China Monetary Policy Report

Quarter Three, 2005

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

Executive Summary

China's economy maintained steady and fast growth in the first three quarters of 2005. Inflation was broadly stable, and household income, corporate profit, and fiscal revenue all witnessed marked growth. GDP grew by 9.4 percent and the CPI increased by 2.0 percent on a year-on-year basis.

Under the guidance of the CPC Central Committee and the State Council, the People's Bank of China (PBC) continued to pursue sound monetary policy to appropriately control money and credit growth and to improve the credit structure. Steady progress was made to push ahead with the reform of financial enterprises and the RMB exchange rate regime, speed up the development of the financial infrastructure, reform foreign exchange administration, and improve the transmission mechanism of monetary policy. Authorized by the State Council and with very careful preparation, the PBC announced on July 21, 2005 the adoption of a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Since July 21, the new exchange rate system has operated stably, and the RMB exchange rate has been kept basically stable at an adaptive and equilibrium level. The exchange rate of the RMB against the US dollar has been moving both upward and downward with greater flexibility, and market expectations for RMB appreciation have gradually eased. A survey of enterprises, households, and financial institutions shows that most market participants have coped well with the impacts of the exchange rate reform, and they all have a positive attitude toward the reform.

The financial system performed soundly in the first three quarters of 2005. Money supply grew at a slightly faster pace, loans extended by financial institutions increased steadily, and the credit structure improved further. These were broadly in line with the general goal of macroeconomic management. As of end-September, broad money reached 28.7 trillion yuan, increasing by 17.9 percent over the same period of last year; base money amounted to 6.1 trillion yuan, a year-on-year growth of 14.3 percent; and RMB loans extended by financial institutions registered 19.1 trillion yuan, up 13.8 percent over the same period of last year. Interest rates in the money market ceased to decline and started to move steadily. As of end-September, foreign exchange reserves reached US$769 billion, US$159.1 billion more than that recorded at the end of 2004. On September 30, 2005, the exchange rate of the RMB against the US dollar stood at 8.0920 yuan per US dollar, appreciating by 2.28 percent over the end of 2004.

Preliminary estimates show that China's economy will maintain good growth momentum in the fourth quarter of 2005. Nevertheless, the problems of the excessively large scale of fixed-asset investment, increasingly unbalanced external trade, and inappropriate export structure need to be addressed.

In the fourth quarter of 2005, under the guidance of the CPC Central Committee and the State Council, the PBC will continue to pursue a sound monetary policy, maintain the consistency and stability of monetary aggregates, and take preemptive and fine-tuning measures. Steps will be taken in the following six areas. First, the PBC will seek to maintain appropriate growth of money and credit by flexibly using a mix of monetary policy instruments. Second, measures will be taken to further implement a market-based interest rate reform. Third, the role of credit policy in promoting the transformation of the economic growth pattern and economic restructuring will be enhanced. Fourth, the development of financial markets and the innovation of financial products will be actively promoted. Fifth, financial system reform will be accelerated. Sixth, continued efforts will be made to promote balanced international payments and to keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

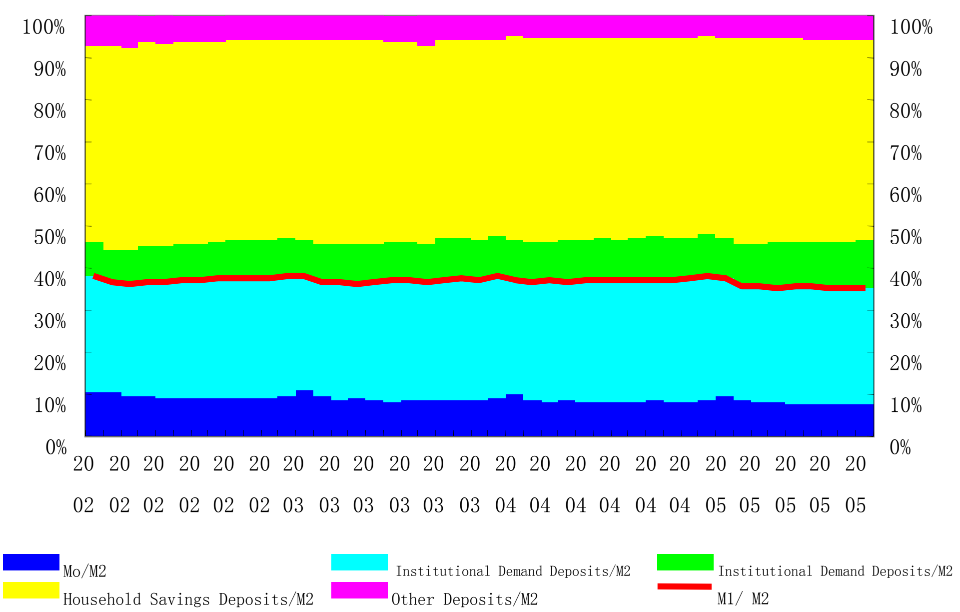
Part One Monetary and Credit Performance

In the first three quarters of 2005, the Chinese economy continued to expand at a steady and relatively fast pace and the performance of the financial industry remained sound. The growth of monetary aggregates picked up somewhat, and loans by financial institutions expanded steadily, with the credit structure being further improved, and basically consistent with the general direction of macroeconomic management.

I. Growth of monetary aggregates picked up somewhat

Broad money M2 reached 28.7 trillion yuan at end-September, a growth of 17.9 percent y-o-y, representing an acceleration of 4 percentage points over the same period of the previous year or 3.3 percentage points up from the end of 2004, hitting its highest level in 2005. Narrow money M1 reached 10.1 trillion yuan at end-September, increasing by 11.6 percent y-o-y, 2.1 percentage points lower than a year earlier or 1.9 percentage points down from the end of 2004. Cash in circulation M0 amounted to 2.2 trillion yuan, increasing by 8.5 percent y-o-y. Cash put into circulation in the first three quarters of the year totaled 80.5 billion yuan on a net basis, 2.6 billion yuan more than that recorded for the same period of 2004.

Figure 1: Changes in the Composition of Broad Money M2 since 2002



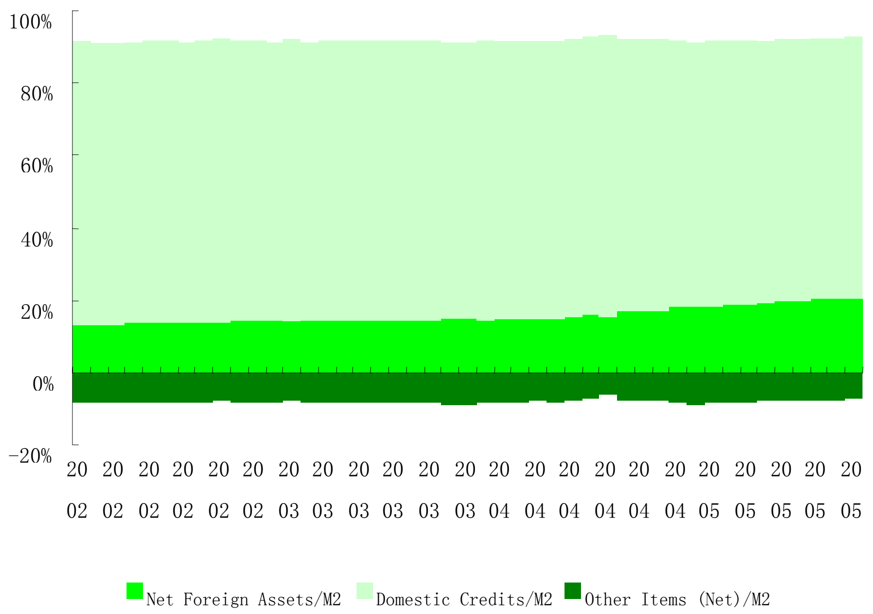
Note: M2=M1+Quasi Money. M1=Cash in Circulation (M0) + Institution Demand Deposits (among which corporate demand deposits account for around 80 percent). Quasi

Money=Institution Time Deposits + Household Savings Deposits + Other Deposits.

Source: The PBC.

In terms of the composition of broad money, the proportion of M0 decreased slowly, while that of corporate time deposits and other deposits that fall into the category of quasi money have recently increased relatively quickly. This is partly a result of a widening interest rate spread between time deposits and demand deposits, and thus enterprises prefer to hold time deposits. Furthermore, with the development of commercial paper financing, acceptance margin deposits increased rapidly, contributing to the fast growth of other deposits. The analysis of the banking survey showed that the impact of net foreign assets on broad money heightened rapidly, while that of domestic credits weakened somewhat, pointing to marked changes in the channels of money supply.

Figure 2: The Impact of Net Foreign Assets and Domestic Credits on Broad Money Since 2002



Note: According to the statistical coverage of the Financial Survey and Statistics Department of the PBC, money supply statistics are derived from the banking survey. The banking survey is compiled by consolidating the monetary survey and combined balance sheets of special depository institutions, and the monetary survey is compiled by consolidating the combined balance sheets of the monetary authority and of deposit money banks. Assets in the banking survey are composed of net foreign assets (NFA) and domestic credits (DC), and liabilities are composed of broad money

(M2) and other items (net) (OIN, including foreign currency deposits, bonds, central bank bills, and paid-in capital in China). The accounting equation of assets and liabilities determines M2=NFA+DC-OIC, based on which the impact of net foreign assets and domestic credits on broad money can be analyzed.
Source: The PBC.

II. Deposits of financial institutions increased at a brisk pace

Outstanding deposits of all financial institutions (including foreign-funded financial institutions) in both RMB and foreign currencies increased by 18 percent y-o-y to 29.3 trillion yuan at end-September, a growth of 3.66 trillion yuan from the beginning of the year or an acceleration of 899.8 billion yuan. In particular, RMB deposits rose by 19.1 percent y-o-y to 28 trillion yuan, up 3.66 trillion yuan over the beginning of the year or accelerating by 962 billion yuan. Foreign currency deposits totaled US$157.5 billion, increasing by 1 percent y-o-y or by US$2.74 billion over the beginning of the year, a deceleration of US$4.02 billion.

Corporations and households tend to prefer time deposits. At end–September, corporate RMB deposits increased by 15.7 percent y-o-y to 9.3 trillion yuan, representing a growth of 838.2 billion yuan from the beginning of the year and an acceleration of 85.9 billion yuan over the same period of 2004, with the acceleration of time deposits recorded at 358.3 billion yuan. Savings deposits in RMB expanded by 18.1 percent y-o-y to 13.6 trillion yuan, increasing by 1.68 trillion yuan over the beginning of the year, 492.9 billion yuan more than in the same period of a year earlier, with increases in time deposits recorded at 573.5 billion yuan more than a year earlier. Fiscal deposits increased by 438.1 billion yuan in the first three quarters, accelerating by 50.2 billion yuan compared with a year earlier.

III. Loans by financial institutions expanded steadily

Outstanding loans by financial institutions in both RMB and foreign currencies reached 20.3 trillion yuan at end-September, a growth of 13.5 percent y-o-y, or increasing by 2.06 trillion yuan over the beginning of the year, an acceleration of 136.4 billion yuan. RMB loans grew by 13.8 percent y-o-y to 19.1 trillion yuan, an increase of 1.96 trillion yuan over the beginning of the year, accelerating by 163.6 billion yuan, with the amount of new loans recorded at the second highest level in history, only behind that recorded in the same period of 2003. Foreign currency loans rose by 12.0 percent y-o-y to US$149.6 billion, a growth of US$16.20 billion over the beginning of the year, accelerating by US$370 million. Since the beginning of 2005 the outstanding balance of RMB loans at the end of each month increased by 13.2 percent on average over a year earlier, and in most months the registered growth was around 13 percent, keeping the momentum of stable expansion.

In terms of loan destinations, the loan structure has been further improved. Working capital loans and agriculture-related loans[1] witnessed relatively stronger growth. In the first three quarters, short-term loans and commercial paper financing for corporate working capital increased by 1 trillion yuan, an acceleration of 254.7 billion yuan. In particular, commercial paper financing increased by 397.2 billion yuan, accelerating by 254.1 billion yuan and accounting for 20.3 percent of total new loans, 12.3 percentage points up compared with the same period of the previous year. One of the important reasons for the robust growth of commercial paper financing was a decline in the money market interest rate, which caused banks to adjust their asset structure and increase financial input into bill businesses. With the advancement of the reform of rural credit cooperatives, the financial sector stepped up efforts to support the development of the rural economy, agriculture, and increases in farmers' income. As a result, in the first three quarters agriculture-related loans expanded by 295.6 billion yuan, 37.6 billion yuan more than during the same period of the previous year. Medium and long-term loans continued their decelerating trend; nevertheless, infrastructure loans maintained relatively fast growth. In the first three quarters RMB medium and long-term loans increased by 890.7 billion yuan, a deceleration of 91.3 billion yuan. Capital construction loans rose by 493.9 billion yuan, accelerating by 79.2 billion yuan with the growth registering 21.3 percent, reflecting that investment growth was remaining at a high level. Consumer credit underwent notable changes, with the balance of household consumption loans reaching 2.1 trillion yuan, an increase of 13.4 percent, down by 17.4 percentage points. In the first three quarters, consumption loans expanded by 150.4 billion yuan, decelerating by 186.9 billion yuan. In particular, individual housing loans increased by 186.9 billion yuan, representing a deceleration of 115.2 billion yuan. The growth of household consumption loans, in particular housing loans, slowed down, both resulting from a natural adjustment following rapid growth over the years and the implementation of real estate control measures, and representing changes in residents' expectations of the real estate market as well as an enhancement of risk awareness by both lenders and creditors. The further developments and their trends deserve monitoring.

