Executive Summary

China's economy continued to grow steadily and rapidly in the first quarter of 2005. Macroeconomic management has achieved expected results, which are reflected in the slower growth of fixed-asset investment, acceleration of consumption growth, continued expansion of export and import, and higher income of urban and rural residents. In the first quarter, GDP grew by 9.4 percent and CPI increased by 2.8 percent on a year-on-year basis.

Under the guidance of the Central Party Committee and the State Council, the People's Bank of China (PBC) continued to pursue the sound monetary policy and strengthened the forward-looking and scientific approach to macro financial management to make it more effective. The PBC appropriately controlled money and credit aggregates by using a mix of monetary policy instruments. It also took further steps to deepen the reform of foreign exchange administration system, steadily push ahead with the reform of the financial institutions, speed up the development of the financial market infrastructure, and further improve the transmission mechanism of monetary policy. The specific measures included the following. First, by flexibly conducting open market operations, the PBC strengthened its liquidity management capability. Second, the excess reserve ratio of the financial institutions was lowered to further advance the market-based interest rate reform. Third, policy for individual housing loans was revised to promote the healthy and sustained development of the housing industry. Fourth, window guidance for the commercial banks was enhanced, and the role of credit policy was further strengthened to guide the commercial banks in their loan granting process. Fifth, steady progress was achieved in the joint-stock reform of the state-owned commercial banks and the reform of the rural credit cooperatives. Sixth, to promote direct financing, the PBC took steps to speed up the development of financial market infrastructure, including introducing credit assets securitizaion on a pilot basis, allowing qualified international development institutions to issue RMB bond, and licensing pilot incorporation of fund management companies by commercial banks. Seventh, the RMB exchange rate was kept stable at an adaptive and equilibrium level to promote balanced international payments.

In the first quarter of 2005, money and credit grew at an appropriate pace, and the financial sector performed soundly. As of end-March, broad money (M2) reached RMB26.5 trillion yuan, up by 14.0 percent over the same period of last year, and base money registered RMB5.8 trillion yuan, a year-on-year increase of 14.1 percent. Loans extended by the financial institutions amounted to RMB737.5 billion yuan in the first quarter, RMB97.6 billion yuan less than that of the same period of the previous year. Money market interest rate remained at a stable and relatively low level. At end-March, foreign exchange reserves totaled US$659.14 billion, US$49.21 billion higher over end-2004. RMB exchange rate stood at 8.2765 yuan per US dollar, the same level as that of end-2004.

Despite the overall good economic and financial performance, certain problems remain, including the excessively large scale of fixed-asset investment, insufficient supply of coal, electricity and oil, and inefficiency in economic growth and the use of resources. In addition, the effectiveness of monetary policy is challenged by the rapid growth of foreign exchange and trade surplus.

As required by the Central Economic Conference and the Third Plenum of the Tenth National People's Congress, the PBC will continue to pursue the sound monetary policy. Efforts will be made to appropriately control money and credit aggregates to support economic development as well as to prevent inflation and financial risks. Measures include further improving the indirect management mechanisms to maintain steady growth of money and credit; deepening the market-based interest rate reform to enhance the role of interest rate in macroeconomic management; enhancing the role of credit policies in promoting economic restructuring by differentiating credit support to various sectors; controlling the growth of medium- and long-term loans with a view to improve the term structure of the loans; actively promoting the development of financial markets; speeding up the reform of the financial enterprises; and deepening the reform of foreign exchange administration to promote balance of payments equilibrium.

Part One Monetary and Credit Performance

In the first quarter of 2005, the Chinese economy expanded at a steady and relatively fast pace. The growth of money and credit remained broadly appropriate, and the performance of financial Industry was sound.

I. Growth of monetary aggregates remained stable

Since policy initiatives to strengthen and improve macro financial control were launched, growth of broad money M2 has been decelerating gradually, falling to the range of 13-15 percent for eight months in a row, which was broadly consistent with the pace of economic growth. M2 reached RMB26.5 trillion yuan at end-March, an increase of 14 percent y-o-y, with the growth registering 5.1 percentage points lower than a year earlier or 0.6 percentage points down from the end of 2004, indicating a largely stable growth.

Table 1: Money Supply and Its Components at end-Q1, 2005

RMB trillion yuan

	Balance	Y-O-Y Percent Change%
Money and Quasi Money (M2)	26.5	14.0
Money (M1)	9.5	9.9
Cash in Circulation (M0)	2.1	10.1
Demand Deposits	7.4	9.9
Quasi Money	17.0	16.5
Time Deposits	2.7	22.6
Savings Deposits	12.9	15.5
Other Deposits	1.4	14.0

Note: margin deposits of securities firms' clients are included in money and quasi money (M2).

Source: Statistics Department, PBC

Growth of narrow money M1 relatively slowed as opposed to M2. M1 reached RMB9.5 trillion yuan at end-March, increasing by 9.9 percent y-o-y, 3.7 percentage points lower than the end of 2004. Slow growth of M1 was mainly attributable to the following factors: first, M1 growth recorded a year earlier was relatively strong, implying a high base figure. Second, with the wide use of payment instruments such as credit cards, household demand for cash in daily consumption has been declining. Third, interest rate sensitivity of enterprises has increased, with financial management capacity enhanced. Following the benchmark interest rate hike on October 29, 2004, the magnitude of rise of the rate on medium and long-term deposits exceeded that on short-term deposits, while demand deposit rate remained unchanged. As a result, enterprises converted some demand deposits to time deposits.

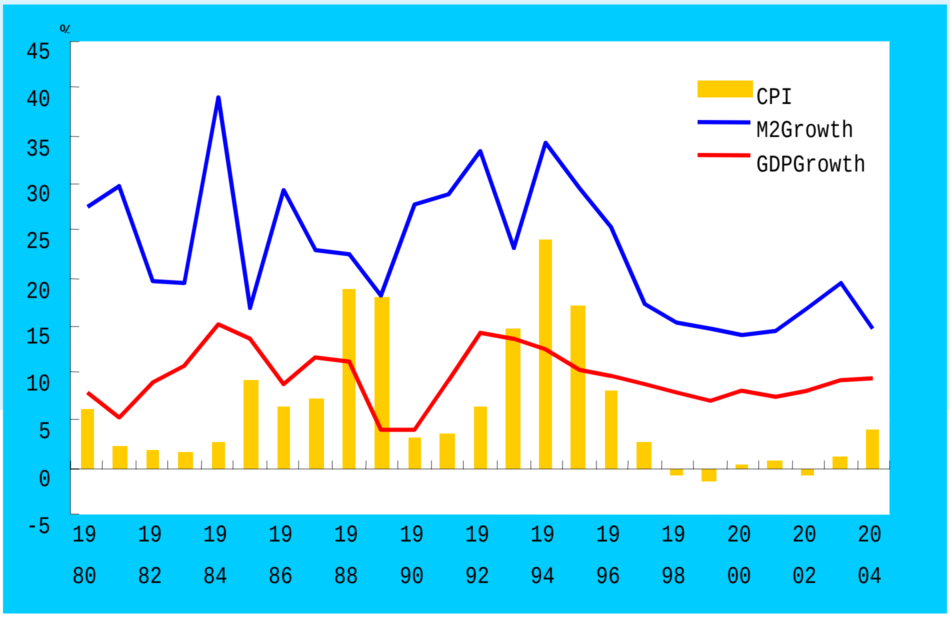
AT end-March, cash in circulation M0 amounted to RMB2.1 trillion yuan, increasing by 10.1 percent y-o-y. Cumulative net cash withdrawal in the first quarter totaled RMB22.9 billion yuan, RMB21.9 billion yuan less than that recorded for the same period of 2004.

Box1：Money supply, economic growth and price stability

The relationship between money supply, economic growth and price stability can be explained using the Equation of Exchange MV≡PY, in which M is money supply, V is velocity of circulation, P average price level and Y real output.

In the long term, holding other variables constant, changes of money supply will invariably result in changes of general price level, which underlies the importance of monitoring and controlling money supply. During 1980-2003, the Chinese economy experienced four price inflations and one deflation. During these episodes, the growth of money supply and output moved in parallel. During economic expansion, money supply grew rapidly. When money supply expanded to approach a certain level, prices rose and economic imbalance emerged, then a passive adjustment was enforced to tighten money and credit. In the 1980's, annual growth of money supply and GDP averaged 24.5 percent and 9.8 percent respectively, and CPI inflation was recorded at an average rate of 7.5 percent. In the 1990's, average annual growth of money supply and GDP stood at 24.9 percent and 9.7 percent respectively, while CPI inflation recorded 7.8 percent. During 2000-2004, average annual growth of money supply and GDP were 15.9 percent and 8.9 percent respectively, and CPI inflation stood at 1.1 percent, a healthy momentum of strong growth and low inflation. The history has proved that oversupply of money will not bring unchecked acceleration of economic growth, but only price inflation. Depression and deflation, which usually follow high inflation, will inflict tremendous damage on economic activities. Therefore, appropriate rate of money growth will promote economic growth positively and contribute to preventing both inflation and deflation.

Chart 1: Changes of money supply, economic growth and price level since 1980



However, prudence is warranted in applying the equation of exchange. Special attention should be paid to the implications of changes of the velocity of money circulation. Money velocity is closely associated with money demand, thus subject to the impact of various factors, such as institutional factors deciding the gap between income and expenditure, the situation of financial technology, interest rate, degree of economic instability or confidence in the economy, inflation expectation and income level. Study shows that money velocity generally decreases first with the deepening of monetarization, then increases as financial innovation deepens and economic stability improves. Since the reform and opening up, China has experienced a process of monetary deepening, in which money velocity generally declined despite periodic fluctuations. In general, money velocity rose as economic growth accelerated, and moderated or declined as economic growth slowed.

The national economic and social development targets set for GDP growth and CPI inflation in 2005 are 8 percent and 4 percent respectively. Taking into account comprehensive factors, the target for M2 growth in 2005 is set to be around 15 percent.

II. Deposits of financial institutions expanded at a steady pace

Outstanding deposits of all financial institutions (including foreign-funded financial institutions) in both RMB and foreign currencies increased by 15.6 percent y-o-y to RMB26.9 trillion yuan at end-March, a growth of RMB1.3 trillion yuan from the beginning of the year or an acceleration of RMB63.4 billion yuan. In particular, RMB deposits rose by 15.9 percent y-o-y to RMB25.6 trillion yuan, up RMB1.23 trillion yuan over the beginning of the year or decelerating by RMB22.3 billion yuan. Foreign currency deposits totaled USD162.8 billion, increasing by 10.9 percent y-o-y or by USD7.98 billion over the beginning of the year, an acceleration of USD10.37 billion.

At end–March, RMB deposits from corporate sector increased by 13.4 percent y-o-y to RMB8.5 trillion yuan, representing a growth of RMB26 billion yuan from the beginning of the year, RMB174.3 billion yuan less than the growth of the same period of 2004. Savings deposits in RMB expanded by 15.5 percent y-o-y to RMB12.9 trillion yuan, increasing by RMB970.5 billion yuan over the beginning of the year, RMB145.9 billion yuan more than the same period of a year earlier, in large part attributable to acceleration of time deposits. Fiscal deposits added RMB193.8 billion yuan in the first quarter, an acceleration of RMB76.6 billion yuan compared with a year earlier.

