the first quarter of 2006, the areas of newly-started and completed commercial housing apparently rose rapidly, and commercial housing vacancies increased, while the sale prices of new commercial housing in some cities continued to rise rapidly.

The growth of real estate investment decelerated steadily. In the first quarter of 2006, cumulative real estate development investment reached 279.3 billion yuan, representing a growth of 20.2 percent, a deceleration of 6.5 percentage points over the same period of the last year. In particular, resident commercial housing investment posted 188.8 billion yuan, up 23.1 percent, a deceleration of 3.5 percentage points; economically affordable housing investment registered 6.2 billion yuan, a growth of 2.6 percent, compared with a decrease of 13.8 percent in the same quarter of the previous year.

The areas of newly-started and completed commercial housing rose apparently rapidly. In the first quarter of 2006, the area of newly-started housing reached 170 million square meters, representing a growth of 22.1 percent, an acceleration of 12.8 percentage points on a year-on-year basis. The area of cumulative completed housing posted 56.57 million square meters, up 35.9 percent, an acceleration of 22.8 percentage points.

Growth in the area of commercial housing sales decelerated and housing vacancies continued to increase. In the first quarter of 2006, commercial housing sales posted 94.59 million square meters, representing a growth of 10.2 percent, a deceleration of 10.1 percentage points on a year-on-year basis; in particular, the area of resident housing sales posted 84.78 million square meters, up 9.2 percent. At end-March 2006, commercial housing vacancies registered 123 million square meters, representing a growth of 23.8 percent, an acceleration of 18.3 percentage points on a year-on-year basis. In particular, resident housing vacancies registered 69.83 million square meters, up 19.7 percent.

Commercial housing sale prices continued to rise, yet the growth in housing sale prices tended to decelerate. In the first quarter of 2006, the housing sale prices in 70 large- and medium-sized cities rose 5.5 percent on a year-on-year basis, a deceleration of 1 percentage point over that recorded in the previous quarter. In particular, the sale prices of new commercial housing rose by 6.3 percent over the same quarter of the previous year, a deceleration of 1.2 percentage points on a quarter-on-quarter basis. Geographically, cities like Dalian, Huhhot, and Shenzhen continued to maintain the momentum of a rapid rise in housing sale prices.

The growth in individual housing mortgage loans slowed down. At end-March 2006, individual housing mortgage loans amounted to 1.9 trillion yuan, growing by 12.8 percent on a year-on-year basis or 46.2 billion yuan over that recorded at the start of 2006, a deceleration of 29.6 billion yuan on a year-on-year basis.[5] The deceleration of

[5] In 2006 the PBC begin to implement a new specialized statistical system for real estate loans. Real estate loans include real estate development loans, housing mortgage loans, and securitized real estate loans. In particular,

growth in individual housing mortgage loans is mainly attributed to the following factors: First, in recent years, individual housing mortgage loans grew rapidly, thus the current deceleration was represented normal adjustment after rapid growth. The weight of individual housing mortgage loans in the total loans has been rising steadily. Second, an individual credit registration system was improving gradually, awareness of risk prevention and internal control mechanisms were strengthened in commercial banks, and thus housing credit businesses were more regulated and standardized. Third, after the prime interest rates for housing mortgage loans reverted to the interest rates for normal loans with the corresponding maturities, the proportion of loan repayments before the maturity date and full payments at purchase increased. At end-March 2006, real estate loans amounted to 3.2 trillion yuan, accounting for 15.7 percent of the total renminbi loans; in particular, real estate development loans amounted to 1.2 trillion yuan, accounting for 37.8 percent of the total real estate loans.

Box 6: A Sample Survey of the Real Estate Market in the 10 Cities

In order to obtain an in-depth understanding of current developments in the housing market, the PBC conducted a sample survey on the real estate markets in Beijing, Shanghai, Tianjin, Chongqing, Guangzhou, Chengdu, Nanjing, Hangzhou, Shenzhen, and Qingdao. The questionnaire for the survey focused on the household repayment capability and developments in the housing loans.

I. Overview of household repayment capabilities

In the randomly selected sample in the 10 cities, the proportions of economically affordable housing, ordinary commercial housing, high-grade apartments, and independent houses were 14:76:8:2. Those housing units with an area less than 120 square meters accounted for 68 percent. The proportions of self-occupied, vacant, and rent housing were 84:10:6.