[1] Including agricultural byproducts loans, agricultural loans, and township enterprises loans.

Broken down by institutions, except for RMB loans by wholly state-owned commercial banks, RMB loans by all the other financial institutions accelerated. In the first three quarters, RMB loans by wholly state-owned commercial banks[2] increased by 580.0 billion yuan, decelerating by 249.5 billion yuan over the same period of the previous year. Lending by policy banks, joint-stock commercial banks,[3] urban commercial banks, and rural cooperative institutions[4] expanded by 255.5 billion yuan, 500.5 billion yuan, 149.1 billion yuan, and 358.2 billion yuan, accelerating by 143.3 billion yuan, 132.1 billion yuan, 38.4 billion yuan, and 52.8 billion yuan respectively. Loans by foreign-funded financial institutions added 28.6 billion yuan, an acceleration of 15.9 billion yuan. New loans by wholly state-owned commercial banks declined somewhat as a proportion of total new loans, mainly because the wholly state-owned commercial banks slowed down credit expansion in the course of the shareholding reform; on the other hand, this reflected further advancement of a competitive financial system in China

IV. Base money growth accelerated somewhat

At end-September, the balance of base money totaled 6.1 trillion yuan, increasing by 14.3 percent y-o-y or 191.4 billion yuan from the beginning of the year, an acceleration of 101.4 billion yuan. Base money grew by 340.7 billion yuan in the third quarter alone. At end-September, the excess reserve ratio of financial institutions averaged at 3.96 percent, up 0.32 percentage points from a year earlier. The wholly state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives recorded a ratio of 3.79 percent, 4.88 percent, and 5.30 percent respectively.

V. The Money market interest rate tended to stabilize after its previous fall

In the third quarter, the weighted average interest rate for one-year RMB loans of financial institutions was 6.81 percent, registering 1.22 times the benchmark rate (5.58 percent since October 29, 2004), down 0.54 percentage points over the previous

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[2] According to the statistical standard used by the Financial Survey and Statistics Department of the PBC, wholly state-owned commercial banks comprise the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and the China Construction Bank.

[3] According to the statistical standard used by the Statistics Department of the PBC, joint-stock commercial banks consist of the Bank of Communications, the CITIC Industrial Bank, the Ever Bright Bank, the Huaxia Bank, the Guangdong Development Bank, the Shenzhen Development Bank, the Merchants Bank, the Pudong Development Bank, the Industrial Bank, the Hengfeng Bank, and the Zhejiang Commercial Bank.

[4] According to the statistical standard used by the Statistics Department of the PBC, rural cooperative institutions include rural credit cooperatives, rural cooperative banks, and rural commercial banks. The Statistics Department of the PBC began to collect data on rural cooperative banks in the beginning of 2005.

quarter. In particular, the weighted average interest rate for fixed interest rate loans,[5] which accounted for 92.7 percent of total loans, was 6.87 percent, down 0.6 percentage points from the previous quarter; and that for floating interest rate loans,[6] which accounted for the other 7.3 percent of total loans, was 6.08 percent, up 0.11 percentage points from the previous quarter. The weighted average interest rate for one-year loans of commercial banks recorded 6.14 percent, 1.1 times the benchmark rate, up 0.19 percentage points from the previous quarter. Among the loans issued by commercial banks, fixed interest rate loans took up 90.5 percent, with the weighted average interest rate standing at 6.17 percent, up 0.21 percentage points from the previous quarter; floating interest rate loans made up 9.5 percent, with the weighted average interest rate recording 5.87 percent, 0.03 percentage points lower than the previous quarter.

The PBC statistics on lending interest rates of financial institutions in the third quarter of 2005 have shown that among total new loans, loans with interest rates floating downward against the benchmark took up 21.77 percent, up 3.05 percentage points over the previous quarter; loans charged at the benchmark rate made up 24.64 percent, up 2.68 percentage points over the previous quarter; and loans with interest rates floating upward against the benchmark accounted for 53.59 percent, down 5.73 percentage points over the previous quarter.

Table 1：The Shares of Loans with Rates Falling in Various Ranges in the Third Quarter of 2005 (by financial institution)

Unit：%

	Sum	(0.9，1]	1.0	Upward Adjustment				
				Sum	（1，1.3]	（1.3，1.5]	（1.5,2]	above 2
Sum	100	21.77	24.64	53.59	27.75	8.42	12.65	4.78
State-owned commercial banks	100	26.81	32.11	41.08	36.45	4.07	0.45	0.11
Joint-stock commercial banks	100	29.63	34.75	35.62	34.52	0.96	0.12	0.02
Regional commercial banks	100	17.34	14.57	68.10	28.57	9.90	17.60	12.02
Urban and rural credit cooperatives	100	5.04	4.28	90.68	12.62	22.39	42.02	13.65

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

Source: Reports of lending rates of commercial banks.

[5] Fixed interest rate loans refer to loans charged at a fixed or unchanged interest rate throughout the term of the loan.

[6] Floating interest rate loans refer to loans whose interest rates vary periodically in line with changes in the market rates or legal benchmark rates. Lenders and borrowers negotiate and determine the adjustment frequency and the criteria when the loans are issued.

In the third quarter, the interest rate on negotiable RMB deposits of commercial banks (above 30 million yuan) declined slightly. In particular, the weighted average interest rate of negotiable deposits with a maturity of 61 months in the third quarter stood at 3.89 percent, down 0.23 percentage points over the previous quarter and 0.57 percentage points from the beginning of the year. The weighted average interest rate of negotiable deposits with a maturity of 37 months was 4.07 percent, down 0.03 percentage points over the previous quarter and 0.25 percentage points from the beginning of the year.

Affected by persistent interest rate hikes of the US Fed and an interest rate rise in international financial markets, the interest rates on domestic foreign currency loans and large-value deposits continued to rise. In September, the weighted average interest rate of one-year large-value US dollar deposits (above US$3 million) stood at 4.14 percent, 1.87 percentage points higher than at the beginning of the year; the weighted average fixed interest rate on one-year US dollar loans was 5.17 percent and the weighted average floating interest rate on US dollar loans was 4.89 percent, up 1.74 and 1.51 percentage points respectively over the beginning of 2005.

Table 2: Average Interest Rates on Large-value US$ Deposits and US$ Loans in the First Three Quarters of 2005

Unit: %

	January	February	March	April	May	June	July	August	September
I. Large-value deposits									
Within 3 months	1.7964	1.5561	2.3159	2.4776	2.9717	2.3956	2.6304	2.8704	3.1364
3—6months	2.1102	2.2490	2.5353	2.9351	2.7800	3.3701	3.5642	3.5427	3.8602
6—12 months	2.4450	2.2419	2.6527	3.3083	2.3960	3.4914	3.4038	3.0301	3.5390
1 year	2.3039	2.3694	3.3022	2.7471	3.5035	3.7372	3.9109	3.8578	4.1357
II. Loans									
1 year（fixed）	3.5366	3.7720	4.2393	4.0664	4.5367	4.5664	4.6544	4.8904	5.1665
1 year (monthly floating）	3.3315	3.6771	3.7462	4.0724	4.1575	4.2477	4.4853	4.6744	4.8872

Source: Reports of foreign currency interest rates of commercial banks.

In the third quarter of 2005, the money market interest rate tended to stabilize from its previous fall. In the third quarter, the weighted average interest rates on 7-day inter-bank lending ranged between 1.55 percent and 1.56 percent, basically unchanged from June; the weighted average interest rates on pledged bond repo in July, August, and September were 1.19, 1.23 and 1.20 percent, 0.09, 0.13, and 0.10 percentage points higher than in June respectively.

VI. RMB exchange rate remained basically stable

The current account surplus recorded US$67.3 billion in the first half, an expansion of US$59.8 billion compared with the same period of the previous year. The capital and financial account ran a surplus of US$38.3 billion, a contraction of US$28.5 billion as opposed to the same period of the previous year. The overall size of the external debt increased, with the share of short-term external debt climbing. At end-June, the balance of external debt in China amounted to US$266.18 billon, increasing by 7.5 percent from the end of 2004. In particular, short-term debt totaled US$141.35 billion, increasing by 14.7 percent from the beginning of the year and accounting for 53.1 percent of the total, up 3.3 percentage points from the end of 2004. A revision[7] of the statistical coverage of trade finance was claimed to be an important factor behind the relatively fast growth of short-term external debt.

At end-September, the official foreign exchange reserves reached US$769 billion, increasing by 49.5 percent over a year earlier. In the first three quarters, foreign reserves expanded by US$159.1 billion, accelerating by US$47.8 billion over the same period of the last year. In particular, growth in the third quarter totaled US$58 billion, with that in each month registering US$21.7, US$20.5, and US$15.8 billion respectively, demonstrating a trend of slowing down month by month.

On July 21, 2005, the reform of the RMB exchange rate regime was carried out smoothly, with the RMB exchange rage against the US dollar appreciating by 2 percent on that day to the level of RMB8.11 yuan per US dollar. Since the reform, the RMB exchange rate against the US dollar on the inter-bank foreign exchange market has been moving up and down by a small margin, with the lowest closing price of the trading day recorded at 8.1128 yuan per US dollar, and the highest at 8.0871 yuan per US dollar. The largest fluctuation recorded was 257 basis points, and the largest single

[7] Trade finance liabilities include importers' payable accounts and exporters' receipts in advance. The SAFE has produced trade finance statistics through a sample survey of corporations employing trade financing since 2002. At present, the sample covers over 5,000 enterprises in 13 regions, including coastal developed regions and middle and western regions, where imports and exports account for around 90 percent of national trade. Previously published trade finance liabilities data were based on estimates by applying a certain ratio of imports. After the revision, trade finance liabilities data are published based on the sample survey.

day appreciation and depreciation both registered 0.07 percent; 21 trading days saw a depreciation and 30 trading days saw an appreciation. On September 30, the RMB exchange rate stood at 8.0920 yuan per US dollar, appreciating by 2.28 percent over the end of 2004.

Part Two Monetary Policy Conduct

In the first three quarters of 2005, the PBC, under the leadership of the central government, continued to implement a sound monetary policy by appropriately controlling credit expansion, encouraging the optimization of the credit structure, and promoting the reform of financial enterprises and the RMB exchange rate regime. Significant progress was achieved in financial market development and foreign exchange management. The monetary policy transmission mechanism has also been improved.

I. Flexible open market operations

In the third quarter, the PBC closely monitored the macroeconomic and financial situation as well as financial market development following the reform of the RMB exchange rate regime, and strengthened the analyses and forecasts of banking system liquidity. To this end, open market operations were carried out flexibly for the purpose of sterilization. In July and August, to provide a sound environment for the reform of the exchange rate regime and to support appropriate credit expansion, the PBC scaled down its sterilization through open market operations in an effort to maintain generally sufficient liquidity in the banking system and to keep the money market interest rate low. In September, as the reform of the exchange rate regime progressed smoothly and the credit of financial institutions expanded modestly, the PBC appropriately increased open market operations and flexibly adjusted their aggregates, structure, and composition of instruments, leaving the liquidity of the banking system generally sufficient and interest rates on various open market operation instruments stable, with a slight increase. In general, the objective of open market operations has been achieved.

In the third quarter, 234.5 billion yuan was recalled through open market operations. In this context, the PBC made 27 issuances of central bank bills, amounting to 535 billion yuan. In particular, bills with a maturity of 3 months amounted to 320 billion yuan and those with a maturity of 1 year amounted to 215 billion yuan. By the end of September, the outstanding value of central bank bills stood at 1.748 trillion yuan, and that of repo was 230 billion yuan.

II. Coordinate interest rates on domestic and foreign currencies

Given the continuous interest rate hikes in the international financial market, the PBC raised the ceiling on small-value deposit interest rates for the US dollar and the HK dollar on May 20. It raised the ceiling on interest rates of small-value foreign currency deposits again on July 22, August 23, and October 15, respectively. In particular, the ceiling of rates on 1-year US dollar deposits and 1-year HK dollar deposits were raised by 0.5 percentage points, 0.375 percentage points, and 0.5 percentage points to 2.5 percent and 2.37 percent, respectively. Raising interest rates on small-value foreign currency deposits is helpful to coordinate the interest rates on domestic and foreign currency deposits, to stabilize foreign currency deposits at home, and to reduce the pressures of foreign exchange sales.

III. Use "window guidance" and credit policy to promote economic structural adjustment

To implement the central government's policy of differentiating credit policies to different sectors, the PBC, by analyzing the credit situation, provided clear-cut "window guidance" and risk alerts for commercial banks, and guided financial institutions to appropriately control the speed of credit expansion, optimize the credit structure, and improve financial services. These efforts contributed to an economic structural adjustment. First, rural financial services were improved. Poverty-reduction loans were increased. The PBC continued to advise rural credit cooperatives to develop micro finance and rural household joint-guarantee loans, and fostered a competitive rural financial market. Second, the PBC further intensified its support for weak areas of the economy. The PBC actively promoted institutional reform of micro guaranteed loans for the unemployed, encouraged the establishment of pilot credit communities, and helped boost employment and re-employment. The regulations on student loans for those graduates working in western and distant areas were also improved. Third, the PBC established a commercial bank deposit and loan maturity mismatch monitoring system that will serve to enhance the commercial banks' liquidity management and their asset and liability management. Commercial banks are required to strengthen the dynamic assessment of credit concentration and risks for key industries, enterprises, and areas, and to timely issue early warning information. Fourth, the PBC advised the Agricultural Development Bank to conduct market-based fund-raising in an effort to improve the liability structure. In 2004 and the first 9 months of 2005, the Agricultural Development Bank issued financial bonds amounting to 190.2 billion yuan and repaid PBC lending of 127.7 billion yuan on a net basis.