III. Growth of loans by financial institutions was broadly stable

Outstanding loans by financial institutions in both RMB and foreign currencies reached RMB19.8 trillion yuan at end-March, a growth of 13 percent y-o-y, down 1.4

percentage points from the end of the previous year, or increasing by RMB826.8 billion yuan over the beginning of the year, a deceleration of RMB86.3 billion yuan. RMB loans grew by 13 percent y-o-y to RMB18.5 trillion yuan, down 1.5 percentage points from the end of 2004, or an increase of RMB737.5 billion yuan over the beginning of the year, decelerating by RMB97.6 billion yuan. Foreign currency loans rose by 13.3 percent y-o-y to USD146.9 billlion, 0.8 percentage points higher than the end of 2004, or a growth of USD10.79 billion over the beginning of the year, accelerating by USD1.37 billion.

In terms of loan destination, RMB short-term loans and bill financing for corporate working capital increased by RMB408 billion yuan in the first quarter, decelerating by RMB40.4 billion yuan over a year earlier. Medium and long-term loans rose by RMb310.9 billion yuan, a deceleration of RMB47.7 billion yuan. In particular, capital construction loans added RMB173.8 billion yuan, an acceleration of RMB3.8 billion yuan. Among total new loans, medium and long-term loans accounted for 42.2 percent, 0.8 percentage points lower than the same period of 2004, or 18.3 percentage points lower than recorded for the whole year of 2004. Capital construction loans made up 23.6 percent of new loans, 3.2 percentage points higher than the same period of 2004, or 4.1 percentage points lower than the whole year of 2004. Consumer loans increased by RMB63.7 billion yuan, decelerating by RMB53.7 billion yuan over the same period of the previous year.

Breaking down by institutions, lending by policy banks accelerated, but lending by both commercial banks and rural credit cooperatives decelerated. In the first quarter, RMB loans by policy banks were added RMB56.6 billion yuan, accelerating by RMB27 billion yuan over the same period of the previous year. Lending by wholly state-owned commercial banks, joint-stock commercial banks, urban commercial bank and rural credit cooperatives expanded by RMB325.3 billion yuan, 112.6 billion yuan, 32 billion yuan and 160 billion yuan, decelerating by RMB74.6 billion yuan, 47.6 billion yuan, 13 billion yuan and 13.9 billion yuan respectively.

Box 2: The increase of medium and long-term loans as a proportion of the overall loans

The outstanding balance of medium and long-term loans as a proportion of the total loans has been rising in recent years, hitting near 40 percent at end-2004 compared with 24 percent at end-2002. There are various reasons behind strong growth of medium and long-terms loans, in particular the rapid expansion of capital construction loans, which deserves a full analysis.

First, as investment rate has been rising year by year, the proportion of medium and long-term loans in the overall lending will have to rise accordingly. The overall structural problems in the economic and financial system in China will be reflected in the changes of money and credit growth inevitably. On the one hand, a misaligned relationship between consumption and investment has resulted in an excessively high investment rate. In particular, acceleration of industrialization and urbanization has led to robust growth of capital-intensive investment. On the other hand, the development of direct financing in China has lagged behind for long, with social financing dominated by bank lending. Loans account for around 90 percent of corporate financing, and enterprises finance their long-term funds needs mostly with medium and long-term bank loans.

Second, commercial banks have a preference to extend medium and long-term loans, due to limited investment channels and concerns over credit risk control. At end-2004, out of the total non-performing loans in China, 78.9 percent were short-term and 21.2 percent were long-term in terms of original maturity, suggesting that the quality of medium and long-term loans was much better than working capital loans. As a result, commercial banks with a relatively high ratio of working capital loans have made strategic adjustment to cut working capital loans. However, existing restrictions on asset management of commercial banks in China imply limited investment alternatives other than loans and a high concentration of fund in the banking system on the medium and long-term loans.

Third, falling demand for inventory as a result of development of information technology and logistics sector as well as diversification of corporate short-term financing sources has eased demand for working capital loans by enterprises. In addition, due to intensifying regulatory pressures and improvement in accounting practices of commercial banks, some short-term loans were redefined as medium and long-term loans on the book in line with their real purposes of use. These factors were directly reflected in the increasing proportion of medium and long-term loans. At present, the ratio of outstanding working capital loans to GDP in China hit a very high level, exceeding 70 percent ever since 1997, almost the highest in the world. However, a significant part of these working capital loans are actually used by enterprises to finance long-term projects.

In general, as credit aggregate is at a broadly appropriate level, the gradually rising proportion of medium and long-term loans can be explained by some intrinsic factors. When exerting efforts to improve lending structure, it should be recognized that many factors affecting loan structure are associated with macro policy adjustment and institutional reform. Only by addressing macro level issues, such as gradually adjusting the relationship between investment and consumption and stepping up development of capital market to expand channels for direct financing, could the rapid growth of medium and long-term loans be effectively contained. But such adjustment can not be finished in one day. Furthermore, it should be noted there does not exist an unchanged level of medium and long-term loans as a proportion of the overall bank lending. With the deepening of economic system reform, adjustment of economic structure and change of business cycles, such a proportion will undergo dynamic movements.

IV. Excess reserve ratio of financial institutions was a little lower than the previous years

At end-March, the balance of base money totaled RMB5.8 trillion yuan, decreasing by RMB126.5 billion yuan from the beginning of the year and increasing by 14.1 percent y-o-y. The average excess reserve ratio of financial institutions was 4.17 percent, down 0.11 percentage points from a year earlier or 1.08 percentage points from the end of the previous year. The wholly state-owned commercial banks, joint-stock commercial banks and rural credit cooperatives recorded a ratio of 3.99 percent, 5.25 percent and 5.55 percent respectively.

V. Loan interest rates of financial institutions edged up, and money market interest rate inched down

Loan interest rates of financial institutions moved up. In the first quarter, the weighted average fixed interest rate for one-year RMB loans of financial institutions was 6.98 percent, 1.25 times the benchmark interest rate, up 0.23 percentage points over the fourth quarter of 2004. Loans charged at interest rates floating upward against the benchmark rate accounted for more than half of total loans. The PBC statistics on lending interest rates have shown that among total new loans in the first quarter, loans with interest rates floating downward against the benchmark took up 21.9 percent, down 1.3 percentage points over the beginning of the year, loans charged at the benchmark rate made up 26.9 percent, up 2.3 percentage points over the beginning of the year, and loans with interest rates floating upward against the benchmark accounted for 51.2 percent, down 1 percentage point over the beginning of the year. In particular, the proportion of loans with interest rates charged above 2 times the benchmark rate stood at 3.6 percent, up 0.9 percentage points over the beginning of the year, suggesting that loans were priced to better cover the risk premium.

Table 2：The Share of Loans with Rates Falling in Various Ranges

in the First Quarter of 2005

(by financial institutions)

Unit：%

	Sum	[0.9，1)	1.0	Upward Adjustment				
				Sum	（1，1.3]	（1.3，1.5]	（1.5，2]	above 2
Sum	100	21.9	26.9	51.2	29.5	7.7	10.4	3.6
State-owned commercial banks	100	27.9	32.4	39.8	35.1	3.8	0.6	0.2
Joint-stock commercial banks	100	27.7	37.7	34.6	32.8	1.5	0.2	0.1
Regional commercial banks	100	15.1	18.1	66.8	40.8	8.4	7.5	10.1
Urban and rural credit cooperatives	100	1.6	4	94.4	14.5	23.4	43.7	12.8

Note: the interest adjustment range for urban and rural credit cooperatives is（2，2.3]

Source: Reports of lending rates of commercial banks

The interest rate on negotiable RMB deposits of commercial banks (above 30 million yuan) declined slightly. In particular, the weighted average interest rate of egotiable deposits with a maturity of 61 months stood at 4.3 percent, down 0.17 percentage points compared with the fourth quarter of 2004, and the weighted average interest rate of negotiable deposits with a maturity of 37 months was 4.21 percent, down 0.11 percentage points over the last quarter of 2004.

Affected by persistent interest rate hikes of the US Fed and interest rate rise in international financial markets, the interest rates on domestic foreign currency loans and large-value deposits continued to move up. In March, the weighted average interest rate of one-year large-value US dollar deposits (above US$3 million) stood at 3.3 percent, 0.6 percentage points higher than the beginning of the year; the weighted average fixed interest rate on one-year US dollar loans was 4.24 percent and the weighted average floating interest rate on US dollar loans was 3.75 percent, up 0.81 and 0.37 percentage points respectively over the beginning of 2005.

In the first quarter, financial institutions were in sufficient liquidity, leading to the steadily fall of the money market interest rates. Due to the downward adjustment of interest rate on excess reserve effective on March 17, the weighted average interest rates on 7-day inter-bank lending and pledged bond repo in March were 1.98 percent and 1.7 percent, down 0.28 and 0.25 percentage points respectively over the previous month, and 0.1 and 0.22 percentage points lower than those recorded in the same period of 2004.

VI. Official foreign exchange reserves continued to grow rapidly and RMB exchange rate remained stable

At end-March, the official foreign exchange reserves reached USD659.14 billion, growing by USD49.21 billion over the end of 2004, or accelerating by US$12.64 billion over the growth recorded for the same period of last year. The RMB exchange rate stood at 8.2765 yuan per US dollar at end-March, on a par with the end of 2004.

Part Two Monetary Policy Conduct

In the first quarter of 2005, the PBC continued to implement the sound monetary policy under the leadership of the central government, and stressed the effectiveness and forward-looking features of financial regulation by utilizing a series of monetary policy instruments to appropriately adjust monetary aggregates in a timely manner. Meanwhile, efforts were made to deepen the reform of the foreign exchange management system, advance the reform of the financial institutions and improve the monetary policy transmission mechanism.

I. Strengthening liquidity management and flexible conduct of open market operations

In the first quarter, the PBC closely monitored liquidity change around the New Year's day and the Spring Festival by analyzing such factors as foreign exchange reserves, fiscal deposit and cash in circulation that have a bearing on liquidity. The PBC further strengthened liquidity management and flexibly determined the mode and size of the issuance of central bank bills as well as their maturity structures. Central bank bills, mainly with a maturity of 1 year and 3 years, were used to appropriately adjust the liquidity in the banking system. Before the Spring Festival, The PBC smoothened the fluctuations of liquidity in the banking system through timely rescheduling the maturity of central bank bills, pre-issuance of central bank bills and conduct of reverse repo operations on a small scale. After the Spring Festival, in light of the abundance of banking liquidity, the PBC flexibly managed the issuance of central bank bills, supported by the cut of interest rate on excess reserve on March 17, to expand the room for money market interest rate movement, which further promoted the market-based interest rate reform and enhanced asset and liability management of commercial banks.

In the first quarter, the PBC issued base money of 422.3 billion yuan via foreign exchange open market operations, and recalled 365.9 billion yuan via RMB open market operations. The net issuance of base money amounted to 56.4 billion yuan. 36 issuances of central bills were made in the first quarter, amounting to 713 billion yuan, among which bills with a maturity of 1 year stood at 301 billion yuan and those of 3 years stood at 180 billion yuan. At the end of March, the outstanding balance of central bank bills reached 1345.25 billion yuan.

II. Cutting interest rate on excess reserves and further promoting market-based interest rate reform

On March 17, the PBC cut the interest rate on excess reserve of financial institutions from 1.62 percent to 0.99 percent. The rate on required reserve was kept intact at 1.89

percent.