1. The liabilities ratio was at a normal level. At end-October 2005, the average monthly payment ratio (the ratio of monthly payments for housing mortgage loans to total income) in the 10 cities was 35 percent; the average liabilities ratio (the ratio of all liabilities to total income) was 38 percent. The liabilities ratio was higher than the

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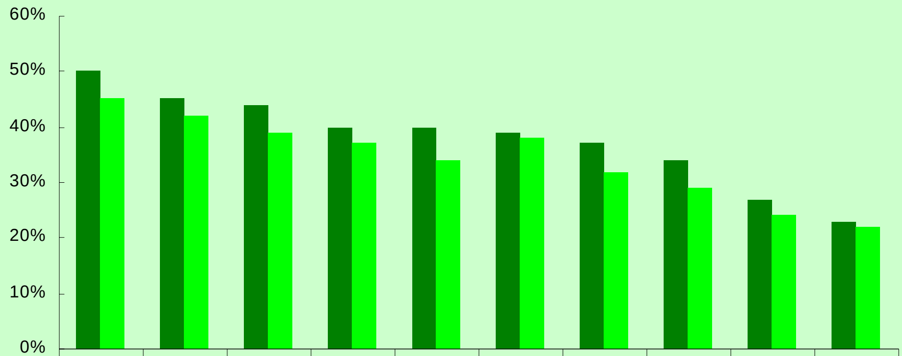
housing mortgage loans include enterprise mortgage loans and individual mortgage loans. Individual mortgage loans in turn include business-purpose individual mortgage loans and resident individual mortgage loans. At end-March 2006, individual mortgage loans amounted to 1.9 trillion yuan and 1.8 trillion yuan in terms of the old and new statistical systems respectively. The differential between the two figures is mainly attributed to the fact that the former also include some business-purpose individual mortgage loans. In order to judge the trend, the former figure was used herein for individual housing mortgage loans. The real estate loans and the real estate development loans utilized the figures under the new system.

monthly payments ratio because the liabilities of residents included auto loans as well as individual housing mortgage loans. The monthly payments ratio and the liabilities ratio were below 50 percent and 55 percent respectively as prescribed by China Banking Regulatory Commission (CBRC),[6] and household repayment capabilities were at a normal level.

Figure 2: Comparison of Household Repayment Levels in 10 Cities



	Shanghai	Beijing	Tianjin	Nanjing	Qingdao	Hangzhou	Guangzhou	Chongqing	Shenzhen	Chengdu
Liabilities Ratio	50%	45%	44%	40%	40%	39%	37%	34%	27%	23%
Monthly Paymants Ratio	45%	42%	39%	37%	34%	38%	32%	29%	24%	22%

Source: Financial Market Department of the PBC.

2. Housing purchasers through mortgage loans had strong capabilities for payment and repayment. At end-October 2005, the ratio of housing prices to income (the ratio of the total price of a housing unit to the annual household income, i.e., the multiplier of the housing price to income) in 8 cities[7] indicated that the multiplier was usually below 8, with the exception of 10 in Shanghai. The multiplier was far smaller than that obtained by dividing the average housing price by annual disposable income, which indicated that the income of housing purchasers through mortgage loans was higher than the average income of urban residents and housing purchasers through mortgage loans had relatively strong capabilities for payment and repayment.

The results of the survey also indicated that from the perspective of consumer psychology and habits, most residents preferred purchasing housing. In the 10 cities, 62 percent of the borrowers of housing mortgage loans did not take into consideration housing rentals when purchasing housing, in particular, the ratio was even as high as 90 percent in Beijing. In terms of confidence in loan repayment, 90 percent of those

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[6] In August 2004 the CBRC issued the *Notice on the Issuance of Guidance on Risk Management for Real Estate Loans by Commercial Banks* (Yinjianfa [2004] No. 57), which stipulates that commercial banks should focus on reviewing the repayment capabilities of borrowers and that commercial banks should keep the monthly payment ratio below 50 percent and the liabilities ratio below 55 percent.

[7] Excluding Shenzhen and Beijing.

surveyed believed that their household income would be basically stable or even rise considerably, and 55 percent of those surveyed noted that future changes in interest rates would not exceed their tolerance. All of the above indicated that residents were strongly confident of their capabilities to repay housing mortgage loans.

II. Overview of housing mortgage loans

The survey indicated that all housing mortgage loans (including provident fund loans and combined loans) had an average maturity of 17 years and an average down payment ratio of 37 percent. In particular, the down payment ratios in Nanjing and Shanghai were both above 40 percent. At end-November 2005, in the 8 cities,[8] the market prices of purchased housing through mortgage loans by residents were all apparently higher than those at the time of purchase, growing at an average rate of 15 percent.

1. Commercial loans were the main form of loans. In terms of the forms of the loans, provident fund loans, commercial loans, and combined loans accounted for 12 percent, 75 percent, and 13 percent respectively, which indicated that commercial loans remained the main loan form for individual mortgage loans, subject to such conditions as loan limits, although provident fund loans had lower interest rates.