IV. Smoothly promote financial enterprise reform

The shareholding reform of the state-owned commercial banks advanced smoothly. The China Construction Bank issued 26.486 billion H shares (accounting for 12 percent of total capital) at a price of 2.35 HK dollars, raising funds of 62.2 billion HK dollars equivalent to US$7.98 billion (calculated at the rate of HK$7.8/US$). On October 27, the Bank was formally listed on the Hong Kong main board market. The shareholding reform of the Industrial and Commercial Bank of China also gained ground. The Bank has so far finished recapitalization, disposed of non-performing loans on a market basis, and issued subordinated bonds worth 35 billion yuan. The Industrial and Commercial Bank of China, Co. Ltd. was established on October 28, 2005. The Bank of China continued to improve its management and internal control, creating conditions for a public listing.

Progress was also made in the pilot reform of rural credit cooperatives. In the third quarter of 2005, the PBC, together with the China Banking Regulatory Commission (CBRC), strictly regulated the seventh issuance of special central bank bills for a pilot reform of credit cooperatives in accordance with the rules and procedures. Special central bank bills were issued to 553 counties in 19 provinces (autonomous regions or municipalities), totaling 39.3 billion yuan. The fund was used to replace non-performing loans of credit cooperatives amounting to 31.1 billion yuan and arrears of loss disposal of 8.2 billion yuan. With the supporting measures put in place, the historical burdens on credit cooperatives were gradually relieved, leading to a significant improvement of asset quality, a rapid increase of the capital adequacy ratio, and a dramatic improvement in the financial situation.

V. Success of the reform of the RMB exchange rate regime

With approval of the State Council, the PBC, following careful preparation, announced on July 21, 2005 it would shift to a managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies. At 19:00 on July 21, 2005, based on an assessment of the equilibrium RMB exchange rate, the PBC adjusted the RMB exchange rate to 8.1100 yuan/US$, i.e., the RMB appreciated by 2 percent.

Since July 21, the new exchange rate regime has operated smoothly and the RMB exchange rate has remained basically stable at the adaptive and equilibrium level. The exchange rate of the RMB against the US dollar has moved up and down, reflecting the exchange rate movements among major currencies and the feature of the new regime.

With the RMB exchange rate moving around its equilibrium level, the expectations of RMB appreciation have primarily eased: first, the forward exchange rate on the domestic RMB forward market and the NDF rate formed abroad converge toward that calculated on the basis of interest parity. On October 31, the 1-year forward rate on the domestic forward market was 7.7950 yuan/US$, and the 1-year NDF rate depreciated from its peak of 7.7100 yuan/US$ on July 22 to 7.7920 yuan/US$. Second, forward contracts at bank counters have shifted from net purchases to net sales. The net sale forward contracts at bank counters stood at US$ 837 million in August and expanded to US$ 1.236 billion in September. Third, capital inflow has decreased, as reflected by a significant slowdown in the growth of foreign exchange reserves.

Box 1: Economic Impact of the Exchange Rate Regime Reform

Since the reform of the RMB exchange rate regime that took place on July 21, 2005, China's economy has continued to grow rapidly. According to the PBC survey of enterprises, residents, and financial institutions conducted in August 2005,[8] the impact of the reform has been modest. At the microeconomic level, market participants reacted positively, with increased adaptability to the change.

Enterprises reacted positively. First, the impact of the reform was modest for enterprises. According to the survey, nearly 50 percent of the sample enterprises have taken such measures as quick surrender, early collection, and taking prepayment of foreign currencies to weather the impact of the reform. Hence, the reform did not have a significant impact on the enterprises' assets and liabilities. At the end of July 2005, the sample enterprises held foreign currency assets of US$ 21.81 billion and foreign currency liabilities of US$ 21.01 billion. The RMB appreciation of 2 percent caused these enterprises to lose US$ 130 million, accounting for only 0.013 percent of their sales revenue. Second, the exchange reform has primarily promoted a structural adjustment of foreign trade and industrial upgrading. The survey indicates that 67.9 percent of the enterprises reacted to the reform by improving productivity and reducing intermediate costs; 60.7 percent chose to cope with the reform by upgrading products, improving technology, and increasing value-added. Among the enterprises, 51.4 percent negotiated to maintain export prices. Third, the appreciation of the RMB has had a limited impact on the enterprises' exports and imports. Only 6.6 percent of the enterprises cut off production of export goods, and 13.7 percent of the enterprises reduced exports and increased domestic sales. Fourth, most enterprises believe that after the exchange reform the number of jobs will increase or remain unchanged. Among the enterprises, 58.6 percent believe that there will be no change in the number of jobs, while 17.3 percent believe that the number of jobs will decline by less than 10 percent. However, given the middle and low level of value-added and the fierce competition in export goods, the profitability of export enterprises is not high. Hence, it is difficult for these enterprises to weather the negative impact of the exchange rate appreciation by raising prices. It is indicated in the survey that 85.9 percent of the enterprises believe that the margin for them to increase prices is less than 3 percent, and 50.5 percent of the enterprises believe that the margin is less than 1 percent. In addition, the ability of the enterprises to hedge exchange rate risk through financial instruments needs to be enhanced. So far, 41.7 percent of the enterprises used forward contracts for foreign exchange surrender, and 19.8 percent used forward contracts to purchase foreign exchange, while only a few enterprises used such instruments as futures, options, and swaps. Enterprises with a substantial amount of foreign trade tend to have a better understanding and use of financial instruments than those with a small amount of trade.

Residents generally benefited from the reform. The appreciation of the RMB has

[8] First, a survey was conducted on the export enterprises or groups in the top 19 provinces, municipalities, and cities with independent budgets in terms of the total trade volume; this survey received 1,092 valid samples. According to the survey, the sampled enterprises registered exports of US$52.043 billion, accounting for 12.96 percent of the total, and reported an import volume of US$52.317 billion, accounting for 14.62 percent of the total. Second, a quick survey was conducted on households keeping foreign exchange assets in 20 cities, and this survey resulted in 3,000 valid respondents. Third, a quick survey was conducted on 1,863 state-owned commercial banks, joint-stock commercial banks, and foreign banks in 31 provinces, receiving 1,844 valid respondents.

increased the purchasing power of RMB assets, thus benefiting the general public. Following the exchange reform, residents have had a better sense of investment and preferred professional financial management. The proportion of residents willing to hold foreign currencies in the form of foreign exchange financial products has almost doubled from 15.6 percent to 30.8 percent. Meanwhile, foreign currency assets have diversified. The ratio of US dollar assets and non-US dollar assets held by residents has increased from 1:0.28 before the reform to 1:0.45 thereafter.

Financial institutions generally supported the reform. First, bankers generally supported the reform. Among the bankers, 86 percent believe that the timing of the reform is appropriate, and 77.6 percent believe that the initial RMB appreciation of 2 percent is appropriate, while 16.7 percent believe that the revaluation is relatively small. Meanwhile, 92.3 percent of the bankers believe that the reform has made exchange management more flexible and self-initiated. Among the bankers, 92.7 percent hold that the benefit of shifting from pegging singly to the US dollar to a regime with reference to a basket of currencies outweighs the cost. Second, the reform has not significantly affected the business of banks. Each bank has positively reacted to the reform, with 77.6 percent of the banks believing that the demand for credit is not affected, and 85.2 percent believing that the supply of credit is unaffected. Following the exchange reform, banks have acted swiftly to develop new products, including new foreign currency products and those aimed at hedging against exchange rate movements.

In general, the reform of the RMB exchange rate regime has been primarily successful. With the reform gradually taking effect, the new regime will serve to promote foreign trade structural adjustment, economic structural optimization, industrial upgrading, and sustainability of economic development. Meanwhile, it is worth noting that domestic demand may be more important in a large economy.

Under the new exchange rate regime, as the margin and frequency of exchange rate movements rise, enterprises, residents, and financial institutions will be subject to more foreign exchange exposure. Hence, it is necessary to develop a complete set of measures to enhance their ability to deal with foreign exchange risk. As the regulatory authorities make tremendous efforts to promote the development of the foreign exchange market and enterprises demand better foreign exchange services, financial institutions face good opportunities to develop foreign exchange products and provide consulting services. At this juncture, efforts shall be made to strengthen risk management, hedge foreign exchange risk through the derivative market, and enhance profitability through new businesses.

VI. Deepen exchange management reform

To support the reform of the RMB exchange rate regime and foster sound development of the balance of payments, the authorities launched a series of foreign exchange management measures in the third quarter of 2005. First, the ceiling for domestic institutions to retain foreign exchange revenue under the current account was raised. As a result, enterprises were granted more autonomy and the demand for and supply of foreign exchange were better matched. The indicated limit on residents' purchase of foreign exchange for private use was also raised, with the required document significantly simplified. Hence, it is easier for residents to buy foreign exchange for private use. Second, the authorities adopted comprehensive management for banks' sale and purchase of foreign exchange. The coverage of banks' foreign exchange purchase and sale position was expanded to all foreign exchange positions related to transactions between foreign currency and RMB, thus increasing the total limit for the banking system. Third, the conversion rate management methods for inter-bank market transactions and foreign exchange purchase and sale at the bank counter were adjusted, giving banks more autonomy. The daily limit of exchange rate movement between RMB and non-US dollar foreign currencies was expanded in the inter-bank market, and was removed for transactions between banks and their customers. The difference between the foreign exchange conversion rate and the foreign currency conversion rate was increased, and banks were allowed to quote different rates in a business day, thus increasing the cost of speculation. Fourth, the authorities adjusted the regulation on guarantees provided by domestic banks for enterprises investing abroad in an effort to support the outward investment of domestic enterprises and enhance the efficiency of domestic fund use.

Box 2: Foreign Exchange Risk Management

After the reform of the RMB exchange rate regime, the managed floating system may have some bearing on the operations of enterprises. Hence, a strengthening of their awareness of and capacity in foreign exchange risk management are urgently needed.

Foreign exchange risk refers to the risk of asset reduction or liability increase when enterprises' holdings of foreign currency assets (claims) or foreign currency debts are converted to RMB or other currencies as a result of exchange rate movements. Enterprises can hedge against foreign exchange risk by choosing the right currencies for economic activities and using appropriate risk-aversion instruments in an effort to match foreign currency assets and liabilities. Specifically, the measures may include:

Choosing the right currencies for economic activities. Currencies can usually be classified as hard currency or soft currency. The former means those with a stable exchange rate or an appreciation trend, while the latter includes those with an unstable exchange rate or a depreciation trend. In foreign trade and non-trade businesses, parties making payments usually prefer soft currencies, while those receiving revenues prefer hard currencies. In foreign financing, borrowers shall try to use soft currencies in order to reduce the debt burden.

Using appropriate risk-aversion foreign exchange instruments. Following the reform of the exchange rate regime on July 21, the PBC allowed qualified non-financial enterprises and non-bank financial institutions to access the inter-bank spot foreign exchange market, expanded the business scope of the banks' forward transactions, and permitted banks to deal with swaps between RMB and foreign currencies, facilitating enterprise hedging against exchange rate risk. The forward product and swap between the RMB and foreign currencies launched by banks can be used to hedge against foreign exchange risk.

The forward transaction of banks refers to transactions where foreign exchange-designated banks and domestic institutions agree to sell or purchase a certain amount of certain foreign currencies at a specified exchange rate on a future date in a forward contract and to make delivery on that date. For example, a domestic importing enterprise expects to pay a certain amount of US dollars in 3 months. To fix the financial cost, the enterprise can sign a forward contract to purchase that amount of US dollars with the bank. Three months later, no matter how the exchange rate might have moved, the enterprise can use RMB to buy US dollars at the pre-specified exchange rate, thus reducing exchange rate risk.

Swaps between the RMB and foreign currencies are also called currency swaps, which refers to two conversions of the RMB and foreign currencies in reverse directions within a certain period in accordance with a previously signed contract. For instance, a domestic exporting enterprise receives a payment of US$ 5 million and needs to convert the money into RMB for domestic payment. Meanwhile, the enterprise is expected to make an import payment of US$ 5 million in three months. In this context, the enterprise can make a 3-month swap between the RMB and the US dollar. That is, the enterprise can spot sell US$ 5 million, and sign a contract to buy US$ 5 million in 3 months. Thus, the enterprise can meet the financial needs of its operations and hedge against exchange rate risk.

Advancing or defering settlement. Enterprises can hedge against exchange rate risk by advancing or deferring settlement according to the prevailing exchange rates. If the foreign currency used for the transaction is expected to depreciate against the domestic currency, domestic importers can defer import or request deferred payment, while domestic exporters can sign export contacts and collect payment as early as possible. In contrast, if the foreign currency used for the transaction is expected to appreciate, domestic importers can import goods and make payment in advance, while domestic exporters can defer delivery of goods or allow importers to defer payment.