The cut of interest rate on excess reserves is conducive for commercial banks to enhance the efficiency of capital use and promote market-based interest rate reform. It is also favorable for the central bank to streamline the interest rate system, optimize the interest rate structure of deposit reserves and strengthen the effectiveness of monetary policy conduct.

Box 3: Excess Reserve and Its Interest Rate

Deposit reserves consist of required reserve and excess reserve. Required reserve refers to deposits of financial institutions at the central bank in proportion to their total deposits. The proportion, which is usually set by the central bank, is called reserve requirement ratio. If the central bank decides to increase reserve requirement ratio, financial institutions have to increase their deposits at the central bank and correspondently reduce lending. As a result, the monetary aggregate will decline, and vice versa. Hence, reserve requirement ratio is a powerful monetary policy instrument. Excess reserve refers to deposits of financial institutions at the central bank in excess of required reserve. They are mainly used for settlement and liquidity management purposes or as stand-by assets. Foreign central banks may pay interest on required reserve only, or pay no interest on deposit reserves at all. In China, however, the central bank pays relatively high interest on all kinds of deposit reserves.

In March 1998, the PBC reformed the reserve requirement system by merging the accounts for required reserve and excess reserve and adopted uniform interest rate. The deposit reserve ratio was reduced from 13 percent to 8 percent, and in November 1999, reduced again from 8 percent to 6 percent. These policies played an important role in expanding monetary base, prompting commercial banks to increase lending and supporting economic growth. In 2003 and 2004, the PBC raised the deposit reserve ratio from 6 percent to 7 percent and later to 7.5 percent in order to reduce the sterilization pressures arising from foreign exchange purchase and appropriately control credit expansion of financial institutions.

In December 2003, the PBC reformed the interest rate system for deposit reserves by differentiating interests on required reserve and excess reserve. The required reserve of financial institutions is subject to the interest rate of 1.89 percent, while the excess reserve is subject to a rate of 1.62 percent. With the development of financial computerization and the efficiency of large-value settlement system enhanced, the liquidity management of commercial banks was significantly improved. On March 17, 2005, the PBC cut the interest rate on excess reserve by another 0.63 percentage points from 1.62 percent to 0.99 percent.

From the perspective of monetary policy management, commercial banks may be induced to keep high level of excess reserve at the central bank and thus make it more difficult for the central bank to forecast the demand for base money and accurately manage base money and money supply if the interest rate on excess reserve is set at a relatively high level. Relatively high interest rate on excess reserve may also reduce the sensitivity of financial institutions with respect to the central bank's money policy conduct and undermine the effectiveness of monetary policy management. To cut interest rate on excess reserve is conducive to promoting money market activities and improving the sensitivity of financial institutions towards monetary policy conduct. The central bank is also in a better position to streamline the interest rate system and establish an interest rate determination mechanism where the central bank guides the market interest rate and the market interest rate guides commercial banks in pricing their products. Under this circumstance, a reasonable yield curve will be formed, giving rise to a better monetary policy transmission mechanism.

III. Adjusting residential mortgage policy and promoting sound development of real estate sector

To promote the sound development of the real estate sector, the PBC decided to change the mortgage policy effective on March 17, 2005.

First, the preferential interest rate currently prevailing in the commercial banks' mortgage business was brought down to the level of interest rate charged on normal lending business of the same maturity. A lower limit of 0.9 times the benchmark lending rates of the corresponding maturities was imposed on the mortgage rate. In this vein, legal persons of commercial banks have the autonomy to determine the mortgage rate and internal pricing methodology. Meanwhile, housing provident fund based loans were subject to a slight increase of interest rate equivalent to 0.18 percentage points. In particular, loans with a maturity of no more than 5 years (inclusive) were subject to a lending rate of 3.96 percent, and the rate on loans with a maturity of over 5 years was set at 4.41 percent.

Secondly, the minimum downpayment proportion was raised from 20 percent to 30 percent in cities or regions where the real estate price hike has seen excessive growth. Legal persons of commercial banks can determine which city or region will be subject to the policy change according to the real estate price movements.

The adjustment of commercial banks' residential mortgage policy has been helpful to guide reasonable expectation of future real estate price, incorporate mortgage loan rate into the normal lending rate management system and strengthen commercial banks' risk management and pricing mechanism.

IV. Strengthening window guidance and credit policy guidance for commercial banks

Since the beginning of 2005, under the leadership of the State Council, the PBC continued to improve its window guidance and credit policy guidance for commercial banks. While strengthening the coordination between the credit policy and industrial policy and guiding financial institutions to optimize lending orientation, the PBC further improved credit policy guidance and promoted financial innovation.

First, the PBC convened conferences on regular basis to advise commercial banks on economic and financial development like industrial production, fixed asset investment growth, real estate sector development and inflationary pressures, etc. The PBC guided commercial banks to take a forward-looking approach in responding to economic cyclical changes and industrial development, improving risk management, developing knowledge on market risk, maturity risk and credit risk, and enhancing the capacity to identify and assess risks. The commercial banks were also encouraged to reform loan approval procedures in line with the market-based principles, strengthen the capacity to assess borrowing applications and be more conscious in optimizing credit structure.

Second, the PBC closely followed the policy of the central government in enhancing the comprehensive agricultural production capacity in the rural area and promoting the development of non-public sectors by guiding financial institutions to further improve financial services and to make financial innovation in an effort to increase lending to the rural economy, non-public sector or SMEs and optimize the credit structure.

Third, the PBC encouraged commercial banks to speed up in adopting the new policy on student loans. On February 28, the PBC and the CBRC jointly convened a video conference on speeding up the implementation of the new policy on student loans, aiming to prompt the banking system to speedily adopt the new policy and finish the biding of student loans for all provincial colleges as soon as possible so that the committed loans can be disbursed in time.

Fourth, the PBC further improved credit policy guidance by strengthening the monitoring of asset and liability ratios of commercial banks and probing the way of establishing the maturity mismatch early warning system. Through these measures, the PBC intended to control the relatively high proportion of medium and long-term loans of commercial banks and prevent possible emergence of liquidity risk and interest rate risk.

V. Smoothly promoting the joint-stock reform of state-owned commercial banks and the reform of the rural credit cooperatives (RCCs)

The joint-stock reform of state commercial banks advanced smoothly. In the first quarter, the Industrial and Commercial Bank of China (ICBC) started the preparatory work for the joint-stock reform, including appointing relevant intermediary institutions, employing foreign consulting firms, disposing of non-performing loans and conducting due-diligence investigation. In April 2005, based on the experiences in the joint-stock reform of the Bank of China (BOC) and the China Construction Bank (CCB), the State Council approved the reform scheme of the ICBC and the work program of the BOC and CCB with respect to their reform in the next stage.

The pilot reform of RCCs also advanced smoothly. In 2005, the pilot schemes of the State Council with respect to deepening the reform of RCCs have been gradually put in place. Reform of RCCs in 8 provinces pioneering in the pilot program has achieved staged progress and is being further expanded and deepened. RCCs in 21 other provinces included in the pilot reform have also had a good start. By the end of March, the PBC has finished five issuances of special central bank bills targeting RCCs participating in the pilot reform after strict examination of these institutions conducted jointly with the CBRC. The bills were issued to RCCs located in 916 counties or cities, amounting to 59.5 billion yuan. The provision of financial support constituted effective incentives to the pilot reform, leading to rapid progress of the RCCs in expanding capital, raising capital adequacy ratio, reducing NPL ratio and improving management and profitability. As a result, financial services in the rural area were enhanced, management system restructuring and ownership reform were promoted smoothly and efforts were also made by some RCCs to probe the way of strengthening internal management and information disclosure.

VI. Maintaining RMB exchange rate basically stable at an adaptive and equilibrium level and promoting sound development of the balance of payments

To foster an orderly relationship between demand for and supply of foreign exchange, promote a sound balance of payments and improve the determination mechanism of RMB exchange rate, The PBC has made efforts in the following three aspects:

First, efforts were conducted to facilitate trade development. Second, the management of capital inflow and foreign exchange surrender were strengthened. The PBC will continue to implement the QFII system. Two qualified foreign institutional investors were newly approved with a quota of USD 325 million. By the end of March, cumulatively 26 qualified foreign institutional investors have been licensed, with total investment quota reaching USD 3.75 billion. The PBC also implemented the policy of supporting international development institutions to issue RMB-denominated bonds in China. Third, capital outflow was expanded to support domestic enterprises to invest abroad. Fourth, development of foreign exchange market was fostered. Business scope and the coverage of pilot banks dealing with forward foreign exchange surrender and sale transactions were further expanded. Efforts were also made to prepare for introducing US dollar market makers and new trading products into the inter-bank foreign exchange market.

Part Three　Financial Market Performance

1. Financial market operation

In the first quarter of 2005, the financial market performed broadly stable, featuring sufficient liquidity, smooth bond issuance and brisk market activities. Compared to the same period of last year, in terms of borrowing by the non-financial sectors (including households, enterprises and government agencies) in China, the proportion of bank loans went up while those in other forms came down. Funds newly raised by the non-financial sectors in the forms of bank loans (in both domestic and foreign currencies), stocks (tradable stocks only), government securities and corporate bonds aggregated 836.9 billion yuan, a deceleration of 136.4 billion yuan, or down 14 percent from a year earlier. In particular, bank loans fell by 86.3 billion yuan or 9.5 percent; and other forms of financing dropped by a large margin of 50.1 billion yuan. The proportion of financing through bank loans, government securities, corporate bonds and stocks stood at 98.8 percent, 0.2 percent, 0.2 percent and 0.8 percent respectively.

Table 3：Financing by Domestic Non-financial Sector sin 2005 Q1

	Total financing (100 million yuan)		Proportion（%）	
	2005 Q1	2004Q1	2005Q1	2004Q1
Funds raised by non-financial sector	8369	9733	100.0	100.0
Bank loans	8268	9131	98.8	93.8
Government securities	17	348	0.2	3.6
Corporate bonds	20	55	0.2	0.6
Stocks	64	199	0.8	2.0

Source：Financial Survey and Statistics Department, PBC

1. The bond repo transactions increased and turnover of money market declined

The first quarter saw the accumulated turnover of bond repo in the inter-bank market going up by 0.13 trillion yuan to 2.61 trillion yuan, and the average daily turnover increasing by 6.9 percent to 43.5 billion yuan. The accumulated turnover of bond pledge repo transactions went up by 0.08 trillion yuan to 2.56 trillion yuan. The accumulated turnover of sell-buy back bond repo registered a total of 46.5 billion yuan. The accumulated turnover of treasury bond repo via stock exchanges stood at 733.5 billion yuan, a climb of 11 percent.

In the first quarter, the inter-bank borrowing market reported an accumulated turnover of 318.7 billion yuan and a daily average turnover of 5.3 billion yuan, representing a year-on-year decrease of 114.9 billion yuan and 25.3 percent respectively. The 7-day borrowing and overnight borrowing dominated the transactions. In particular, the 7-day borrowing constituted 74.3 percent of the total, and that of the overnight 12.7 percent.

There were some fluctuations in the money market rates due to the effects of the Spring Festival and the interest rate cut on excess reserve. In January, the monthly-weighted average interest rates of inter-bank bond pledge repo market and inter-bank borrowing market stood at 1.91 percent and 2.07 percent respectively. Due to the large demand for funds by financial institutions before the Spring Festival, they first stood high at 2.05 percent and 2.31 percent respectively in February, then slid to 1.7 percent and 1.98 percent respectively in March given there was ample liquidity as a result of substantial fund inflows and a cut of interest rate on excess reserve by the central bank.