2. Down payments came mainly from household savings. The survey indicated that household savings provided down payments for 85 percent of the borrowers of housing mortgage loans. Personal support (e.g., from parents) provided down payments for 10 percent of the borrowers, and lending from relatives or friends provided down payments for 5 percent of the borrowers.

3. Most borrowers of housing mortgage loans had good records of repayment. In terms of repayment, 81 percent of those surveyed did not have records of late repayments, 15 percent delayed their repayments because of negligence or business trips etc., and 35 percent repaid the loans before maturity, of whom 10 percent did so because of interest rate hikes.

[8] Excluding Shenzhen and Shanghai.

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

I. Macroeconomic outlook

With respect to consumer demand, with the growth of household income, the reform of the social security system, and improvements in the consumption environment, consumer demand is likely to increase steadily. The results of the survey on urban household savings in the first quarter of 2006 showed that the household income confidence index rose by 1.8 percentage points over the same period of the last year. Regarding investment demand, with the implementation of the Eleventh Five-Year Program and the building of the socialist new countryside, local governments still have a strong incentive to accelerate economic development. The unduly large amounts of newly approved projects and projects under construction imply that aggregate demand continues to increase and fixed-asset investment faces pressure to grow at an excessively fast pace. As to foreign trade, China's exports will continue to benefit from the good momentum of global economic growth, but uncertainties about exports will increase as trade protectionism in some countries has strengthened due to the increasing global economic imbalances.

Uncertainties still remain with respect to price movements, but the upward risks are larger than the downward risks. With respect to the downward risks, the prices of consumer goods and products in excessive supply are downward pressures. The upward risks can be summarized as follows. First, the rapid growth of investment and the acceleration of industrial production will push up the purchase prices of upstream products such as raw materials, fuels, and power, and will to some extent lead to higher factory prices for industrial products. Second, prices of utilities and resources are likely to go up amid the reform of the prices of resources, including water, electricity, gas, and land. Third, wage increases and the reform of the social security system may directly drive up the general price level. Fourth, the high fluctuations of oil, ferrous metal, and other large commodities in the international market will have an impact on domestic prices. Fifth, excess liquidity and a low level of money market rates may continue to build up inflationary pressures on asset prices such as real estate prices. Given that China's economy could maintain a high growth rate of nearly 10 percent and the prospects for a robust global economic expansion, the general price level is unlikely to fall in the foreseeable period, while increased inflationary pressures on the prices of services and assets could contribute to potential inflationary risks.

In general, in the process of urbanization and industrialization, the rapid growth of investment is inevitable. However, attention should be paid to the effects of investment growth on the stability and sustainability of economic growth, and to its pressures on the environment and resources. At present, high priority should be given to monitoring the risks to be brought about by the excessively rapid growth of fixed-asset investment, structural imbalances in foreign trade, excess liquidity, and global economic imbalances.

II. Monetary policy stance to be adopted in the period ahead

In line with the guidelines of the Central Economic Work Conference and the Fourth Session of the Tenth National People's Congress, the PBC will continue to pursue a sound monetary policy, maintain the consistency and continuity of the policy, appropriately control money and credit aggregates, strengthen policy coordination between domestic and foreign currencies, and enhance the effectiveness of macroeconomic management so as to prevent an excessively rapid growth of money and credit and to provide a stable monetary and financial environment for the transformation of the pattern of economic growth and economic restructuring.

1. Apply a mix of policy instruments to strengthen the preemptive nature of monetary policy

Considering the excess liquidity accumulated in the banking sector, the PBC will take concrete measures to intensify open market operations, enhance coordination of open market operations and other policy tools, strengthen the capability of open market operations in guiding the development of credit and the interest rate, effectively adjust the liquidity of the banking system, and ensure stable movements of the money market interest rate so as to enable the market to play a more effective role in leading market expectations.

2. Continue to implement policies related to market-based interest rate reform

Building on the removal of the upper limit of the lending rate and the lower limit of the deposit rate, the PBC will properly streamline the maturities of the benchmark interest rates of loans and promote a market-based reform of the interest rate on long-term large-value deposits. Meanwhile, the PBC will make efforts to explore ways to develop the benchmark market rate system, improve the interest rate determination mechanism, and enhance its capability to guide the movement of market interest rates. The PBC will also improve the central bank interest rate system and establish a central bank interest rate determination mechanism which can be used to adjust the central bank rediscount rate on a dynamic and timely basis. Commercial banks and rural credit cooperatives will be encouraged to improve their interest rate pricing capabilities and to implement measures associated with a market-based interest rate reform. Pricing mechanisms for the interest rate and products of the commercial paper market will be further improved to appropriately reflect the term structure and credit risks. The monitoring system for the market interest rate will be improved to enhance the effectiveness of the interest rate policies.