Matching foreign currency assets with liabilities. Export enterprises shall make every effort to align costs with the foreign market, including increasing imports of raw materials, spare parts, and unfinished products from abroad, and transferring some production and business operations abroad. When foreign currency borrowing does not match RMB revenue, foreign exchange market instruments shall be used to hedge against exchange rate risk.

Exchange rate movements shall be taken into account when a foreign trade contract is signed. For instance, domestic exporters shall increase the price of export products or share losses incurred by the exchange rate movement with importers when the currency used for the transaction is expected to depreciate. In contrast, when the currency is expected to appreciate, domestic importers shall request the foreign exporters to lower the price.

In sum, with the development of a domestic foreign exchange market, enterprises have more means to manage foreign exchange risk. Meanwhile, they shall strengthen internal management, intensify technological innovation, reduce operating costs, enhance the competitiveness of their products, and strengthen their capacity to make profits and weather risks.

Part Three Financial Market Performance

I. An overview of financial market performance

The first three quarters of 2005 saw sound financial market performance, featuring sufficient liquidity in the money market, reversal of the downward trend of market interest rates, a growing variety of bond instruments, and progress in institutional development of the financial market.

Compared to the same period of last year, the proportion of corporate bonds issued by non-financial sectors (including households, enterprises, and government agencies) went up, while that of government securities declined. In the first 9 months of this year, borrowing by non-financial sectors in terms of debt (both domestic and foreign currencies), equity (domestic and overseas tradable stocks only), government securities, and corporate bonds (short-term bills included) totaled 2.4645 trillion yuan, 56.9 billion yuan more than that during the same period last year, or up by 2.4 percent; compared with a year before, bank lending and corporate bonds grew by 136.4 billion yuan and 79.1 billion yuan respectively, or by 7.1 percent or 4.3-fold respectively, while government securities dropped by 159.6 billion yuan. The percentage of debt, equity, government securities, and corporate bonds in non-financial sector financing was 83.6 percent, 4.7 percent, 7.7 percent, and 4.0 percent respectively.

Table 3: Financing by Domestic Non-financial Sectors, Q1-Q3, 2005

	Total Financing (100 million yuan)		Percentage （%）	
	Q1-Q3, 2005	Q1-Q3, 2004	Q1-Q3, 2005	Q1-Q3, 2004
Funds raised by non-financial sectors	24,645	24,076	100.0	100.0
Bank loans	20,614	19,250	83.6	80.0
Stocks	1,159	1,149	4.7	4.8
Government securities	1,896	3,492	7.7	14.5
Corporate bonds	976	185	4.0	0.8

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

1. **Trading in the inter-bank market was brisk**

In the first 3 quarters of 2005, the turnover of bond repo in the inter-bank market grew by 4.66 trillion yuan over the same period of last year to 11.86 trillion yuan, averaging 63.1 billion yuan per day, a year-on-year growth of 65 percent; bond pledged turnover increased by 4.58 trillion yuan to 11.73 trillion yuan, with the daily average turnover increasing by 65 percent, while the turnover of outright bond repo totaled 137.1 billion yuan. The accumulated turnover of government securities repo on stock exchanges was 1.94 trillion yuan, down 43.5 percent from the corresponding period in

2004. Since last April, the monthly turnover of over-night bond pledged repo has surpassed that of 7-day repo.

In the first 3 quarters, inter-bank borrowing totaled 964.8 billion yuan, down by 181.7 billion compared with the same period last year, and the daily average turnover was down by 15.4 percent to 5.13 billion yuan. The bulk of inter-bank borrowing was short-term instruments, i.e., 7-day and over-night, accounting for 68.9 percent and 18.3 percent respectively. This was roughly the level in the corresponding period of 2004.

In the inter-bank market, the decline of interest rates reversed and liquidity abounded. As financial institutions generally need a large amount of funds in the run-up to Spring Festival, the monthly weighted average interest rate of bond pledged repo and inter-bank borrowing rose from 1.88 percent and 2.07 percent respectively in December 2004 to 2.05 percent and 2.31 percent respectively in February, and dropped to 1.7 percent and 1.98 percent respectively in March when liquidity became abundant again. The decline continued thereafter and reversed only in the third quarter when the bond pledged repo rate and inter-bank borrowing rate both rose by 0.05 percentage points from their June levels to 1.15 percent and 1.51 percent respectively in September.

With respect to fund flows in the market, state-owned commercial banks were still net fund providers for both bond pledged and sell-buy bond repo, whose net lending in the first three quarters amounted to 6.82 trillion yuan, 3.32 trillion yuan more than that in the same period last year, representing a growth rate of 94.9 percent. Other commercial banks,[9] other financial institutions,[10] and foreign financial institutions, as net recipients, borrowed 3.0413 trillion, 3.4260 trillion, and 356.8 billion yuan respectively, up by 36.8 percent, 1.7-fold, and 12-fold year-on-year. Among other financial institutions, insurance companies, securities firms and fund companies received, on a net basis, 610.3 billion yuan and 990.2 billion yuan respectively, about 3.7 times and 2.3 times their net borrowings last year.

As for inter-bank borrowing, state-owned commercial banks and other commercial banks supplied, on a net basis, 270.3 billion yuan and 309.2 billion yuan respectively, representing a decline of 107.1 billion yuan and an increase of 87.9 billion yuan respectively year-on-year. On the demand side, other financial institutions and foreign financial institutions received, on a net basis, 467.8 billion yuan and 111.8 billion yuan respectively. Fund flows into securities companies declined by 44.5 percent year-on-year.

Table 4: Fund Flows of Financial Institutions in the Inter-bank Market,

[9] Other commercial banks include joint-stock commercial banks and city commercial banks.
[10] Other financial institutions include policy banks, rural credit union cooperatives, finance companies, trust and investment companies, insurance companies, and securities firms and fund management companies.

Q1-Q3 2005

Unit: 100 million yuan

	Q1-Q3 2005	Q1-Q3 2004
State-owned commercial banks	-2,703	-3,774
Other commercial banks	-3,092	-2,213
Other financial institutions[11]	4,678	5,701
Of which: Securities firms	2,998	5,404
Foreign financial institutions	1,118	286

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

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

2. The bond market saw sound issuing activities and more variety of instruments

In the first three quarters, the accumulated turnover of spot transactions in the inter-bank bond market increased by 2.23 trillion yuan to 4.04 trillion yuan, while the daily average turnover soared by 1.3-fold to 21.5 billion yuan. The turnover of government bond spot transactions on the stock exchanges totaled 215.6 billion yuan, 6.7 billion yuan less year-on-year.

In the inter-bank spot market, state-owned commercial banks, as the net buyers, made a net purchase of 212.3 billion yuan, representing a growth of 20.4-fold year-on-year. Insurance companies, and securities firms and fund companies made a net sale of 37.5 billion yuan and 13.3 billion yuan respectively, 18.8 billion yuan and 26.3 billion yuan more than the same period last year.

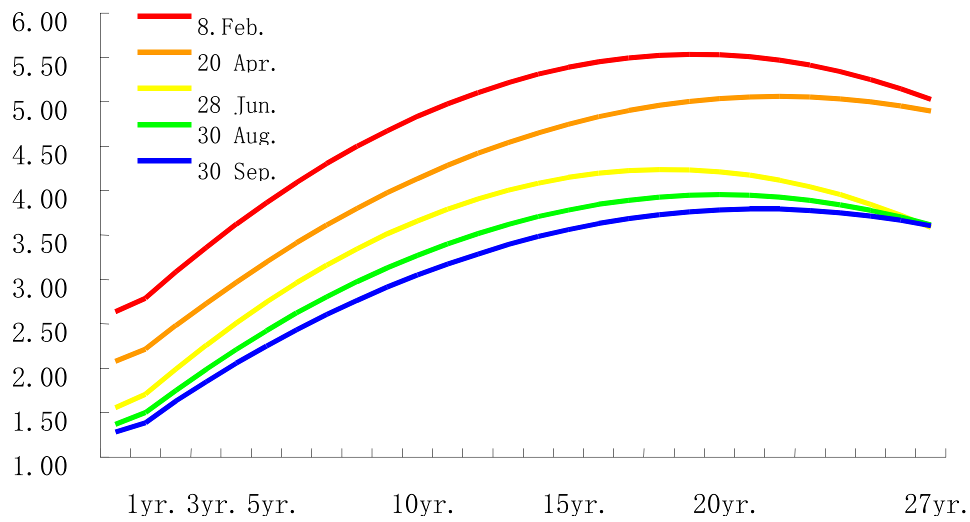
In the period under review, bond indices on the inter-bank market and stock exchanges moved upward. The bond index on the inter-bank market rose by 8.49 points, or 8.16 percent, from 104.02 points at the beginning of 2005 to 112.51 points at end- September, while the third quarter alone saw an increase of 1.88 points or 1.70 percent. The government securities index on the organized exchanges rallied by 13.01 points, or 13.60 percent, from 95.69 points at the beginning of 2005 to 108.70 points at end-September; growth in the third quarter was 3.36 points, or 3.19 percent.

In the period under review, the yield curve of government securities in the inter-bank market shifted downward steadily, as the rally in the bond market continued. With liquidity flowing into the market after the interest rate on the excess reserve ratio was slashed, bond prices surged while yield to maturity along the yield curve dropped. The bond market rally continued into the third quarter, albeit at a slower pace, and the

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

yield curve shifted downward by a smaller margin. In comparison, yield to maturity of longer maturity bonds dropped by a larger margin than that of short maturity bonds, causing the yield curve to become a little flatter.

Figure 3: Yield Curve of Government Securities in the Inter-bank Market in the First Three Quarters of 2005



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

Bond issuance was smooth and more variety of bonds was introduced into the market. In the first 9 months, a total of 479.1 billion yuan worth of government securities was issued, a year-on-year decrease of 70.3 billion yuan, or a decrease by 12.8 percent. Compared with same period of last year, new issues of bearer's treasury bonds decreased by 81.5 billion yuan to 150 billion yuan, while that of book-entry treasury bonds increased by 11.2 billion yuan to 329.1 billion yuan. A total of 401.4 billion yuan worth of policy financial bonds (subordinated debt of policy banks) was issued, 131.4 billion yuan more than that during the same period last year. A total of 100.6 billion yuan worth of corporate debt (including short-term bills) was issued, 82.1 billion yuan more than that during the same period last year; among the new issues, short-term financing bills of enterprises issued since May 2005 amounted to 54.2 billion yuan, medium and long-term corporate bonds reached 46.4 billion yuan, 2.5 times that of the same period in 2004, subordinated debt totaled 95.9 billion yuan, and short-term bills of securities firms totaled 2.9 billion yuan. In October, the International Finance Company and the Asian Development Bank issued a total of 2.13 billion yuan worth of RMB-denominated bonds in China.

The issuing rates of government securities and policy financial bonds displayed a declining trend. The issuing rate of 3-year and 5-year bearer's treasury bonds in the 4th issue (issued in the 3rd quarter) were 3.24 percent and 3.6 percent respectively, 0.13 and 0.21 percentage points lower than that of the same bonds with the same maturities in the first three issues (issued in the first half of 2005); the issuing rate of 7-year book-entry treasury bonds in the 7th issue (issued in the 3rd quarter) was 2.83 percent, 0.54 percentage points lower than that of the same bonds with the same maturities in the 5th issue (issued in the first half of 2005).

3. The commercial paper market developed rapidly under regulation

In the period under review, a total of 3.21 trillion yuan worth of bills was issued, a year-on-year growth of 31 percent; the accumulated amount of discount bills reached 4.74 trillion yuan, 41 percent more than that in the same period last year, while that of rediscount bills totaled 2.3 billion yuan, representing a year-on-year reduction of 18 billion yuan. At end-September, the outstanding balance of commercial paper stood at 2.07 trillion yuan, a year-on-year growth of 46 percent; the outstanding balance of discount bills reached 1.32 trillion yuan, a year-on-year growth of 38 percent; the outstanding balance of rediscount bills was 650 million yuan, 4.55 billion yuan less than that during the same period last year.

Among all financing methods, commercial paper has seen the highest growth rate. Since the beginning of 2005, the commercial paper market has developed rapidly under regulation,= and has played an increasingly important role as reflected in the following. First of all, commercial paper has become the most important source of enterprise short-term financing. Financing by commercial paper as a share of outstanding loans increased from 1.6 percent at end-2000 to 8 percent at end-September 2005. New issues of commercial paper as a share of new lending grew from 7.4 percent in 2000 to 20 percent in the first 3 quarters of 2005. The boom of commercial paper has helped improve the enterprises' financing structure, increased the share of direct financing, helped regulate market players, and built a credit culture in China. Second, commercial paper has become an important channel for commercial banks to adjust capital structure, manage liquidity, and enhance competitiveness. Third, it has become an important money market instrument, which is of great significance for improving market efficiency, enriching the variety of money market instruments, and deepening and speeding up money market development.

4. Enterprises borrowed more from overseas markets and securities investment funds enjoyed rapid growth

In the period under review, the accumulated turnover of the Shanghai and Shenzhen Stock Exchanges was 2.51 trillion yuan, 0.93 trillion yuan less than during the same period last year. The accumulated turnover of A shares stood at 2.46 trillion yuan, a reduction of 0.91 trillion yuan year-on-year; the daily turnover averaged 13.5 billion yuan, 27 percent less than that during the same period last year.

The Shanghai Stock Exchange Composite Index slid to 998 points in June after peaking at 1,329 points in February. Thereafter, it recovered amidst fluctuation and reached 1,156 points at end-September, 8.8 percent lower than that of end-September 2004. After plummeting to 2,591 points in June from a high of 3,481 points in March, the Shenzhen Stock Exchange Composite Index climbed to 2,903 points at end-September, 5.4 percent lower than that at end-2004.