Table 4: Fund Flow of Financial Institutions in Inter-bank Borrowing Market 2005Q1

Unit: 100 million yuan

	2005Q1[1]	2004Q1[1]	Change
State-owned commercial banks	-842	-1820	978
Other commercial banks	-915	-750	-165
Other financial institutions	1445	2484	-1039
Of which: Securities firms and Fund Companies	1147	2222	-1075
Foreign financial institutions	313	86	227

Note：1. Negative figure indicates net fund outflow ; positive figure indicates net fund inflow.

Source： *"China Financial Market Monthly Statistical Bulletin"*, PBC

With respect to fund flow in inter-bank bond repo market, the state-owned commercial banks as a whole continued to be the largest net providers of funds that lent out a total of 1.36 trillion yuan in the first quarter, down 116.3 billion yuan, while other commercial banks[1] and other financial institutions[2] were the main recipients of funds, which borrowed in 826.2 billion yuan and 460 billion yuan respectively.

---

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

[2] Other financial institutions include policy banks, rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities firms and fund companies.

With respect to fund flow in inter-bank borrowing market, the state-owned commercial banks and other commercial banks saw net lending out of 84.2 billion yuan and 91.5 billion yuan with the former down by 97.7 billion yuan and the latter up 16.5 billion yuan yoy. Other financial institutions, being the primary fund recipients, borrowed in 144.5 billion yuan and securities firms received the largest portion of funds. Net borrowing by foreign financial institutions in inter-bank market reached 31.3 billion yuan, an increase of 22.7 billion yuan with the proportion of net borrowing in the money market rising by 14.5 percentage points from a year earlier to 17.8 percent.

2. Trading in bond market was active, and government bond issuance accelerated

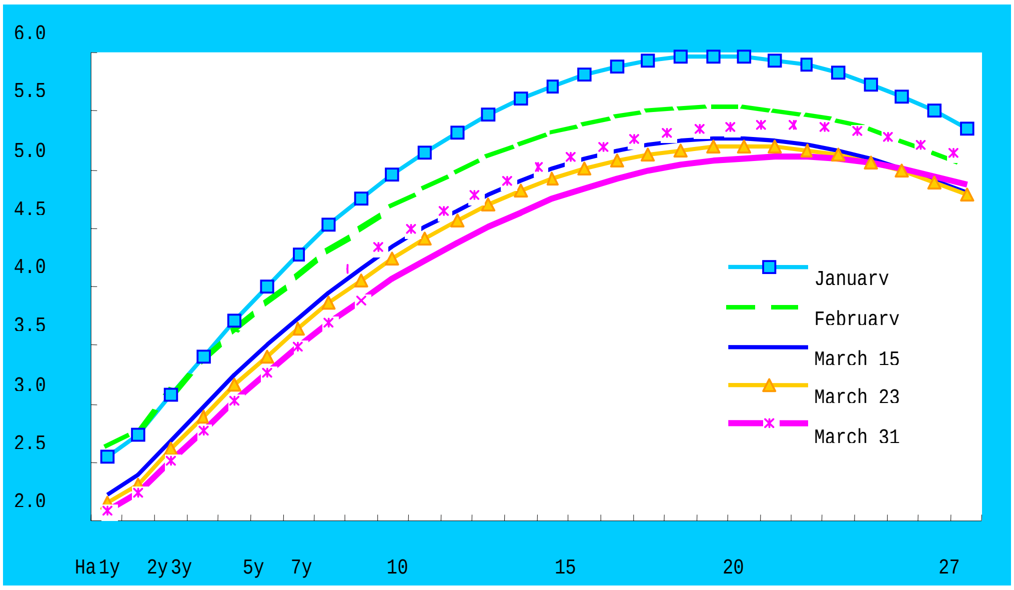
In the first quarter, the accumulated turnover of spot transactions in inter-bank bond market increased by 269.3 billion yuan to 971.8 billion yuan, while daily average turnover jumped by 40.6 percent to 16.2 billion yuan. The turnover of government bond spot transactions at the stock exchanges totaled 71 billion yuan, an augment of 1.9 billion yuan.

In the first quarter, bond indices of the inter-bank market and exchange market both displayed a rising trend while the yields witnessed a fall. The China Securities Index and the treasury bonds index at Shanghai Stock Exchange moved up from 104.02 and 95.69 at the beginning of the year to 107 and 100.19 at the end of March respectively.

The yield curve shifted downward and became steep. The yield curve of government securities in inter-bank market (hereafter referred to as “the curve”) demonstrated a steady downward trend as prices went up. The development could be divided into three stages. (1) From the beginning of the year to the time right before the Spring Festival, the curve descended by about 15 basis points as the prices rebounded since the end of last year with yields of medium-term maturities falling faster than that of short-term ones. (2) From after the Spring Festival to mid-March, during which the curve dropped by another 35 basis points driven by inflowing funds, bringing the accumulated drop to 50 basis points. (3) After the central bank cut the interest rate on excess reserve by 63 basis points to 0.99 percent, the curve descended another 10 basis points across all maturities within a week. By the end of March, the curves dipped further down by 20 basis points from mid March. The curve tended to steep as the yields of bonds with short-term maturities experienced even a larger decline. By the end of March, the yields of government securities in the inter-bank market fell close to the level of April, 2004.

In the first quarter, a total of 95 billion yuan worth of government securities were issued, an increase of 11.8 billion yuan, or a year-on-year increase of 14.2 percent. Among the new issues, 35 billion yuan were bearer's treasury bonds, approximately 10 billion yuan less than that of last year; and 60 billion yuan were book-entry treasury bonds, up 21.8 billion yuan or 57.2 percent. A total of 80 billion yuan worth of policy financial bonds were issued, up 20 billion yuan or 33.3 percent from the same period of the previous year, and a total of 2 billion yuan worth of corporate bonds were issued, down 3.5 billion yuan from the same period of last year.

Figure 2：Yield Curve of Government Securities in Inter-bank Market 2005 Q1



Source: www.chinabond.com.cn

1. Commercial paper market enjoyed sound development

In the first quarter, the accumulated amount of commercial papers reached 947.7 billion yuan, a year-on-year growth of 21 percent. The accumulated amount of bills discount totaled 1.35 trillion yuan, up 29 percent, while that of bills rediscount reached 1.5 billion yuan, down 8.5 billion yuan. At the end of the first quarter, the outstanding balance of commercial papers reached 1.55 trillion yuan, up 20 percent on a year-on-year basis. The outstanding balance of bills discount amounted to 1.12 trillion yuan, up 18 percent, while that of bills rediscount declined substantially by 24.3 billion yuan to 2.3 billion yuan. Participants in the bills markets were mainly small- and medium-sized financial institutions, while those in the discount market were mainly state-owned commercial banks.

The commercial paper market continued to grow steadily under state regulation, showing the following characteristics. First, financing by commercial paper continued to grow as a share of new loans and has become an important source of enterprises working capital. At the end of March, newly issued commercial paper accounted for 13 percent of new loans, up by 7 percentage points. Second, as the market continue to grow, commercial paper has become an important money market instrument and inter-bank financing means as nearly 30 percent of the money market turnover could be attributed to commercial paper financing. Third, the interest rates of commercial paper, reflecting the supply and demand of funds in the market, have become an important part of the transmitting mechanism of macro-economic adjustment.

2. Turnover of stock market declined.

In the first quarter, the turnover in the stock market declined on a year-on year basis. The combined turnover of Shanghai and Shenzhen stock exchanges shrank by 971.3 billion yuan to 670.2 billuon yuan, while the average daily turnover decreased by 59.1 percent to 12 billion yuan. The accumulated turnover of A-share market dropped 956.1 billion yuan to 654.3 billion yuan, and the daily average turnover slid by 59.4 percent to 11.7 billion yuan.

The Shanghai Composite Index closed at 1191.82 at end-January, and rose to the height of 1328.53 in February. The Index dropped further to the bottom of 1162.03 in March before climbing slightly to 1181.24 at end-March, down 6.73 percent yoy. The Shenzhen Composite Index dipped as low as 2936.37 in January and climbed to 3481.44 in March before plummeting again to 3170.35 at the end of March, 3.35 percent higher than that of a year earlier.

In the first quarter, a total of 6.4 billion yuan was raised in stock markets, a year-on-year decrease of 13.4 billion yuan. Funds raised by enterprises in overseas markets witnessed large reduction. Financing via H-share market amounted to US$112 million billion, down 86.6 percent. In addition, funds raised in A-share market (including IPO, and rights and additional share issuance) totaled 5.5 billion yuan, down 57.7 percent from the same period of last year.

Securities investment fund business grew fast, with 14 new funds launched in the first quarter. The gross volume of securities investment funds reached 392.6 billion yuan, a year-on-year increase of 82 percent, or a growth of 18.6 percent from the beginning of the year, and the net asset value totaled 385.3 billion yuan, rising by 60.5 percent yoy or by 18.7 percent from the end of last year.

3. Insurance market maintained robust growth with noticeable changes in asset structure

In the first quarter, the premium income of the insurance sector aggregated 147.7 billion yuan, a year-on-year growth of 23.1 percent. The property premium income totaled 34.3 billion yuan, a growth of 23.5 percent. Statistics also showed that the accumulated insurance claim payment in the first quarter amounted to 25.9 billion yuan, down 28.7 percent yoy. Total assets of the insurance sector grew rapidly, reaching 1.3121 trillion yuan at end-March, up 31.5 percent on a year-on-year basis.

Along with the rapid growth of the insurance sector, the disposal assets of the insurance companies further built up. Of the total assets, the proportion of investment in government securities continued to rise, reaching 22.5 percent, 7.4 percentage points higher over the same period of last year, while the proportion of assets in the form of bank deposits continued to drop, down 10.7 percentage points yoy to 37.9 percent at end-March. In addition, investment in securities investment funds accounted for 6.1 percent of the total assets, about the same level of last year.

Table 5：Investment of Insurance Funds in the first quarter of 2005

	Outstanding balance (100 million yuan)		Share of total assets (%)	
	Q1 2005	Q1 2004	Q1 2005	Q12004
Total assets	13121	9980		
In which: Bank deposits	4971	4844	37.9	48.5
Investment	6532	4361	49.8	43.7
Government securities	2975	1516	22.5	15.2
Securities investment funds	798	604	6.1	6

Source: *"China Financial Market Monthly Statistical Bulletin"*, PBC

4. Inter-bank foreign exchange transactions continued to grow substantially

In the first quarter, inter-bank foreign exchange transactions continued to grow significantly. The accumulated market turnover of transactions in various currencies increased by 53 percent from the pervious year to US$63.2 billion. In particular, the turnover of transactions in US dollar was US$61.9 billion, up 53.3 percent.

II. Institutional building in the financial markets

1. Pilot program of credit securitization was launched

With the approval of the State Council, credit-backed securitization and mortgage-backed securitizaton were launched on a trial basis at China Development Bank and China Construction Bank on March 21, 2005. A PBC-led working group was established, consisting of officials from the PBC and other governmental agencies, to take charge of organizing and coordinating the pilot program. This new move was expected to promote financial innovation, improve the asset-liability structure of commercial banks and increase direct financing.