3. Enhance the role of policy guidance to advise financial institutions to appropriately control credit expansion and improve the loan structure

Financial institutions will be advised on a timely basis to rationally issue loans within the year according to the credit needs of the real economic sectors to prevent large fluctuations of loans and to support the steady and relatively fast growth of the economy. The financial institutions will be guided to appropriately control medium- and long-term credit expansion such as capital construction loans to improve credit structure. Steps will be taken to strengthen the cultivation of the financial ecological environment and to improve financial services to support the development of the western and central areas as well as the old industrial bases of northeast China to promote balanced economic development among different regions. Credit support will be strengthened to promote development of the weak sectors of the economy such as agriculture, non-public sectors, small- and medium-sized enterprises, employment, and education. Efforts will be made to encourage and support commercial banks to expand the consumer credit business, to improve the pricing mechanism for housing loans through the effective use of relevant information provided by the personal credit information database, and to improve housing-related financial services and risk management to support a rational housing demand. The development of a discount lending business should be regulated to enable the discount bill business to play a greater role in increasing working capital injections and in easing the access of SMEs to bank loans.

4. Improve rural financial services to support the building of a socialist new countryside

Under the guidance of the State Council, on the basis of strengthening and improving policies on rural financial services, rural financial reform and innovation will be stepped up. Efforts will be made to guide the RCCs, the Agricultural Bank of China, and other financial institutions to steadily enhance credit support to the rural economy and to expand rural credit business3w. Measures will be taken to bring into play the dominant role of the RCCs in providing rural financial services, to encourage the RCCs to improve their lending rate pricing capabilities, and to enhance their incentives to grant credit support to the rural economy. Efforts will also be made to strengthen the monitoring of high-risk financial institutions in the rural areas to better prevent and resolve financial risks. The building of a rural financial service infrastructure should be promoted to provide secure, convenient, and efficient payment and settlement services.

5. Actively promote the development of financial markets

Steps will be taken to establish a multi-layer market system, expedite the development of direct financing, further develop the bond market, and strengthen the market infrastructure and functions supported by the motivation of the market participants, with priority given to financial product innovation. Active efforts will be made to cultivate institutional investors and further improve the market-maker and broker system. Financial derivative innovations will also be promoted so as to meet the diversified needs of the market.

6. Continue to deepen the reform of financial institutions

Continued efforts will be made to push ahead with the joint-stock reform of the state-owned commercial banks, encouraging them to further improve corporate governance and establish effective mechanisms, discipline, risk control, and capital constraints, and to strengthen the role of the capital market in supervising and disciplining the state-owned commercial banks. Reform of the policy banks will be deepened by applying different reform schemes to different banks according to their unique circumstances and carrying out the reform in a targeted and sequenced way. Steps will be taken to promote the reform of the rural financial system, to further improve financial services in the rural areas, deepen the reform of rural credit cooperatives, and endeavor to establish financial institutions with clear ownership, a sound financial situation, effective supervision, and sustainable viability that mainly provide financial services to the rural sector. Efforts will also be made to improve the performance of joint-stock commercial banks and steadily advance the reform and restructuring of small- and medium-sized financial institutions. The reform of financial asset management companies will be promoted and the postal savings system reform will be deepened.

7. Deepen the reform of the foreign exchange management system and improve the RMB exchange rate regime

According to the needs arising from the process of China's economic and financial development and to safeguard economic and financial stability, efforts will be made to improve the managed floating exchange rate regime in a self-initiated, controllable, and gradual way. Efforts will be made to enable market supply and demand to play a fundamental role in the formation of the RMB exchange rate and to improve the flexibility of the RMB exchange rate, so as to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. To promote a balanced development of international payments, the PBC, with a transformed mind-set and innovative instruments, will further deepen the reform of the foreign exchange management system. Steps will also be taken to improve current account transactions verification, strengthen the off-site surveillance system, and facilitate the use of foreign exchange by enterprises and individuals. The PBC will steadily advance the RMB capital account convertibility, strengthen its support for overseas investment by enterprises, and steadily expand the channels for capital outflows. Foreign exchange inflows and foreign exchange surrender will be regulated, and efforts will be intensified to crack down on illegal foreign exchange transactions. In addition, measures will be taken to accelerate the development of the foreign exchange market and to foster an orderly relationship between demand for and supply of foreign exchange.