In the period under review, a total of 115.9 billion yuan was raised in the equity market, 1 billion or 0.8 percent more than that in the same period last year. After the expansion in 2004, enterprise external financing further grew to an accumulated amount of US$9.98 billion in the first three quarters, US$4.14 billion or 70.9 percent more than that in the same period last year, accounting for 70.9 percent in total financing, a year-on-year growth of 28.7 percentage points. A total of 33.9 billion yuan was raised in the A share market, including IPOs, additional offerings, and rights issues.

Securities investment funds continued to grow, with 43 funds launched in the first three quarters. At end-September, the gross volume of securities investment funds reached 481 billion yuan and net assets totaled 475.5 billion yuan, representing a growth of 45.4 percent and 46.5 percent respectively over the level at year-end 2004.

5. The insurance industry grew quickly, with visible changes in the asset structure

In the first 3 quarters, the securities industry’s total premium income reached 377.9 billion yuan, a year-on-year growth of 13.1 percent. The accumulated premium income of persons insurance stood at 281.5 billion yuan, representing a year-on-year growth of 13.6 percent, 5.7 percentage points higher than that during the same period last year. The accumulated insurance claim payments grew by 12 percent year-on-year to 81.4 billion yuan. At end-September, assets of the insurance industry totaled 1.4378 trillion yuan, 27 percent more than that in the same period last year.

As the insurance market expanded, the insurance sector constantly endeavored to strengthen channels for fund use and management, and to improve efficiency. As a result, the amount of funds used continued to surge, in which a growing share was invested in treasury bonds and securities, while a smaller share was placed with banks. At end-September, deposits as a proportion of assets declined by 9.9 percentage points year-on-year to 34.7 percent, while treasury bonds and securities investments reached 23.2 percent and 7.4 percent respectively, 3.8 percentage points and 1.5 percentage points higher than that in the same period last year.

Table 5：Use of Insurance Funds at end-September 2005

	Outstanding balance (100 million yuan)		Share of total assets （ percent）	
	End Sept., 2005	End Sept., 2004	End Sept., 2005	End Sept., 2004
Total assets	14,3387	11,379		
In which: Bank deposits	4,994	4,972	34.7	43.7
Government securities	3,340	2,207	52.6	42.0
Securities investment funds	1,062	667	24.0	16.7

Note: Coverage of use of funds as redefined by the China Insurance Regulatory Commission in 2005.

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

6. The foreign exchange market remained stable

After the reform of the RMB exchange rate regime, the RMB to dollar exchange rate on the inter-bank market was basically stable. On May 18, a spot transaction was launched for 8 pairs of foreign currencies (i.e., euro vs. US dollar, Australian dollar vs. US dollar, pound sterling vs. US dollar, US dollar vs. Swiss franc, US dollar vs. Hong Kong dollar, US dollar vs. Canadian dollar, US dollar vs. Japanese yen, euro vs. Japanese yen). At end-September, the combined turnover of transactions of all 8-currency pairs reached US$29 billion.

Box 3: The RMB Forward Market

With the reform of the managed floating exchange rate regime based on market supply and demand on July 21, 2005, enterprises were urged to enhance risk awareness and avoid exchange rate risk by using foreign exchange derivatives. This has created demand for foreign exchange derivatives. At the same time, the development of such a market will help improve the foreign exchange market system in China, deepen and broaden the foreign exchange market, strengthen the fundamental role that the market plays in determining the exchange rate, and guarantee and promote the smooth functioning of the new exchange rate regime. In order to foster positive interactions between the exchange rate regime and foreign exchange market development, the People's Bank of China, through the *Notice of the People's Bank on Expansion of Designated Foreign Exchange Banks' Forward Sale and Purchase of Foreign Exchange Business and the Launch of Swaps between RMB and Foreign Currencies* (PBC Document No. 201 [2005]) and the *Notice of the People's Bank of China on Accelerating the Development of the Foreign Exchange Market* (PBC Document No. 202 [2005]), expanded the base of service providers for forward sale and purchase of foreign exchange business, and launched inter-bank RMB forward transactions, thus initiating the sequenced and coordinated development of the RMB forward market, including an over-the-counter retail market and an inter-bank wholesale market.

As important exchange rate risk management instruments, RMB forward transactions are transactions where two parties have agreed to exchange, at a future date, a certain amount of RMB for an agreed currency at a specified exchange rate. Following the market and standardized principle, and drawing on international experience, the People's Bank of China has established an institutional framework for RMB forward market development. With regard to market access, a registration system was established to simplify entry formalities for market players and to allow financial institutions with derivative transaction qualifications to enter the market; the internationally accepted quoting system was introduced into the market for the two parties to negotiate their transaction; both clearance by full amount at due date and netting amount are allowed for the two parties of a transaction to decide on their own; with regard to risk control, both parties of a transaction are to take risks by signing a forward agreement that clearly defines rights and obligations of each party, and are allowed to agree on a certain amount of margins.

The inter-bank RMB forward market started operations on August 15, 2005. By the end of October, membership had grown from 3 to 54, including major categories of banks, such as state-owned commercial banks, joint stock commercial banks, policy banks, and branches of foreign banks. Along with membership expansion and a better understanding of forward transactions, quoting and transactions on the market have become more brisk.

According to interest rate parity, the price on the RMB forward market is determined by four factors, the spot exchange rate, the interest rate on the foreign money market, the interest rate on the domestic money market, as well as the exchange rate expectation. When the RMB forward position can be hedged on the spot foreign exchange market, the hedged interest rate parity holds, and the premium (discount) of the forward RMB exchange rate equals the interest rate spread of the same maturity between the RMB and the foreign currency. At present, the forward position cannot be hedged on the spot foreign exchange market, and the inter-bank RMB forward market is priced similar to the overseas NDF market, reflecting the participants' expectation of the future exchange rate. However, the overseas NDF market meets the speculative demand of overseas participants whereas the transactions on the inter-bank RMB forward market are usually linked to trade activities and aimed at exchange rate management, featuring stable demand and supply and imposing a strong influence on prices. Therefore, arbitrage activities by participants in the two markets will help the NDF price gradually to move closer to the domestic inter-bank forward price.

Price movements on the domestic inter-bank RMB forward market and overseas NDF market since August 15 have shown that the members of the inter-bank market failed to adjust in a timely manner their appreciation expectations immediately after the exchange rate regime reform. The operation of the new exchange rate regime and the basic stability as well as the normal fluctuation of the spot exchange rate have gradually rationalized the market players' expectations and boosted confidence in a stable RMB exchange rate. As a result, the inter-bank RMB forward price became more competitive and helped narrow the quote difference among NDF markets, further easing the RMB appreciation expectation on the international financial market.

Before the launching of the domestic inter-bank forward market, the 1-year forward contract premium on the NDF market peaked at 1 dollar for 7.7100 yuan on July 22, reflecting a 4.9 percent appreciation of the RMB one year thereafter. As a result of the establishment of the inter-bank forward market, the 1-year NDF forward rate depreciated to 1 dollar for 7.7920 yuan at end-October, reflecting an adjusted expectation of appreciation by 3.6 percent, while the 1-year forward rate on the domestic inter-bank market was 1 dollar for 7.7950 yuan.

II. Financial market institutional building

1. Promote the development of the money market and bond market

Ever since the beginning of this year, the People's Bank of China has endeavored to promote money market and bond market development, expand financing channels, and optimize assets structure through financial product innovation. In the third quarter, the issue of enterprise short-term financial bills took on a larger scale. The Pudong Development Bank successfully issued financial bonds on the inter-bank bond market, the first ever by a commercial bank. Forward transactions on the bond market remained stable, while pilot credit assets securitization progressed steadily. The bond market has further opened up and RMB-denominated bond issuing by international development agencies on the domestic market has proceeded smoothly. Infrastructure building in the financial market further improved and the 3 approved commercial banks in the first pilot project have already jointly incorporated fund management companies with overseas institutions.

Box 4: Incorporation of Fund Management Companies by Commercial Banks

A pilot project to allow commercial banks to incorporate fund management companies was an important measure to implement the *State Council Opinions on Promoting Reform, Opening-up, and Development of the Capital Market*.

The People's Bank of China, China Banking Regulatory Commission, and China Securities Regulatory Commission jointly issued *Administrative Rules for Pilot Incorporation of Fund Management Companies by Commercial Banks* (People's Bank of China, China Banking Regulatory Commission and China Securities Regulatory Commission Public Announcement No. 4 [2005]) on February 20, 2005, allowing commercial banks to incorporate fund management companies and providing regulations for possible connected trading and cross-market risks resulting from commercial banks as fund management companies' shareholders, especially a mechanism to separate banking and fund management businesses and a division of labor among the three regulatory agencies.

On March 21, upon the approval by the State Council, the People's Bank of China, China Banking Regulatory Commission, and China Securities Regulatory Commission chose the Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB), and the Bank of Communications as the pilot banks on the principle of following strict standards, gaining experience by piloting, and spreading the experience prudently. Thus, the pilot project started in full scale. The People's Bank of China, China Banking Regulatory Commission, and the China Securities Regulatory Commission set up a coordinating mechanism to enhance communication with the three banks and formulated and publicized timetables for the three banks in an effort to promote the smooth progress of the pilot project.

On June 21, the ICBC Credit Suisse Asset Management Co. jointly incorporated by the Industrial and Commercial Bank of China, the Credit Suisse First Boston and the China Ocean Shipping (Group) Company, was officially opened for business. On July 26, its first fund product, the ICBC Credit Suisse Core Value Equity Fund, was launched on the market. By the end of the subscription period on August 26, a total of 4.357 billion yuan was raised. Among the total, individual investors subscribed 3.38 billion yuan, accounting for 77.58 percent of the total subscription. A total of 145,048 accounts were opened and individual investors, averaging 30,000 yuan per account, opened 98.9 percent of the accounts.

On August 12, the Bank of Communications Schroders Fund Management Co., incorporated by the Bank of Communications, Schroders, and China International Marine Containers Group (CIMC), was officially opened for business. On August 26, Bo Com. Schroders Core Equity Fund was launched and by September 26, when its subscription period ended, had raised a total of 4.893 billion yuan. Individual investors subscribed 2.936 billion yuan, accounting for 60 percent; a total of 114,661 accounts were opened, with 98.1 percent opened by individual customers, averaging 42,700 yuan per account.

On September 28, the CCB Principal Asset Management Co., a joint venture of the China Construction Bank, Principal, and China Huadian Corporation, started operations. Its first fund product was made available to investors on November 7.

The market warmly received the two fund products offered by the fund management companies incorporated by commercial banks. The practice of commercial banks establishing fund management companies has boosted investor confidence, promoted a balanced development of the capital market and the money market, and helped deepen commercial bank reform, with a view to increasing international competitiveness.

2. Further develop the foreign exchange market

The People's Bank of China initiated a series of measures to support the implementation of the exchange rate regime reform and the smooth functioning of the new regime. As the first step, on August 2, it issued the *Notice on Issues Regarding Expanding Designated Banks' Forward Sale and Purchase of Foreign Exchange Business to Customers and Launching RMB Swaps Against Foreign Currencies*, to include more banks in the foreign exchange forward sale and purchase market, to adopt a registration system for market access, to allow banks to quote in light of their own business and risk management capacity, to ease the restrictions on transaction terms, and to expand the coverage of transactions. The Notice has also allowed banks to provide RMB swaps against foreign currencies where no interest rate swap is involved. The second measure was the issuance of the *Notice of the People's Bank of China on Accelerating the Development of the Foreign Exchange Market* on August 8, which included more banks on the inter-bank foreign exchange spot market, allowed qualified non-financial businesses and non-bank financial institutions access to the inter-bank foreign exchange spot market, diversified the trading modes on the inter-bank market, introduced quoting to lay the ground for tailored and diversified derivative transactions, and increased the variety of products. The adoption of these policies helps domestic economic entities manage exchange rate risks, and enables the inter-bank foreign exchange market to play a fundamental role in resource allocation.

3. Prudently carry out non-tradable state share reform

After the State Council laid down the basic principles for non-tradable state share reform in its *Opinions on Promoting Reform, Opening-up, and Stable Development of the Capital Market*, i.e., the principle of respecting the law of the market, conducive to market stability and development, and protecting the legitimate rights and interests of investors, especially individual investors, the relevant agencies moved to carry out non-tradable state share reform step by step, proceeding with pilot projects before a coordinated spreading of the reform measures. On April 29, 2005, the China Securities Regulatory Commission issued, upon State Council approval, *Notice on Issues Relating to Reform of Non-Tradable State Shares of Public Companies*, thus launching the pilot reform. By August 19, a total of 46 pilot companies approved in two batches had completed the required reform procedures, and the pilot reform had been concluded. The market accepted the operational principles and practice of the pilot reform while the policy expectations and market expectations stabilized incrementally. As the basic conditions for wider reform were already there, the China Securities Regulatory Commission, the State-owned Asset Supervision and Administration Commission, the Ministry of Finance, the People's Bank of China, and the Ministry of Commerce jointly issued *Guidelines on Non-Tradable State Share Reform of Listed Companies* on August 23, to sum up the experience of the pilot projects and to refine the pilot institutional arrangements to cope with the complex issues that further reform might trigger. Later on, the China Securities Regulatory Commission, Shanghai and Shenzhen Stock Exchanges, and China Securities Depository Trust and Clearing Co. Ltd. issued supporting regulations, such as the *Administrative Rules for Non-tradable State Share Reform of Listed Companies*, *Operational Guidelines for Pilot Projects of Reforming Non-tradable State Shares of Listed Companies*, and *Guidelines for Sponsoring in Reform of Non-tradable State Shares of Listed Companies*. Beginning from September 9, the state share reform was introduced to the community of listed companies, and one batch of companies was approved each week. By end-September 2005, 45 listed companies had completed the state share reform, while another 99 companies had started the reform procedures.