2. Domestic bond market opened further

On February 18, 2005, the People's Bank of China, the State Development and Reform Commission, China Securities Regulatory Commission jointly released *Provisional Administrative Rules on International Development Institutions' Issurance of RMB Bonds*. The document, consistent with the existing laws and regulations, allows qualified international development institutions to issue RMB bonds in China, and defines the division of labor among government agencies, taking into consideration of the needs of capital market development and China's WTO commitment. Special attention is also paid to setting up the relevant legal framework to regulate market development. By introducing new issuers such as international development institutions, this move intends to promote development and further opening of domestic bond market.

3. Pilot program was launched for commercial banks to set up fund management companies

On February 20, 2005, the People's Bank of China, China Banking Regulatory Commission and China Securities Regulatory Commission jointly released *Administrative Rules on Incorporation of Fund Management Companies by Commercial Banks.* The Industrial and Commercial Bank of China, China Construction Bank and Bank of Communications became the first group of commercial banks participating in the pilot program. Allowing commercial banks to set up fund management companies would encourage financial innovation, foster healthy and coordinated development of financial markets in the long-run, promote commercial bank reform and optimize resource allocation.

4. The interactive development of the stock market and insurance market

In order to prepare for insurance funds entering the stock market directly, on the basis of *Provisional Rules on Administration of Stock Investment by Insurance Institutional Investors* released in 2004, China Insurance Regulatory Commission, China Banking Regulatory Commission and China Securities Regulatory Commission released a set of directories, including the *Notice on Issues Related to Stock Investment by Insurance Institutional Investors, Guidelines on Registration and Settlement of Stock Investment by Insurance Institutional Investors, Guidelines on Insurance Companies' Stock Asset Custody,* and *Notice on Issues Related to Stock Investment with Insurance Funds.* These documents provide clear guidance for insurance funds to invest in the stock market and promote interactive development of the stock market and insurance market, indicating the reform has come into the operation stage.

Part Four Analysis of Macroeconomic Developments

I. The world economic and financial situation and forecast

Since the start of 2004, the US economy maintained its strong momentum of growth and its employment continued to improve. The euro zone recovered slowly. The Japanese economy decelerated and had yet to shake off the trouble of deflation. The Latin American and Asian emerging economies kept robust growth. The US current account and fiscal deficits, coupled with imbalance of economic development among developed economies, intensified disequilibrium of the global economy. Such uncertainties as oil price, energy security and exchange rate volatility among major currencies were still major recent risks.

The International Monetary Fund (IMF) forecast in April 2005 that global economic growth would reach 4.3 percent, 0.8 percentage points lower than that in 2004. In particular, the US economy would grow by 3.6 percent, 0.1 percentage points higher than the forecast made in September 2004. Economic growth in the euro zone and Japan would reach 1.6 percent and 0.8 percent respectively, 0.6 and 1.5 percentage points respectively lower than the forecast made in September 2004. The IMF pointed out that the differential widened between the US economic growth and that of the other developed economies and the global economic growth was ever less balanced.

1. Economic development of major economies

The US economy continued to maintain strong growth momentum. In the first quarter, the annualized quarterly GDP growth rate posted 3.1 percent over the previous quarter. The US employment kept improving, with the unemployment rate decreasing to 5.3 percent by 0.4 percentage points from the same period of 2004. Inflationary pressure built up with consumer price index (CPI) increasing by 3 percent over the same period of 2004. In March 2005, due to increase of exports and decrease of imports, the US foreign trade deficits contracted from USD60.6 billion in February to USD55 billion.

The euro zone continued its slow recovery. In the first quarter, the GDP grew by 1.4 percent at the same pace as that in the same period of 2004. The unemployment rate remained as high as 8.9 percent. Harmonized Index of Consumer Prices (HICP) rose by 2 percent, higher than 1.7 percent in the same period of 2004 and with those in the first three months registering 1.9 percent, 2.1 percent and 2.1 percent respectively. The European Central Bank (ECB) forecast that HICP would be likely to remain higher than 2 percent in the coming months with rising oil prices. However, ECB pointed out at the same time that the forecast did not imply that pressure of inflation was building up in the euro zone. At present, the fiscal deficits did not fall but rise in some member states in the euro zone. ECB called on speeding up fiscal and structural reform, in a bid to reinforce sustainability of the public finance and strengthen confidence of all member states in growth prospects.

The Japanese economy slowed down its momentum of recovery. In the first quarter, the GDP grew by 1.2 percent over the same period of last year, far lower than 4.5 percent recorded in the same period of the previous year. The unemployment rate kept falling and that in March posted 4.5 percent, 0.2 percentage points lower than that in the same month of 2004. Deflation didn’t ease markedly. The CPI decreased by 0.1 percent, 0.3 percent and 0.2 percent respectively in January, February and March, and the core CPI dropped by 0.3 percent, 0.4 percent and 0.5 percent respectively.

Major developing economies continued to grow yet with subdued momentum of growth. Since the start of 2005, the industrial and export growth slowed down in the economies of South Korea and Taiwan Province of China.

2. Developments in the international financial market

The US dollar went up slightly against the euro and the yen over end-2004. At end-March, the euro closed against the US dollar at $1.2964 with the dollar strengthened by about 4 percent over end-2004. The US dollar ended against the yen at ¥107.15, with the dollar strengthened by about 3 percent over end-2004.

The yield of long-term treasury bond first dropped and then climbed in the US, the euro zone and Japan. Influenced by the forecast for a lower economic growth and a long-term inflation in the US, the US long-term bond yield decreased in January and February. Late February, Mr. Greenspan delivered an optimistic speech about the US economic growth when testifying at the hearing before the Congress, the yield rallied rapidly. After the Fed raised the Federal Fund rate on March 22, the US bond yield increased further, with the differential widened between the US bond yield and that in Japan and the euro zone. At end-March, the yield of the US 10-year treasury note reached 4.49 percent. The yield of 10-year government bond in the euro zone and Japan stood at 3.76 percent and 1.45 percent respectively, up 0.13 percentage points and 0.08 percentage points over the year-beginning.

In the first two quarters of 2005, global stock markets witnessed an overall rise. In March, however, the US stock markets saw a widespread decline due to soaring oil price and the market expectation for the Fed to quicken the pace of interest rate hike. At end-March, the Dow Jones Industrial Average closed down 1.6 percent from end-2004. Financial Times Stock Exchange 100 Index and the Nikkei 225 Stock Average ended up 3.8 percent and 5.8 percent respectively.

3. Monetary policies of major central banks

The Federal Open Market Committee raised the federal-funds target rate to the current level of 3 percent by 25 basis points respectively on February 2, March 22, and May 3, with the Fed raising the interest rate eight times in a row since June 2004. The European Central Bank, the Bank of Japan and the Bank of England kept their monetary policy unchanged. The European Central Bank's governing council continued to leave the interest rates in June 2003 unchanged, i.e., the interest rates of deposit facility, main refinancing operations and lending facility remained at 1 percent, 2 percent and 3 percent respectively. The Bank of Japan (BOJ) continued to keep the upper limit of the total current account balance held with the BOJ by commercial banks at around JPY35 trillion, in order to ensure sufficient liquidity in the market. The Bank of England kept the repo rate unchanged at 4.75 percent.after raising the rate four times in 2004.

II. Analysis of China's macroeconomic movements

Since the start of 2005, all localities and departments comprehensively carried out the spirit of the Central Economic Working Conference and the Third Plenary Session of the Tenth National People's Congress, continued to strengthen and improve macro control, and maintained the steady and rapid development of the national economy. Growth of fixed-asset investment continued to decelerate, growth of consumption accelerated, foreign trade kept on expansion, and urban and rural household income increased further. There were, however, still some problems in the economic activities. The size of fixed-asset investment was larger than desired, coal, power, oil and transportation fell short of supply, pressure of inflation persisted despite the drop of CPI, etc. In the first quarter of 2005, GDP grew by 9.4 percent, 0.4 percentage points lower than the same quarter of 2004. CPI rose by 2.8 percent at the same pace as that in the same period of 2004. Foreign trade posted a surplus of USD16.6 billion, compared with a deficit of USD8.4 billion in the same period of 2004.

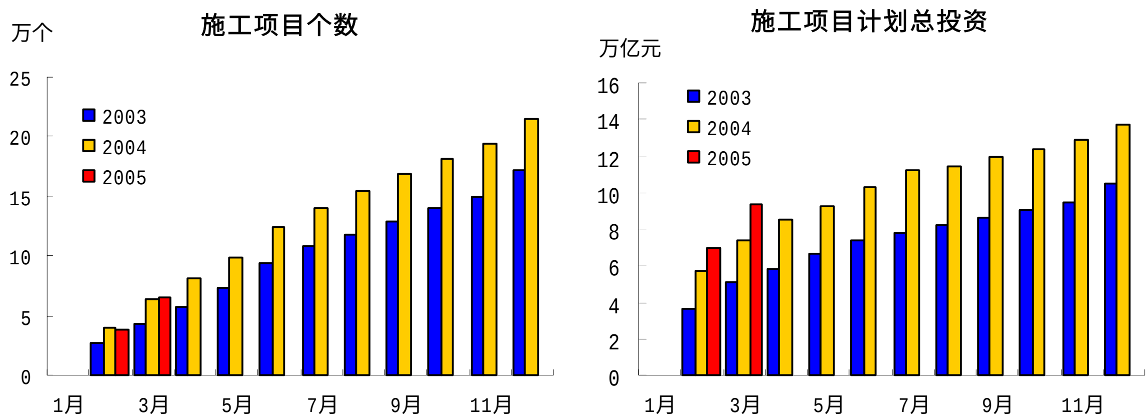
1. Consumption demand grew steadily and rapidly, growth of investment demand continued to decelerate and foreign trade surplus expanded.

Household income increased by a big margin and consumption demand grew steadily and rapidly. In the first quarter of 2005, per capita disposable income of urban residents stood at RMB2,938 yuan, representing an inflation-adjusted real growth of 8.6 percent. The per capita earnings in cash by farmers fetched RMB967 yuan, representing a real growth of 11.9 percent. The total volume of retail sales swung to RMB1.5 trillion yuan, representing a nominal growth of 13.7 percent, an inflation-adjusted real growth of 11.9 percent and an acceleration of 2.7 percentage points over the same period of 2004. In particular, the total volume of urban retail sales increased by 14.7 percent, that at county level and below county level grew by 11.7 percent. The growth pattern persisted in that consumption of urban residents grew faster than that of rural residents. However, contribution by rural consumption to total consumption increased.

Growth of fixed-asset investment continued to decelerate. In the first quarter of 2005, total fixed-asset investment posted RMB1.1 trillion yuan, representing a growth of 22.8 percent and a deceleration of 20.2 percentage points compared with that recorded a year earlier. In particular, urban fixed-asset investment accounted for RMB903.7 billion yuan, up 25.3 percent on a year-on-year basis while rural fixed-asset investment chalked RMB196.2 billion yuan, up 12.7 percent. Growth of investment decelerated and yet localities still showed keen enthusiasm for investment. In the first quarter of 2005, total fixed-asset investment grew further by 22.8 percent on the basis of the high growth of 43 percent recorded in the first quarter of 2004. The number of projects under construction and newly-started projects increased and the size of projects under construction was markedly larger than that in the past years. In the first quarter of 2005, the number of projects under construction reached 65,000, up 1,087 over the same quarter of 2004. Their total planned investment amounted to RMB9.4 trillion yuan, up 26.7 percent. The number of newly-started projects registered 23,000, up 1,176. Their total planned investment amounted to RMB1 trillion yuan, up 1.5 percent.