4. Expand the avenues for insurance fund investment

With the rapid expansion of the insurance industry, insurance institutions, holding a large amount of long-term funds, have become important institutional investors. In order to guide insurance institutions to expand securities investment, improve asset quality, and optimize asset structure under the prerequisite of effective risk prevention, the China Insurance Regulatory Commission issued the *Provisional Rules on Securities Investment Management by Insurance Institutional Investors* on August 21, 2005. The implementation of the Provisional Rules will promote the transformation of the insurance fund investment structure, further securities insurance investment, and enhance the core competitiveness of such investment.

In recent years, foreign exchange assets have become an important part of insurance assets, due to the rapid and sound growth of the domestic insurance market. In order to add to the avenues of insurance fund investment, the China Insurance Regulatory Commission issued, on September 11, 2005, *Implementation By-Laws for Provisional Rules of Overseas Investment of Foreign Exchange Funds of the Insurance Industry*, which were issued in 2004. This kicked off actual overseas investment of foreign exchange funds by the insurance industry. This institutional development helps insurance fund investment become international, professional, market-based, and regulated, and provides effective risk prevention.

Part Four Analysis of Macroeconomic Developments

I. The global economic and financial situation and forecast for 2005

In the third quarter of 2005, the global economy grew steadily. Afflicted by the hurricanes, the US economy slowed down compared with the previous quarter but still maintained its strong momentum of growth. The economies in the euro zone continued to recover slowly but with heightened pressures of inflation. The Japanese economy saw a gradual and clear recovery and the consumer price index was expected to emerge from the negative side. The Latin American and Asian emerging economies generally maintained robust growth. Rising oil prices and trade protectionism constituted major risks for global economic growth. The International Monetary Fund (IMF) forecast in September 2005 that global economic growth would reach 4.3 percent, 0.8 percentage points lower than that in 2004. Whereas the forecast remained the same as that in April 2005, it adjusted the composition of the contributions, with slightly lower growth forecast in the developed economies and consequently higher growth forecast in the emerging markets and developing economies.

1. Economic development of the major economies

The US economy continued to maintain strong growth momentum. In the first three quarters, the annualized quarterly GDP growth rates posted 3.8 percent, 3.3 percent, and 3.8 percent respectively. US employment further improved. The annualized unemployment rates were 5.0 percent, 4.9 percent, and 5.1 percent respectively in the 3 months of the third quarter of 2005, averaging 5 percent, lower than the rates of 5.3 percent and 5.1 percent recorded respectively in the first and second quarters. Inflationary pressures built up. The consumer price index (CPI) registered 3.2 percent, 3.6 percent, and 4.7 percent respectively on a year-on-year basis in July, August, and September, averaging 3.8 percent for the whole quarter, 0.9 percentage points higher than the figure recorded in the second quarter. US foreign trade deficits increased further, amounting to US$463.37 billion in the first eight months and increasing by US$66.95 billion over the same period of the previous year.

The economies in the euro zone continued to recover slowly. In the first and second quarters, GDP grew by 1.3 percent and 1.1 percent respectively on a year-on-year basis. The unemployment rate in the euro zone dropped, registering 8.5 percent and 8.6 percent respectively in July and August, after reaching a high level of 8.8 percent and 8.7 percent respectively in the first and second quarters. Against the backdrop of rising oil prices, inflationary pressures built up. The Harmonized Index of Consumer Prices (HICP) was 2 percent in both the first two quarters. The HICP posted 2.2 percent, 2.2 percent, and 2.6 percent respectively in July, August, and September, averaging 2.3 percent, higher than the figures recorded in the previous two quarters. The quantitative definition for price stability by the European Central Bank is that the year-on-year increase of the HICP be less than 2 percent.

The Japanese economy witnessed a gradual and clear recovery. In the first and second quarters, GDP grew by 1.3 percent and 2.1 percent over the same period of the previous year. The labor market improved further. The annualized unemployment rate posted 4.6 percent, 4.4 percent, and 4.3 percent respectively in the first three quarters. In particular, unemployment in September was only 4.2 percent, a low level since 1999. The CPI was expected to shake off the negative growth. The quarterly CPI registered -0.2 percent, -0.1 percent, and –0.3 percent respectively on a year-on-year basis in the first three quarters. Excluding fresh food, the CPI posted -0.3 percent, -0.1 percent, and -0.1 percent respectively. The Bank of Japan forecast that the CPI excluding fresh food would reach zero or higher in the 2005 financial year (from April 2005 to March 2006) and it would register a positive figure in the 2006 financial year.

The major developing economies continued to grow. The Asian region maintains the fastest economic growth worldwide. Russia, Latin America, and some nations of Africa benefited from the rising prices of primary commodities, with their economies maintaining rapid growth.

2. Developments in international financial markets

Since the start of 2005, in general the US dollar has been on the rise. At end-September, the euro closed against the US dollar at US$1.213, with the dollar strengthened by 11.7 percent over end-2004. The US dollar ended against the yen at JPY111.919, with the dollar strengthened by 10.4 percent over end-2004. The "twin deficits" of the US, however, were not yet eased and the US dollar is still likely to depreciate.

Yields of long-term government bonds in major economies dropped. Afflicted by the hurricanes, the market lowered the forecast for US economic growth, and consequently the yields of US treasury bonds declined. In the beginning of September, the yield of 10-year US treasury bonds was as low as 4.033 percent. The market, however, quickly came to the perception that the impact of the hurricanes on the US economy was temporary and controllable, hence the yields bounced back. At end-September, the yield of 10-year US treasury bonds increased to 4.326 percent. The yield of 10-year Japanese government bonds climbed as well, from an average of 1.28 percent in the second quarter to 1.36 percent in the third quarter, mainly because the market expected that the Japanese economy would achieve a higher growth rate and the policy of the zero interest rate was expected to come to a close. The yields of bonds in the euro zone generally remained stable, with the yield of 10-year government bonds registering 3.26 percent in the third quarter.

The stock markets of the major economies rose to varying degrees. At the end of the third quarter, the Dow Jones Industrial Average closed slightly up, by 0.27 percent over the end of the second quarter. The Financial Times Stock Exchange 100 Index and the Nikkei 225 Stock Average ended up 6.76 percent and 14.5 percent respectively. Energy stocks surged, taking advantage of the rising oil prices.

3. Monetary policies of the major economies

The Federal Open Market Committee (FOMC) raised the federal-funds target rate to 4 percent by increments of 25 basis points respectively on August 9, September 20, and November 1, with the Fed raising the interest rate 12 successive times since June 2004. At all its meetings from June 2003 to the present, the Governing Council of the European Central Bank decided to keep the interest rates unchanged, i.e., the interest rates of deposit facilities, main refinancing operations, and lending facilities remained at 1 percent, 2 percent, and 3 percent respectively. The Bank of Japan (BOJ) decided to maintain the upper limit of the total current account balance held with the BOJ by commercial banks at JPY30-35 trillion in order to ensure sufficient liquidity in the market. The Bank of England decided on August 4 to lower the official interest rate by 25 basis points from the original 4.75 percent to 4.5 percent, the first cut after lifting the rate four times in 2004.

II. Analysis of China’s macroeconomic movements

Since the start of 2005, all localities and departments have earnestly implemented the policies of the CPC Central Committee, built on the achievements of the macroeconomic adjustment, promoted the economic restructuring and the change of the growth mode, maintained stable and rapid growth of the national economy and the broad stability of prices. Urban and rural household income, profits of enterprises, and fiscal revenue increased by a large margin. In terms of current economic performance, there are still some problems such as a larger-than-desired size of fixed-asset investment, an aggravation of the contradiction from the imbalance of exports and imports, and an irrational export structure. In the first three quarters, the GDP posted 10.6 trillion yuan, increasing by 9.4 percent, which was 0.1 percentage points lower than that in the same period in the previous year. The CPI rose by 2.0 percent, 2.1 percentage points lower than that recorded in the same period of last year. The trade surplus registered US$68.3 billion, 64.4 billion more than that recorded in the same period of the previous year.

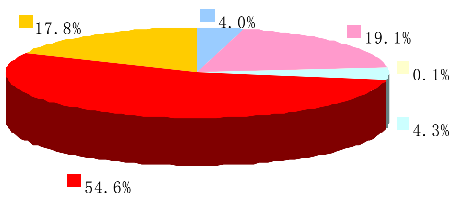
1. Consumption demand grew rapidly, the growth of investment demand accelerated with each passing quarter

Household income and consumption grew rapidly. In the first three quarters of 2005, the per capita disposable income of urban residents stood at 7, 902 yuan, representing an inflation-adjusted real growth of 9.8 percent and an acceleration of 2.8 percentage points over the same period of the previous year. The per capita cash earnings by farmers came to 2,450 yuan, representing a real growth of 11.5 percent and an acceleration of 0.1 percentage points. In the first three quarters, the total volume of urban retail sales was 4.5 trillion yuan, representing a nominal growth of

13.0 percent, an inflation-adjusted real growth of 12.1 percent, and an acceleration of 2.4 percentage points over the same period of the preceding year.

The growth of investment demand accelerated with each passing quarter, with the investment size still larger than desired. In the first three quarters, total fixed-asset investment posted 5.7 trillion yuan, representing a growth of 26.1 percent, a deceleration of 1.6 percentage points over that recorded in the previous year and an acceleration of 3.3 and 0.7 percentage points respectively over that in the first quarter and the first half of the year. Urban fixed-asset investment accounted for 4.9 trillion yuan, up 27.7 percent on a year-on-year basis. In terms of projects under construction, by end-September, the total investment planned for projects under construction amounted to 15.2 trillion yuan, up 27.9 percent on a year-on-year basis. In terms of funds availability, investment funds available amounted to 5.4 trillion yuan, representing a growth of 27.2 percent and a supply of ample funds. Generally, against the backdrop of the larger-than-desired size and the quite high base amount of fixed-asset investment in 2004, the growth of urban fixed-asset investment in the first three quarters remained higher than 24 percent and was accelerating with each passing quarter, and the growth of the total planned investment and the funds available for the projects under construction remained at the same high level. All the above indicated that the pressures of investment rebounding still remained high and risks of stronger-than-desired investment still persisted.

Figure 4: Fund Availability for Fixed-asset Investment in the First Three Quarters of 2005



The budgetary funds: YOY growth 21.1 percent
Domestic loans: YOY growth 15.2 percent
Bonds: YOY decrease 16.4 percent
Utilization of foreign funds: YOY growth 26.9 percent
Independently raised funds: YOY growth 36.4 percent
Other funds: YOY growth 17.9 percent

Note: Of the independently raised funds, equity funds or the capital of enterprises and institutions accounted for 67 percent, up 40 percent on a year-on-year basis.
Source: The National Bureau of Statistics (NBS).

The trade surplus contracted in September following surges in July and August. In the first three quarters of 2005, exports and imports totaled more than US$1 trillion, increasing by 23.7 percent, with the growth rate down by 13 percentage points on a year-on-year basis. In particular, exports posted US$546.42 billion, up 31.3 percent; imports registered US$478.08 billion, up 16.0 percent. The trade surplus reached US$68.34 billion, compared with US$3.9 billion in the same period of last year. In the third quarter, the trade surplus posted US$10.55 billion and US$10.59 billion respectively in July and August and then decreased to US$7.56 billion in September mainly because imports increased in September, in particular, imports surged for machinery, electronics, and high-tech products. At present, a prominent problem in foreign trade lies in the fact that exports of highly energy-consuming resource commodities grow faster than desired, which not only heightens pressures on energy resources, and the environment at home but also intensifies the foreign trade frictions. In the first three quarters, contracted FDI posted US$130.3 billion, up 21.8 percent over the same period of last year; actual utilization of FDI registered US$43.2 billion, down 2.1 percent.

2. The growth of the primary and tertiary industries decelerated, while the growth of the secondary industries accelerated

In the first three quarters, the value-added of the primary industries posted 1.3 trillion yuan, growing by 5.0 percent and decelerating by 0.5 percentage points over the same period of last year; that of the secondary industries registered 6.0 trillion yuan, growing by 11.1 percent and accelerating by 0.2 percentage points; that of the tertiary industries reached 3.2 trillion yuan, increasing by 8.1 percent and with the growth rate decelerating by 0.4 percentage points. In terms of the composition of GDP, the proportions of the three industries were 12.7:56.9:30.4.