Figure 3. Numbers of Projects of Fixed-asset Investment and Their Total Planned Investment since 2003

10,000 Number of Projects trillion yuan Total Planned Investment



Note: The data in the Figure are those for urban fixed-asset investment, excluding real estate investment and investment for housing construction by individuals in the urban area and in factories and mines.

Source: State Bureau of Statistics

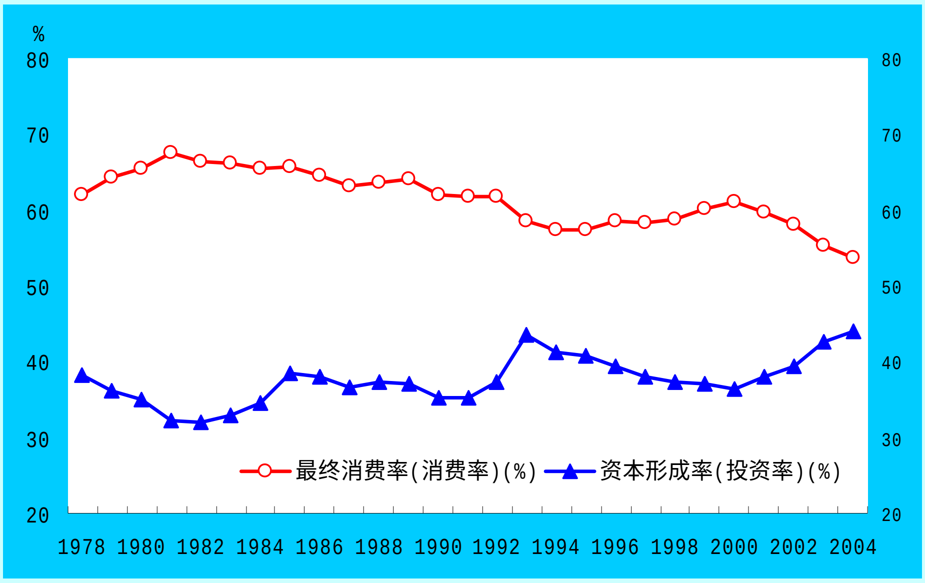
Total volume of foreign trade kept on expansion and foreign direct investment (FDI) continued to grow. Since the start of 2005, while the total volume of foreign trade kept on rapid growth, trade surplus has taken on the momentum of continued expansion. In the first quarter, foreign trade totaled USD295.2 billion, a year-on-year rise of 23.1 percent. In particular, exports amounted to USD155.9 billion, up 34.9 percent while imports reached USD139.3 billion, up 12.2 percent, resulting in a trade surplus of USD16.6 billion compared with a trade deficit of USD8.6 billion. Growth of imports decelerated mainly due to drop of imports of crude oil, steel products and automobiles etc. Exports grew rapidly due to rapid growth of exports of products with high energy consumption, high pollution and resource products. In the first quarter, contracted FDI posted USD35.2 billion, up 4.5 percent over the same period of 2004 while actual utilization of FDI registered USD13.4 billion, up 9.5 percent.

Box 4 Relationship between investment and consumption

The relationship between investment and consumption is one of the important relationships within the national economy. In statistical terms, it is interpreted as investment ratio and consumption ratio. Investment ratio, or capital formation ratio, refers to ratio of total capital formation to the GDP during a certain period of time. Total capital formation is composed of two parts. One is total fixed capital formation. The other is increase of inventory. Consumption ratio, or final consumption ratio, refers to the ratio of final consumption to the GDP. Final consumption is also composed of two parts. One is private consumption. The other is government consumption. Investment ratio and consumption ratio are calculated based on current prices the sum of which is not equal to 100 percent as the GDP is derived from investment and consumption as well as net exports (exports minus imports).

Since the reform and opening up, changes of investment and consumption are characterized by the following. First, generally speaking, investment ratio tended to be rising while consumption ratio tended to be falling. Second, during the period of high economic growth, the relationship between investment and consumption was more volatile in that investment ratio was on the high side while consumption ratio was on the low side and economic growth was mainly propelled by investment.

Figure 4. Movements of China's investment and consumption ratios since 1978



Final Consumption Ratio (Consumption Ratio)

Capital Formation Ratio (Investment Ratio)

Source: China Statistical Yearbook, NBS

China was in the important stage of economic development. Besides, there was much to be made up for in terms of construction of infrastructure and public facilities . Therefore, there was objective reason for keeping a high investment ratio within a certain period of time. On the other hand, however, higher than desired investment ratio and lower than desired consumption ratio would bring about negative impacts. According to the law of diminishing marginal return, given the technological condition and inputs of other parameters, with the increase of input of one parameter, output would increase but the increase would decelerate. From the macro perspective, investment efficiency would decrease. From the micro perspective, enterprise profit margin would decrease. From the perspective of costs of enterprises, rapid growth of investment demand would bring about price hike of production factors and enterprise cost would increase accordingly. From the perspective of product sale, the ultimate aim of investment is to meet the needs of consumption. As exports are decided by foreign demand and would not change immensely in the short term, if the domestic consumption ratio is lower than desired, room for profitability would shrink. In China, investment mainly relies on bank credit and the social financing is excessively concentrated in the banking system. Deteriorating performance of the enterprises may result in non-performing loans in the banking system, compromising financial stability.

At present, with increase of household income, China's consumption structure is upgrading. Efforts shall be made to leverage the favorable opportunity to promote stable growth of consumption demand. Meanwhile, endeavors shall be made to guide investment through systemic reform and transformation of mechanism. Vigorous efforts shall be made to develop the capital market. Measures shall be intensified to strengthen market supervision and restraint on investment through decision-making by various financial intermediaries and assumption of risks by various investors, in a bid to foster a rational growth of investment.

2. Growth of the primary industry accelerated while that of the secondary and tertiary industries decelerated.

In the first quarter of 2005, the primary industry grew by 4.6 percent and accelerated by 0.1 percentage points over the same period of 2004. The secondary industry grew by 11.1 percent and decelerated by 0.5 percentage points. And the tertiary industry grew by 7.7 percent and decelerated by 0.3 percentage points.

Agricultural production took on a good situation. It is projected that the sown area of grain in 2005 would increase over 2004. In particular, the sown area of summer grain would increase by a bigger margin. The survey by the NBS on farmers' growing intent indicated that the impetus for farmers to grow grain would still be high in 2005. In the first quarter, fixed-asset investment by farmers grew by 11.5 percent and accelerated by 4.9 percentage points over the same quarter of 2004. Prices of agricultural production means increased enormously while prices of some agricultural products kept on falling. Therefore, there were difficulties for farmers to further increase their income. Efforts should be intensified to carry out the policies of the Party Central Committee and the State Council on steadily increasing grain output and continuously increasing farmers' income. In the first quarter, prices of agricultural products grew by 6.4 percent, in particular, grain price grew by 6.6 percent. Prices of agricultural production means surged by 10.6 percent, in particular, those of chemical fertilizers soared by 14.5 percent.

The industrial production maintained rapid growth and growth of realized

profits decelerated. In the first quarter of 2005, the industrial value-added by statistically large industrial enterprises (all the state-owned enterprises and all those non-state-owned enterprises that have annual sales of products above RMB5 million yuan) reached RMB1.4 trillion yuan, representing a growth of 15.8 percent and a deceleration of 1.9 percentage points. In terms of product segmentation, production of energy, raw material and products of telecommunications maintained rapid growth, that of equipment of power station grew by a big margin, while that of autos slowed down markedly. In the first quarter, production of raw coal and crude oil and power generation grew by 9.1 percent, 5 percent and 13 percent respectively over the same period of 2004 while that of pig iron and steel products grew by 27.3 percent and 22.4 percent respectively. Growth of enterprise profits decelerated. Statistically large industrial enterprises realized profits of RMB276.4 billion yuan, representing a growth of 17.2 percent and a deceleration of 27 percentage points from the same period of last year.

3. Attention shall still be paid to pressure of inflation.

Rise of the consumer price index (CPI) was kept under control. In the first quarter of 2005, CPI grew by 2.8 percent at the same pace as that in the same quarter of 2004. In particular, 1.5 percent was attributable to new factors for price increase this year while 1.3 percent to old ones in 2004. In terms of segmentation, food price increased by 6.1 percent, accounting for 2.1 percentage points in the hike of CPI and representing a contribution of 75 percent. Non-food price rose by 1.1 percent, accounting for 0.7 percentage points in the increase of CPI and representing a contribution of 25 percent. In terms of non-food, price of energy[3] soared by 13.2 percent, accounting for 0.2 percentage points in the rise of CPI. In particular, price of gasoline, diesel oil and liquefied petroleum gas surged by 16.4 percent, 14.5 percent and 16.1 percent respectively. As the weight of energy in the calculation of CPI is only 2-3 percent, much lower than 8-9 percent in the developed economies, the recent oil price spike had smaller direct effect on CPI than it did in the nations and regions like the US and the EU. Geographically, all localities continued to strictly carry out the measure of “double controls” on prices stipulated by the National Development and Reform Commission (NDRC), i.e. those provinces (autonomous regions and municipalities) that had month-on-month increase rate of CPI bigger than (or equal to) 1 percent or had year-on-year increase rate of cumulative CPI bigger than (or equal to) 4 percent for three consecutive months must suspend for three months price increase programs administered by the provincial organizations or administered by city or county organizations with authorization of provincial organizations. In the first quarter, year-on-year CPI increase exceeded 4 percent only in Hubei, Hunan, Guangxi and Xichuan.

Increase of the Producer Price Index (PPI) was higher than that in 2004. In the first quarter, the purchasing price index of industrial raw material, fuels and motive power increased by 10.1 percent and accelerated by 1.8 percentage points over the preceding year. The purchasing price index of nine categories of raw material, fuels and motive

[3] By “energy”, we mean gasoline, diesel oil, liquefied petroleum gas, pipeline gas and other fuels.

power increased across the board. In particular, ferrous metals, fuels and motive power and non-ferrous metals increased by more than 11 percent and even as high as 15 percent at maximum. Influenced by price surge of raw material, factory prices of industrial products increased by 5.6 percent and accelerated by 1.9 percentage points over the previous year. The differential between purchasing prices of raw material etc. and factory prices of industrial products reached 4.5 percent, 0.1 percentage points smaller than that in the previous year.

International crude oil price soared. During January-February, influenced by persistently weak US dollar, cold weather in Europe and the US and drop of inventory of heating oil in the US, international crude oil price continued to edge up. In March, prices of oil futures contracts rose in New York Mercantile Exchange. On March 17, the price surged to USD57.5 per barrel, breaking the record in the past 22 years since the dealing started for light crude oil in the Exchange. The persistent price spike of international oil ratcheted up oil price in the domestic market. On March 23, the NDRC increased once again the petroleum price with factory price increasing by RMB300 yuan per ton and retail middle price rising by the same margin as the factory price.

Imports prices continued to climb with growth rate higher than those of exports. In the first quarter, exports prices rose by 7.6 percent while those of imports increased by 10.1 percent, accelerating by 2.3 and 4.1 percentage points respectively on the year-on-year basis.