The situation for agricultural production was good, but the agricultural foundation has yet to be strengthened. The total output of summer grain reached 106.3 million tons, up 5.1 percent on a year-on-year basis. The total output of early rice posted 31.8 million tons, down 1.3 percent. The growing areas of late rice and corn increased and output was likely to increase. Grain production will achieve another bumper harvest in 2005. Animal husbandry and fishery witnessed a good momentum of growth. In the first three quarters, the total output of pork, beef, mutton, and poultry grew 6.7 percent and that of aquatic products rose by 3.9 percent on a year-on-year basis. Since the start of 2005, however, increases in the prices of agricultural produce have all along been lower than the increases in the prices of agricultural production materials, which will have an adverse impact on the growth of farmers' incomes and the development of agricultural production. In the first three quarters, the production prices of agricultural products (i.e., prices at which producers of agricultural products directly sell their products) increased by 3.7 percent over the same period of 2004, and the production prices of grain decreased by 0.1 percent, while the prices of agricultural production materials surged by 9.5 percent.

Industrial production grew steadily; enterprise returns were generally good. In the first three quarters, statistically large industrial enterprises realized industrial value-added of 5.0 trillion yuan, representing a year-on-year growth of 16.3 percent, a deceleration of 0.7 percentage points from the same period of the previous year or a deceleration of 0.1 percentage points from the first half of this year. Production and sales were still well matched. The ratio of sales to production for industrial products stood at 97.86 percent, flat with that in the same period of last year. Due to various factors, returns apparently differed from industry to industry. Upstream industries enjoyed surging profits while downstream industries witnessed a decelerating growth of profits or even suffered losses. Generally, enterprise returns were good. In the first three quarters, statistically large industrial enterprises realized profits of 988.3 billion yuan, up 20.1 percent over the high base figure in the same period of 2004, representing an acceleration of 1.6 percentage points over that recorded in the first half-year.

The 2005 Third Quarter Survey on Economic Activities by the PBC indicated that the satisfaction of entrepreneurs with the current macroeconomic environment was high and the performance of enterprises was good. Since the second quarter of 2004, the number of those claiming the macroeconomic environment was “normal” have continued to increase to a record-high of 85.19 percent in the third quarter. The enterprise performance index in the third quarter was 23.38 percent, a record-high level since 1993, 3.69 percentage points higher than that in the second quarter and 5.94 percentage points higher than that in the first half of this year.

3. The year-on-year rise of various prices decelerated steadily, yet inflationary pressures still persisted

The year-on-year rise of the CPI continued to decelerate steadily. In the first three quarters, the CPI grew 2.0 percent on a year-on-year basis, with the quarterly rises of the CPI registering 2.8 percent, 1.7 percent, and 1.3 percent respectively. In terms of segmentation, the rise in food prices decreased the effect on the CPI, while the rise in non-food prices increased the effect on the CPI. In the first three quarters, food prices rose by 3.3 percent, accounting for 1.1 percentage points in the increase of the CPI and representing a contribution of 58 percent, 7 percentage points lower than that recorded in the first half-year. Non-food prices rose by 1.3 percent, accounting for 0.8 percentage points in the hike in the CPI and representing a contribution of 43 percent, 7 percentage points higher than that recorded in the first half-year. As for non-foods, prices of energy such as oil surged by 12.2 percent, accounting for 0.2 percentage points in the rise of the CPI. In particular, the prices of gasoline, diesel oil, and liquefied petroleum gas soared by 15.1 percent, 14.6 percent, and 16.6 percent respectively. Excluding food and energy, the CPI rose by 1 percent. From the perspective of consumer goods and services, the rise in the prices of services has always been greater than the rise in the prices of consumer goods and has continued to accelerate since November 2004, which merits attention. In the first three quarters of 2005, service prices grew by 3.5 percent and consumer prices increased by 1.5 percent. Generally, the rise in the CPI decelerated mainly because food, in particular, grain, witnessed a deceleration in the rise of prices. Although prices of oil and its related products soared, energy such as oil accounted for only 1.2 percent of the CPI, and its impact on the CPI was marginal.

The increase in the Producer Price Index (PPI) decelerated further but still remained at a high level. In the first three quarters, the purchasing price index for industrial raw materials, fuels, and power increased by 9.2 percent and decelerated by 1.2 percentage points over the preceding year. In particular, the PPI for fuels and power and the PPI for non-ferrous metal materials rose by 15.8 percent and 13.5 percent respectively in September over the preceding year. The factory prices of industrial products increased in cumulative terms by 5.4 percent and decelerated by 0.1 percentage points over the same period of last year. In particular, crude oil prices soared by 33.2 percent, gasoline prices by 27 percent, diesel oil prices by 22.3 percent, kerosene prices by 21.4 percent, and crude coal prices by 21.8 percent in September over the same period of the previous year. The rise in the prices of various steel products ranged from 0 percent to 5 percent while the rise in the prices of copper, aluminum, lead, zinc, and nickel ranged from 2.5 percent to 20 percent. In the first three quarters, the differential between the rise in the purchasing prices for industrial raw materials, fuels, and power and the rise in the factory prices for industrial products stood at 3.8 percent, representing a deceleration of 0.3 and 1.5 percentage points respectively over the same period of the previous year, which indicated that pressures had eased for enterprises to absorb the rise in prices of upstream products.

Prices of both imports and exports tended to decline. In the first three quarters, the quarterly rises in the customs' prices of exports posted 7.6 percent, 2.6 percent, and 2.5 percent respectively, while the quarterly rises in the customs' prices of imports rose by 10.1 percent, 6.2 percent, and -0.9 percent respectively. In the third quarter, the rise in the prices of imports was lower than the rise in the prices of exports, and trade terms improved markedly.

The rise in real compensation accelerated. In the first three quarters, the cumulative amount of compensation for employees in urban units increased by 14.8 percent on a year-on-year basis, accelerating by 0.2 percentage points over the first half-year, while the average compensation increased by 13.4 percent, accelerating by 0.2 percentage points.

The GDP deflator decreased over the same period of the previous year. In the first three quarters, the nominal GDP growth rate was 13.7 percent, while the real GDP growth rate was 9.4 percent. Their differential reached 4.3 percent, 1.2 percentage points lower than that in the first half-year or 2.5 percentage points lower than that in the same period of last year.

The year-on-year rise in various prices decelerated steadily; however, the satisfaction of urban households with the current price levels declined with each passing quarter and their expectations of inflation were strong. The 2005 Third Quarter Survey on Urban Household Savings indicated that the households' satisfaction index for current price levels was -12.5, 1.4 points lower than in the second quarter. In particular, 25.1 percent of the surveyed households considered the current price levels "rather high and not acceptable," up 0.8 percentage points over the last quarter; 12.6 percent claimed the current price levels to be "satisfactory," down 0.6 percentage points from the second quarter.

It is noteworthy that there are some differences between the CPI in Chinese statistics and the real inflation level. First, in current Chinese statistics for the CPI, the weights of services and resource commodities are too low to properly reflect the changes in their prices. Second, the prices of public utilities and services like water, electricity, gas, and transportation are controlled, and their scarcities are not reflected in their prices. Since the start of this year, due to soaring crude oil prices in the international market, the prices of refined oil products have been on the rise. Besides, under the heightened pressures of costs, all localities have successively raised the prices of water and electricity, and so forth. All of the above has exerted an extensive impact on the residents' life. Due to the small weights assigned to these items in the CPI statistics, however, their impact on the CPI is marginal, even though each and every item has witnessed surging prices. Furthermore, due to price controls, the supply of some products fell short in some localities, such as "oil shortages," electric outages, and so forth.

Box 5: The Influence of Rising International Crude Oil Prices on China's Economy

In recent years, international oil prices have been on the rise, repeating one record-high after another. Take the prices of New York crude oil futures for example. The West Texas Intermediate (WTI) price increased by 250 percent from around US$19 per barrel at end-2001 to around US$69 per barrel on August 30, 2005. On August 29, 2005, the price reached over US$70 per barrel during the trading session, with the nominal price at a record-high level. Corresponding with the soaring crude oil prices, the prices of finished oil products in the international market surged by a large margin as well.

Due to China's pricing mechanism for refined oil products, soaring crude oil prices in the international market did not lead to a corresponding surge in the prices of finished oil products in China. The subsequent phenomenon whereby crude oil prices were higher than the prices of refined oil products exerted an adverse impact on the national economy. At present, the prices of refined oil products are based on the weighted average of a basket of prices in the markets of New York, Rotterdam, and Singapore (i.e., the central price), allowing the oil companies a fluctuation margin of 8 percent around the central price. In practice, in order to minimize the impact of fluctuations of international oil prices on domestic oil prices and on the domestic economy, only when changes in the oil prices in the three above-mentioned markets exceed a definite level will the central price be adjusted, with a time-lag of at least around one month. Therefore, the movements of the prices of refined oil products often diverge from the international trend, especially when the prices of crude oil and refined oil products are both on the rise. Since the start of 2005, the domestic crude oil price has been brought in line with the international crude oil price movements and has been continuously on the rise, while the domestic price of refined oil products has not been so adjusted and is relatively lower, resulting in the price of domestic crude oil being higher than the price of refined oil products. Upstream oil exploration companies earned surging profits, while downstream refineries suffered more and more losses as the government strictly regulated the domestic prices of refined oil products and they were still far lower than the international average prices after several small hikes. The refineries in some areas chose to suspend or even to cut production in order to prevent big losses. Meanwhile, lower-than-desired prices of refined oil products rendered the price leverage unable to play its proper role in adjusting oil demand and supply. The fundamental role of the market in allocating oil resources malfunctioned, which not only was detrimental to the frugal use of oil, but also gave rise to rampant speculative demand. The situation in turn worsened the oil supply and “oil shortages” even emerged in some regions.

In view of the various problems caused by the current oil-pricing mechanism, it is imperative to speed up the market-oriented reform of the oil price discovery mechanism in order to straighten up the oil price system. The Nationla Development and Reform Commission (NDRC) has stated that China will uphold the orientation and principle of bringing the domestic oil price in line with the international oil price, will institute an oil price discovery mechanism that not only reflects the movements of oil prices in the international markets but also takes into account factors like domestic oil demand and supply, oil production costs, and the adaptability of relevant parties in the society, and that China shall establish a mechanism to reasonably adjust the interests among the upstream enterprises and the downstream enterprises, a price coordination mechanism among related industries, and a mechanism for properly subsidizing some weak industries and groups. In addition, we shall institute a system of relevant supporting policies as follows: improve the system of relevant laws and regulations related to the markets, improve the administration and supervision system, develop policies and measures to encourage non-state-owned capital to invest in the oil industry, step up construction of a modern oil market system, especially standardizing the oil spot market and making good use of the oil futures market.

4. Fiscal revenues and expenditures were in a good position

Fiscal revenue grew steadily and rapidly. In the first three quarters, fiscal revenue was

2.4 trillion yuan, representing a growth of 16.7 percent, a deceleration of 9.5 percentage points over the same period of last year or an acceleration of 2.1 percentage points over the first half of this year. Fiscal expenditures posted 2 trillion yuan, representing a growth of 16.4 percent, an acceleration of 4.1 percentage points over the same period of last year or an acceleration of 1.4 percentage points over the first half of this year. Netting revenue and expenditure, the result was a fiscal surplus of 381.8 billion yuan.

5. Industrial analysis

In the first three quarters, the major industries performed well. In terms of realized value-added, production in the processing and manufacturing industries grew rapidly. In particular, ferrous and non-ferrous metal smelting and pressing, textiles, garments, footwear and headwear, general equipment, communications equipment, and computers and other electronic products saw growth rates of value-added ranging from 18.7 percent to 26.9 percent. In terms of realized profits, the profit margin (i.e., the ratio of profits over average costs) of the mining industries surged, with that at end-August increasing by 8.5 percentage points on a year-on-year basis. The profit margin of the processing and manufacturing industries decreased by 0.5 percentage points. Of the 39 industries, 17 saw increasing or flat profit margins, while 22 witnessed decreasing profit margins to some extent. In the first three quarters, the top-five industries with the highest profits were oil exploration, coal, iron and steel, chemicals, and textiles. The top industries with the highest year-on-year growth rate of profits were coal, oil, ferrous metal mining, non-ferrous metal mining, and non-metal minerals and other mining industries of resources, with their growth rates ranging from 45 percent to 125 percent. Manufacturing of communications and transportation equipment, chemical fibers, building materials, and telecommunications saw decreasing profits, while oil processing and coking industries witnessed a net loss of 12.7 billion yuan. In terms of investment, industries like coal and oil enjoyed rapid growth. Investment in coal mining and washing grew 76.8 percent over the same period of last year, while investment in oil and natural gas exploration grew by 31.3 percent.

The shortages in supplies of coal, electricity, oil, and transportation eased, but supply generally still fell short of demand. In the first three quarters, output of crude coal increased by 10.2 percent over the same period of last year, and coal exports decreased by 16.9 percent. The total inventory of coal began to climb in March and reached 133 million tons by end-August, up 28.5 percent over the beginning of the year. The prices of some types of coal in some regions have been on a gradual decline since May. In the first three quarters, power generation increased by 13.4 percent over the same period of last year. The largest shortage of electric power during the summer peak period decreased by about 10 million kilowatts over that recorded in 2004. Output of crude oil grew 4.2 percent over the same period of last year, crude oil imports grew by 10.6 percent, and the volume of crude oil processing increased by 7.3

percent. Domestic consumption of refined oil products increased by 5.6 percent, decelerating by 14.1 percentage points over the same period of last year. Influenced by multi-faceted factors such as the large oil price differential between the domestic and international markets and difficulties in transportation due to natural calamities, the supply of refined oil products tended to fall short of demand in some localities like Guangdong province. Due to concerted efforts by all parties, supplies have currently been brought back to normal. Inventories of refined oil products climbed in the two conglomerates of Petro China and Sinopec. In the first three quarters, the volume of rail freight increased by 6 percent, the volume of freight handled by major ports increased by 18 percent, and the volume of freight handled by the three major shipping companies grew by 11.7 percent.