Real compensation increased rapidly. In the first quarter, the total amount of compensation of employees in urban units increased by 16.4 percent and accelerated by 4 percentage points over the previous year. And the average compensation gained 14.9 percent and accelerated by 1 percentage point. In particular, the three provinces with the highest growth rates were Anhui (24.8 percent), Guangdong (24.7 percent) and Hainan (20.6 percent) successively.

The GDP deflator was higher than that in the same quarter of the previous year. In the first quarter, the nominal GDP growth rate was 15.5 percent while the real GDP growth rate was 9.4 percent with their differential reaching 6.1 percent or 1.6 percentage points higher than that in the same period of last year.

4. Fiscal revenue maintained a favorable situation with bigger pressure to increase revenue

In the first quarter of 2005, the fiscal revenue was RMB778.3 billion yuan, representing a growth of 12.1 percent and a deceleration of 21.3 percentage points over the same quarter of 2004. Fiscal expenditure was RMB520.9 billion yuan, grew by 15.7 percent at the same rate as that in the same period of last year. The net result of fiscal revenue and expenditure was a fiscal surplus of RMB257.4 billion yuan, up 13.2 billion. The main reasons for deceleration of growth of fiscal revenue were as follows. First, imports tended to grow at a slower pace and consequently tax revenue for imports decreased over the same period of last year. Second, spurred by soaring exports, tax rebate for foreign trade enterprises surged. In addition, such factors as trial implementation of value-added tax reform, reduction of general customs duty and stamp duty for securities transaction also influenced growth of fiscal revenue. 2005 is the first year that China changes its pro-active fiscal policy into the sound fiscal policy. Fiscal expenditure is expected to maintain stable growth. However, the pressure still looms big to increase fiscal revenue.

5. Overview of major industries and analyses on hot-spot industries

Since the start of 2005, investment in such bottleneck industries as coal, power, oil and transportation was further strengthened and that of some over-heated industries was further held in check. In the first quarter, investment in coal mining and ore dressing grew by 86.1 percent over the same period of last year, that of oil processing, coke-making and processing of nuclear fuels 36 percent, that of production and supply of power, gas and water 44 percent, and that of railway construction 4.3 times. Meanwhile, investment of ferrous metal smelting and casting decreased by 1.4 percent, that of non-ferrous metal smelting and casting increased by 6 percent and that of non-metal mineral products decreased by 2.9 percent. In March, price of products in mining industry increased by 26.8 percent, that of raw material industry 11.1 percent and that of processing industry 2.7 percent.

Utilization of funds in mining and raw material industries increased immensely. The six industries with the highest growth rate of funds utilization were ferrous metal mining (61.1 percent), oil processing, coke-making and processing of nuclear fuels (58.5 percent), coal mining and ore dressing (47.2 percent), non-ferrous metal mining and ore dressing (37.3 percent), ferrous metal smelting and casting (36.5 percent) and oil and natural gas exploitation (33.7 percent). The reasons for surge in funds utilization in finished products of these industries were as follows. First, prices of products of these industries soared. Second, demand exceeded supply and the enterprises increased inventory by their own initiatives.

Influenced by price surge in products of mining industries, profits of mining industries soared across the board while profits of their downstream industries dropped. In the first quarter, profits of non-ferrous metal mining, coal mining, non-metal mineral mining and oil exploitation grew by 172.2 percent, 111.4 percent, 71 percent and 62.7 percent respectively over the same period of last year. Profits of manufacturing of transportation equipment dipped by 52.1 percent, those of building material 43.1 percent, those of chemical fibre 41.1 percent, those of power 30.5 percent and those of oil processing 28 percent. The top 5 industries in terms of increase of profits were oil exploitation, coal, iron and steel, chemicals and tobacco, accounting for 100.6 percent of the total incremental profits of all industries.

Generally speaking, prices of products of mining and raw material industries soared, fixed investment increased, inventory built up and profits surged. However, in some processing industries, market competition was intensified, room was limited for price increase and profits declined.

(1). The real estate industry

In the first quarter of 2005, with the further implementation of various macro control measures, growth of real estate credit and investment for real estate development decelerated markedly. In some areas, however, there were still such problems as bigger than desired size of investment for real estate, irrational supply structure of real estate and faster than desired price increase of commercial housing.

Growth of real estate credit decelerated further. At end-March, loans for commercial real estate reached RMB2.5 trillion yuan, representing a growth of 25.1 percent and a deceleration of 17.1 percentage points over the same quarter of last year. In particular, loans for real estate development reached RMB817.7 billion yuan, representing a growth of 15 percent and a deceleration of 25 percentage points.

Growth of real estate development decelerated markedly. In the first quarter, real estate development completed investment of RMB232.4 billion yuan, representing a growth of 26.7 percent and a deceleration of 14.4 percentage points on a year-on-year basis. Cumulative areas of the lands purchased by developers nationwide registered 73.74 million square metre, representing a growth of 3.9 percent and a deceleration of 28.3 percentage points. The areas of newly-started real estate projects posted 141 million square metre, growing by 9.3 percent and decelerating by 13.2 percentage points. The total planned investment for real estate was as high as RMB460 million yuan, a year-on-year growth of 49 percent or about 50 percent of the total planned investment of fixed investment projects under construction. The planned investment this year reached as high as RMB1.1 trillion yuan, up 26 percent.

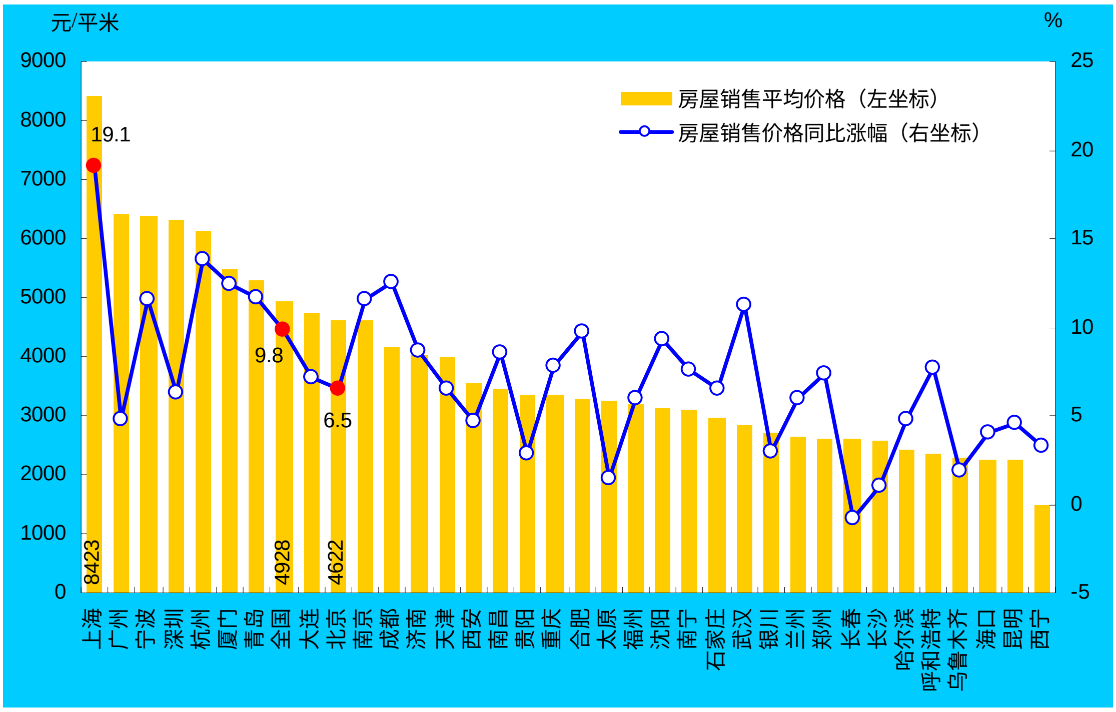
Growth of the sale area of commercial housing was faster than that of completed area, and the area of idle commercial housing kept on falling. In the first quarter of 2005, the sale area of commercial housing posted 51.73 million square metre, up 20.3 percent on a year-on-year basis. The cumulative area of completed housing came in at 41.61 million square meter, up 13.1 percent. At end-March, the area of idle commercial property was 99.20 million square metre, up 5.5 percent. In particular, that of idle commercial housing was 58.31 million square metre, decreasing by 0.6 percent and constituting a drop for 8 months consecutively since July 2004.

Investment for economically affordable housing dwindled. In the first quarter of 2005, economically affordable housing finished investment of RMB6 billion yuan, decreasing by 13.8 percent over the same period of last year. The investment accounted for 2.6 percent of the total investment for real estate development, 1.2 percentage points lower than that in the same quarter of 2004. Investment for office building was RMB11.9 billion yuan, growing by 23.8 percent and accounting for 5.1

percent. Investment for commercial property of business operation was RMB28.2 billion yuan, growing by 21.7 percent and accounting for 12.1 percent.

Real estate prices kept on rising, in particular, that of commercial housing rose faster than desired. In the first quarter, prices of land transaction in 35 medium-and large-sized cities grew by an average 7.8 percent or accelerated by 0.3 percentage points over the same period of last year. In particular, those in 6 cities grew by more than 20 percent, namely Dalian, Hanzhou, Hefei, Ningbo, Fuzhou and Zhenzhou. Sale prices of housing grew by an average 9.8 percent or accelerated by 2.1 percentage points. In particular, those in 8 cities grew by more than 10 percent, namely Shanghai, Hanzhou, Chengdu, Xiamen, Qiangdao, Ningbo, Nanjing and Wuhan. Prices of property leasing grew by 1.9 percent, in particular, those of housing leasing grew by 1.3 percent.

Figure 5. Average sale prices of housing and their year-on-year growth rates in 35 medium- and large-sized cities in the first quarter of 2005



yuan/square metre

average sale prices of housing (the left axis)

year-on-year growth rates of sale prices of housing (the right axis)

Source: NBS

Box 5 Influence of readjustment of interest rate of household housing mortgage loans on the real estate market

On March 16 2005, the People's Bank of China (PBC) announced that starting from

March 17 2005 the policy of household housing mortgage loans be readjusted. The interest rate of housing mortgage loans was brought to the same level as the interest rate for loans with corresponding maturities. Lower limit management was carried out for household housing loans. The lower limit should be 0.9 times that of benchmark interest rate for loans with corresponding maturities. The lowest down payment ratio should be decided by discretion of commercial banks themselves according to growth rates of real estate prices in their respective areas. The readjustment of household housing mortgage loans policy was an important step of the market-based interest rate liberalization, in line with the reform orientation that micro participants should be vested with the autonomy of adjusting their behavior in accordance with macro economic symbols.

The readjustment of household housing mortgage loans policy was introduced against the backdrop where investment was bigger than desired for real estate sector, demand for real estate tended to be strong and its prices kept on rising. The readjustment began with demand control. On the one hand, it would help contain rapid rise of real estate prices and guide the public to form a rational expectation on future real estate prices. On the other, it would help inhibit speculation, promote the healthy development of the real estate market under the circumstances of stable prices and basic equilibrium of demand and supply, in a bid to ensure sustained, balanced and rapid development of the national economy. Meanwhile, the readjustment also aimed to alert recipients of mortgage loans and banks for risks. For recipients of mortgage loans, the interest rate readjustment indicated that interest rates of housing mortgages would fluctuate with changes of state macroeconomic policy and economic cycle. Therefore, recipients of mortgage loans should have a reasonable judgment on future interest payment and individual repayment capability. For banks, although current housing loans had smaller risks than corporate loans, risks still persisted for banks as banks could have their judgment on average default ratio for household housing loans only after one or two economic cycles. The policy readjustment urged commercial banks to pay full attention to long-term tendency of movements of the default ratio of household housing loans and to enhance their pricing capability.

The policy readjustment was a fine-tuning, with small influence on the general public. Interest rate increase for loans with various maturities ranged from 0.07 percentage points to 0.32 percentage points. In particular, interest rate for the loans with maturities more than 5 years, which accounted for the biggest proportion, increased by 0.20 percentage points. Take for example a loan with a principal of RMB100,000 yuan and a maturity of 20 years. Based on the lower limit interest rate of commercial banks, the monthly installment of a home purchaser would increase from RMB677.2 yuan before the readjustment to RMB688.5 yuan by RMB11.3 yuan. Meanwhile, in view of the correlation and proportional relationship between interest rates of housing reserve loan and interest rates of other housing loans, interest rates of housing reserve loan increased slightly by 0.18 percentage points accordingly, preserving the preferential treatment for housing reserve loans.

Readjustment of policy of household housing credit was an adjustment on the demand side and one at the aggregate level as well. As the real estate market involves various aspects, therefore, it calls for coordination and joint functionality of various policies in terms of monetary and credit policy, land policy, taxation policy and regulation and supervision, in an effort to promote the healthy development of the real estate market.

(2). The iron and steel industry

In the first quarter of 2005, influenced by an array of macro control measures, fixed investment of the iron and steel industry fell sharply, progress was made in structural adjustment, economic results improved. There were, however, such problems as faster than desired growth of iron and steel production and big volatility of market prices of steel products.

Growth of fixed investment of the iron and steel industry decreased noticeably. Starting from March 2004, China implemented the comprehensive measures of macro control like controlling newly-started projects, size of credit, land use and its favorable price and straightening out projects proposed for construction. The momentum of faster than desired investment was effectively contained. The clarification and readjustment of fixed investment of the iron and steel industry produced good results. In the first quarter, the iron and steel industry (excluding mines) completed fixed investment of RMB33.22 billion yuan, decelerating by 1.4 percent compared with the growth rate of 106.4 percent in the first quarter of 2004.

The iron and steel enterprises operated well with improved economic results. In the first quarter, 68 key medium- and large-sized enterprises included in the statistics of the iron and steel association, realized sales of RMB286.91 billion yuan, profits and tax of RMB42.48 billion yuan, and profits of RMB25.04 billion yuan, up 28 percent, 15.9 percent and 18.6 percent respectively over the same period of last year.

Production of iron and steel soared, and growth of their domestic demand decelerated. In the first quarter, output of crude steel was 77.786 million ton, that of pig iron 72.566 million ton and that of steel products 82.535 million ton, up 23.8 percent, 27.3 percent and 22.4 percent respectively over the same period of last year, maintaining the momentum of rapid growth. Growth of consumption of steel products in the domestic market fell from 25.8 percent in 2003 to 13 percent in 2004 and further to 9.8 percent in the first quarter of 2005. The above fact indicated that domestic demand on steel products changed from the high growth of over 20 percent in the past two years to the stable and rapid growth of about 10 percent.

Prices were volatile in the market of steel products. In the first quarter, pushed by domestic and foreign demand and influenced by price hike of 71.5 percent of international contracts of iron ore, prices of steel products kept on rising. According to survey and statistics of China Iron and Steel Industrial Association, the composite price index of steel products in the domestic market was 138.33 at end-March, increasing by 10.48 percent and representing the highest index since it reached 108.56 at end-May 2004. Since April this year, prices of some steel products like building material fell sharply.

Exports of iron and steel products soared while imports dropped. In the first quarter, imports of steel products were 5.97 million ton and those of steel billets were 390,000 ton, down 40.8 percent and 77.8 percent respectively over the same period of last year. Exports of steel products were 5.19 million ton and those of steel billets were 2.86 million ton, up 2.19 times and 9.71 times respectively over the same period of 2004. Faster than desired exports of iron and steel products intensified contradiction in terms of supply shortage of domestic energy and transportation.

The iron and steel industry is a key fundamental industry of the national economy and an important symbol for measuring the level of national economic and social development and the comprehensive strength. Efforts shall be furthered to strengthen and improve macro control of the iron and steel industry, reasonably control the aggregate level, focus on structural readjustment, moderately control exports, in a bid to forestall risks out of excessive volatility of prices of steel products and faster than desired expansion of capacity of the iron and steel industry.

Part Five Development of Monetary Policy

I. Economic forecast for 2005

In 2005, GDP is projected to grow by 8 percent and the increase of CPI will be controlled below 4 percent. Regarding consumer demand, with the rapid growth of the economy and the adoption of a series of policy measures aimed at supporting agriculture and grain production, the income of the urban and rural residents is expected to increase further, which will lead to stronger consumer demand. The results of the survey on urban household savings of the first quarter of 2005 show that 31 percent of the respondents believed that their income would increase, 4.5 percentage points higher than the proportion of the same period of last year, and 6.9 percent of the respondents expected a lower income, 1.6 percentage lower from the same period of the previous year. In general, people have a strong confidence in the future increase of their income. With respect to investment demand, given the large scale of the projects in construction and the existing rigidity in cutting down the investments that have already started, fixed-asset investment is expected to continue to grow rapidly in the period ahead. As for export and import, against the background of generally good global economic fundamentals that create a favorable environment for China’s external trade as well as some unfavorable factors including volatile oil prices, higher prices of raw materials and heightened trade frictions, China’s total export and import will continue to grow. In general, China’s economy will maintain the steady and rapid growth momentum in 2005.

Inflationary pressures remain a concern. At present, inflationary pressures in China are mainly in the following three areas. The first is the pressure resulting from the adjustment of the prices of utilities services including water, electricity, fuels and urban transportation. The second is the pressure posed by higher prices of oil and key commodities on the prices of downstream products. The third is pressure of increased labor cost. Preliminary forecasts show that the year-on-year CPI growth will remain steady in the second and third quarter of 2005, and slightly go up in the fourth quarter. It is expected that CPI growth for the whole year will be controlled below 4 percent.

II. Monetary Policy Stance to be adopted in the near term

As required by the Central Economic Conference and the Third Plenum of the Tenth National People’s Congress, the PBC will continue to pursue the sound monetary policy. Efforts will be made to appropriately control money and credit aggregates to support economic development as well as to prevent inflation and financial risks. The financial institutions will be encouraged to improve their credit structure by actively providing working capital loans to the enterprises with marketable products and good profitability and appropriately controlling the growth of medium- and long-term loans. Market-based mechanisms will be adopted in macro financial management to build on achieved results.

(1) Further improve the indirect management mechanisms to maintain steady growth of money and credit

The PBC will take further measures to improve the effectiveness of open market operations in absorbing the shocks resulting from the changes of foreign exchange, fiscal position and cash in circulation. By taking into account the trend of money and credit development, the PBC will strengthen its macro-management capability by appropriately using the mix of monetary policy instruments. Steps will be taken to further improve the transmission mechanism of monetary policy and promote steady development of money and credit.

(2) Deepen the market-based interest rate reform to enhance the role of interest rate in macroeconomic management

In accordance with the requirement of market-based interest rate reform, the PBC will revise the rules concerning the calculation of interest rate and related regulations, and improve relevant systems and procedures. In accordance with the reform measures that have been adopted, the PBC will guide the commercial banks to enhance their risk pricing and liability management capabilities, and improve the formation and transmission mechanisms of interest rate. Macroeconomic development including changes in the general price level and asset prices will be closely monitored. Based on the scientific, forward-looking and effective principles, the PBC will seek to enhance the role of interest rate in macroeconomic management and ensure the steady and rapid development of the economy.

(3) Enhance the role of credit policies in promoting economic restructuring by differentiating credit support to various sectors

Window guidance of the central bank will be improved to further strengthen coordination between credit policies and industrial policies and timely convey the policy intentions to the financial institutions. The commercial banks are encouraged to take preemptive measures to respond to cyclical development and industrial changes, strengthen their ability to judge market risks, improve risk control and further transform their operating mechanisms. The loan granting and approval procedures will be reformed based on market principles, and the risk management system will be improved. The commercial banks will be encouraged to continue adopting different loan policies to different sectors and enterprises. In particular, working capital loans will be timely provided to the enterprises with marketable products and good profitability and those contributing to job creation. Credit support will be strengthened to promote the development of agriculture, small- and medium-sized enterprises, consumer spending, employment and education. Policy guidance on consumer credit will be enhanced, and the commercial banks will be encouraged to improve their financial services to the non-state sector. Developments of the housing market will be closely monitored and various policies be coordinated to ensure the healthy development of the housing market.

(4) Control the growth of medium- and long-term loans with a view to improve

the term structure of the loans
Research will be conducted on the establishment of a monitoring system that will be used for assessing whether the term structure of deposits and loans of the commercial banks are matched. Risk warning will be given to the banks with a significant extent of mismatch, and they will be required to take corrective measures within a specified period of time. For those banks that fail to meet relevant requirements, restrictive measures will be imposed to discourage them from extending medium- and long-term loans. Meanwhile, the PBC will devote major efforts to develop money market and capital market, speed up the pilot program of asset securitization, actively promote the issuance of long-term corporate bond, and improve the structure of the yield curve to enable the risks of bonds of different maturities to be properly reflected in their yields. Steps will also be taken to develop the long-term debt instruments including financial bond and CDs of long maturities with an aim to strengthen the liability management capability of the commercial banks.

(5) Actively promote the development of financial markets
Priority efforts will be made to promote financial product innovation so as to expand the direct financing channel and speed up the development of financial market infrastructure. The issuance and trading of new investment products, including the corporate bonds, will be actively promoted, so that the enterprises will become less reliant on bank loans for their working capital needs. Steps will also be taken to develop the institutional investors. The pilot projects for the Industrial and Commercial Bank of China, China Construction Bank and Bank of Communications to set up fund management companies will be accelerated to enable them to formally issue funds at an early date. Various types of investors including the enterprise annuity fund, insurance fund and Qualified Foreign Institutional Investors will be encouraged to participate in the inter-bank bond market in an orderly manner. In addition, measure will be taken to promote the development of financial derivatives to meet the diversified needs of the market.

(6) Speed up the reform of the financial enterprises
The financial enterprises will be encouraged to take further steps to transform their operating mechanism and establish modern corporate structure. Continued efforts will be made to push ahead with the joint-stock reform of the state-owned commercial banks, strengthen the role of policy banks and improve the recovery ratio of the asset management companies. Further research and analysis will be conducted on the overall reform plan for the rural financial system to promote rural financial reform and innovation and establish a rural financial system that has clearly defined ownership structure and functions and is under effective supervision by the authorities.

(7) Deepen the reform of foreign exchange administration to promote balanced international payment
Aiming at promoting balance of payments equilibrium, the PBC will take further

reform measures to set up market-based mechanisms and administration system for managing international payments, with the aim of promoting coordinated domestic and external economic development. Steps will be taken to facilitate and regulate trade activities, further expand the channels for capital outflows, actively promote the development of foreign exchange market, and strengthen the management of capital inflows and related foreign exchange transactions. Management of the external debts of foreign-fund enterprises and foreign banks will be strengthened to contain the excessively rapid growth of external debt, particularly the short-term external debts. The mechanism for determining the RMB exchange rate will be improved to keep the exchange rate basically stable at an adaptive and equilibrium level.