(1). The real estate industry

In the third quarter, the growth of real estate investment continued to decelerate and the rise of housing sale prices furthered slowed down, while the increase in commercial housing sales climbed. Influenced by seasonal factors (autumn generally is a season for brisk housing sales), the trading volume of commercial housing in some cities rose and yet was still lower than that before May 2005. Growth in real estate development loans increased, while that in individual housing mortgage loans continued to decelerate.

Growth in real estate investment decelerated steadily. In the first three quarters, real estate development investment reached 1 trillion yuan, representing a growth of 22.2 percent, a deceleration of 6.1 percentage points over the same period of last year. In particular, commercial housing investment reached 701.0 billion yuan, up 21.5 percent. Land development investment posted 43.8 billion yuan, up 6.2 percent.

The growth in the sale prices of housing continued to slow down. In the third quarter, the sale prices of housing in 70 large- and medium-sized cities rose 6.1 percent over the same period of last year, decelerating by 1.9 percentage points over the second quarter. In particular, the growth in the sale prices of housing in both Shanghai and Hangzhou decelerated by 5.1 percentage points over the second quarter. The sale prices of new homes grew by 6.8 percent, decelerating by 2.1 percentage points over the second quarter. The sale prices of previously owned homes rose by 6.7 percent, decelerating by 2.8 percentage points over the second quarter. The lease prices of housing climbed by 2.1 percent. The trading prices of land increased by 9.8 percent.

The area of housing sales continued to grow. In the first three quarters, the area of housing sales reached 347 million square meters. In particular, the sales area of “ready-made” homes reached 133 million square meters, representing a growth of 23 percent, an acceleration of 3.7 percentage points over the same period of last year and constituting a growth 3.3 percentage points higher than the growth in the sales area of completed homes during the same period. The sales of “off-plan” homes registered

215 million square meters. The ratio of the sales of "off-plan" homes to total housing sales came to 61.7 percent. At end-September, commercial housing vacancies reached 109 million square meters, up 10.8 percent on a year-on-year basis. In particular, residential housing vacancies stood at 60.06 million square meters, up 4.2 percent.

The growth in real estate loans continued to drop, while that in real estate development loans rose. At end-September, commercial real restate loans amounted to 2.68 trillion yuan, increasing by 19.0 percent over the same period of last year, representing a deceleration of 9.7 percentage points over the end of the previous year. In particular, real estate development loans amounted to 886.6 billion yuan and increased by 16.8 percent over the same period of last year, representing an acceleration of 2.3 percentage points over the end of the previous year. The government reserve land loans amounted to 118.5 billion yuan, up 56.2 percent. The growth of individual housing mortgage loans continued to decelerate. At end-September, individual housing mortgage loans amounted to 1.8 trillion yuan and increased by 20.1 percent on a year-on-year basis, decelerating for 17 successive months. In addition, entrusted housing provident fund loans, issued by commercial banks, amounted to 251.6 billion yuan, up 30.9 percent. Growth accelerated over the previous three months, but was still lower than growth in the first 5 months of 2005.

The real estate industry is one of the pillar industries in the national economy. The healthy development of the real estate industry is of significant importance for solidifying and developing the achievements of macro control and for maintaining the steady and rapid growth of the national economy. Financial institutions shall not only strengthen risk management but also shall strive to improve financial services and actively develop new financial products in order to reasonably support real estate development projects that are in conformity with the policy orientation of the government. Meanwhile, efforts should be made to guide real estate companies to develop direct finance, encourage construction and consumption of low-price ordinary housing, beef up support for consumption of housing for home ownership, control housing mortgage loans for the purpose of investment, and promote the broad stability of housing prices and the sound development of the real estate industry.

(2). Water production and supply industry

China is deficient in water supplies, with unfavorable natural water resource conditions. Meanwhile, the extensive mode of economic growth and the distortion of the price mechanism of water resources by some measure have also brought about a waste of water resources. Inadequate water resources have become an important constraining factor for the national economy and social development. In 2004, China's water resources totaled 2.4 trillion cubic meters, with the per capita figure accounting for only 31 percent of the world's average.

Of China's 39 industries, water production and supply has the lowest profit margin and more than half of its enterprises suffer losses. During January-August 2005, the water production and supply industry suffered a cumulative loss of 2.3 billion yuan after netting profits and losses of all enterprises in the industry, and its ratio of profits over costs and expenses was -1.74 percent. Water production and supply, as an entire industry, suffered a loss mainly because the water price in China was kept below cost for a long period of time. Water prices only covered engineering and processing costs but excluded the value of water as a resource, the costs of water management, and the costs of sewage treatment.

The excessively low water prices resulted in a relatively extensive mode of utilization of water resources, low efficiency of water use, and severe waste in water use. In 2004, water use totaled 554.8 billion cubic meters. In particular, water use for daily life accounted for 11.7 percent, industrial water use accounted for 22.2 percent, agricultural water use accounted for 64.6 percent, and water use for ecological purposes accounted for 1.5 percent. Water used for every 10, 000 yuan of industrial value-added in China was 5-10 times that used in the developed economies, while irrigation water utilization was only 40-45 percent of that in the developed economies. In recent years, against the backdrop of generally decreasing aggregate water resources, the ratio of water utilization by households and enterprises to aggregate water resources remained stable and even tended to rise.

The too-low prices of sewage treatment led to a severe pollution of water resources. At present, a fee levy on sewage treatment is still not widespread. In the case of the levy, the fee was only 0.2-0.3 yuan per cubic meter. The fee could not cover the investment for the construction of sewage treatment projects, and it even could not ensure the proper operation of the sewage treatment facilities. Due to the low externality costs borne by the enterprises, a great quantity of sewage or polluted water, which was not treated or fell short of standards, was directly or indirectly discharged into rivers and lakes and caused a deterioration in the water quality, exacerbating the shortage of water resources. Annual discharges of sewage water from industrial use or daily use increased from 58.4 billion tons in 1997 to 69.3 billion tons in 2004, with the cumulative growth rate reaching 18.7 percent.

Generally, the top priority is to reform the water management system, establishing a reasonable discovery mechanism of water prices and mobilizing public enthusiasm to save water and to prevent and treat water pollution. On October 28, 2005, the National Development and Reform Commission (NDRC) indicated at a National Seminar on Resource Prices, that the NDRC would push ahead with the reform of water prices in an all-round way. The reform would cover the following: extend the scope for a levy of fees on water resources and enhance the standards for levying the fees; implement a water price system for farmers as end-users and raise gradually the prices of agricultural water use; levy fees for sewage treatment in an all-round way and adjust fees for sewage so as to cover the costs and to produce slight profits; raising reasonably the prices for water conservancy projects and water supplies in cities, and so forth.

It is foreseeable that water prices will witness a trajectory of gradual rise with the comprehensive implementation of the reform of water prices. On the one hand, this will encourage enterprises to invest in water businesses, increase water supplies, and ease the current shortages of water resources. On the other, it will promote frugal utilization of water resources, raise continuously the efficiency and returns of water utilization, and safeguard sustained economic and social development by means of the sustainable utilization of water resources. The reform of water prices is, for sure, closely related to the daily life of the general public; attention shall be paid to the tolerance of low-income groups. The reform shall be implemented at an opportune time in a sequenced manner.

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

I. Macroeconomic prospects

In general, China's economy will maintain good growth momentum in 2005. Preliminary forecasts show that the growth of GDP will exceed 9 percent and the increase in the CPI will be around 2 percent.

China's economic growth will continue to be driven jointly by consumption, investment, and net exports. The rapid growth of household income, relatively low interest rate on deposits, and further progress in the reform of the social security system will all help boost consumer demand. The results of the survey on urban household savings in the third quarter of 2005 show that the household income confidence index rose by 1.9 over the previous quarter and by 1.7 over the same period of last year. With respect to investment demand, the number of new projects that started during the first three quarters of 2005 increased by 23,000 over the same period of last year, representing a year-on-year growth of 21.1 percent. Total planned investment in new projects increased year-on-year by 27.9 percent, higher than that during the same period of last year, implying that the growth of fixed-asset investment was still likely to rebound. As to foreign trade, China's exports will continue to be supported by the good momentum of global economic growth, but uncertainties remain as trade protectionism in some industrial countries has strengthened.

With respect to price movements, the impact of base period factors will become significantly weaker in the fourth quarter of 2005. Therefore, the decline in the CPI is expected to be reversed, with the index moving up steadily toward the end of the year. The year-on-year increase in the CPI will not rebound significantly as long as price readjustment measures are not taken on a large scale in different localities to raise the prices of public utilities, including water, electricity, gas, and transportation. Taking the various factors into consideration, despite the decline in the price indices, deflation is unlikely to occur and inflationary pressures will remain. China's economy has maintained rapid growth in recent years. Increases in the wages of workers and public servants since the beginning of 2005 have given them a stronger spending capability. The prices of production materials have dropped somewhat, but remain at relatively high levels. Due to the greater losses suffered by enterprises, the prices of water, electricity, gas, and transportation are under greater upward pressures, calling for reform of the pricing of natural resources in the near future. From the longer-term perspective, in the course of China's economic development, the prices of various production factors, including land and labor, are all facing upward pressures, and the cost of environmental protection will keep rising. According to the survey on urban household savings in the third quarter of 2005, 36.2 percent of the respondents expected that prices would go up, 3.7 percentage points higher than the previous quarter, and 6 percent of the respondents expected lower price levels, 1.9 percentage lower than the previous quarter, indicating stronger inflation expectations.

II. Monetary policy stance to be adopted in the fourth quarter of 2005

In the fourth quarter of 2005, under the leadership of the CPC Central Committee and the State Council, the PBC will continue to pursue a sound monetary policy, maintain the consistency and stability of monetary aggregates, and take preemptive and fine-tuning measures. Preliminary estimates show that RMB loans will increase by 2.3-2.5 trillion yuan in 2005, and the money supply will grow by around 17 percent.

1. Maintain appropriate growth of money and credit by using a mix of monetary policy instruments

Monetary policy will be conducted in a flexible manner in accordance with economic and financial developments. The PBC will, based on the forecast of liquidity development in the banking sector and according to the need of monetary policy implementation and the changes in the liquidity of the banking system, appropriately control the frequency and scale of open market operations, and effectively adjust the liquidity of the banking system. Efforts will be made to maintain appropriate growth of money and credit by ensuring a proper total amount and a reasonable structure of market liquidity and general stability of the money market interest rate.

2. Continue to implement a market-based interest reform policy

In accordance with the requirement of market-based interest rate reform, the PBC will continue to implement the reform policies, consider adopting relevant supporting measures, and guide the commercial banks and rural credit cooperatives to enhance risk pricing and liability management. Steps will be taken to improve the formation and transmission mechanisms of interest rates, strengthen systematic research on money market interest rates, informal lending rates, and interest rates of deposits and loans. Pricing mechanisms for the bills market interest rate and market-based products will be further improved to appropriately reflect the term structure and credit risk. The PBC will make efforts to gradually improve the interest rate management system so as to enhance its capability to influence market interest rates.

3. Enhance the role of credit policy in promoting the transformation of the economic growth pattern and economic restructuring

The role of window guidance and credit policy will be further strengthened in improving the credit structure. The commercial banks will be encouraged to adopt different credit policies for different sectors and enterprises. More loans will be provided to the weak sectors in the economy to promote their development as well as to those enterprises with marketable products and good profitability. Credit support will also be strengthened to promote the development of agriculture, small- and medium-sized enterprises, employment, and education. Meanwhile, efforts will be made to improve the quality of credit assets. The monitoring system for identifying a mismatched term structure of credit assets will be further strengthened and the growth of medium- and long-term loans will be appropriately controlled. The financial ecological environment will be further improved. The commercial banks will be encouraged to strengthen their ability to respond to cyclical changes in economic development and to improve the incentives and disciplinary mechanisms in the loan business. The PBC will consider adopting certain financial measures to complement other policy measures aimed at boosting consumption. The PBC will also conduct research on measures to increase the variety of consumer credit products and to encourage the commercial banks to further develop their consumer credit business. Measures will be taken to carefully review the implementation of policies for the housing industry, closely monitor the development of the housing market, support rational housing demand, and guide the commercial banks to improve housing-related financial services and relevant risk management, with a view to promoting and safeguarding the healthy development of the housing market.

4. Accelerate the development of financial markets and the innovation of financial products

Active efforts will be made to promote the institutional development of financial markets, expand the direct financing channel, and improve the structure of financial assets and financial markets, so as to accelerate the coordinated development of the entire financial market system. Steps will also be taken to actively develop institutional investors and to promote the development of financial derivatives to meet the diversified needs of the market. Market infrastructure will be strengthened to create a sound legal and technical environment for the development of the financial market. Regulation and supervision of the financial market will be enhanced to ensure the effective implementation of monetary policy and the smooth operation of the financial market.

5. Speed up the reform of the financial system

Continued efforts will be made to push ahead with the joint-stock reform of the state-owned commercial banks, encouraging them to further transform operating mechanisms and improve their governance structure. The reform of the policy banks will be deepened to transform them into development financial institutions that have sustainable financial positions, strong competitiveness, and ability to meet market demand. Steps will be taken to promote the comprehensive reform of the rural financial system by deepening the reform of the rural credit cooperatives, actively considering the establishment of new types of rural financial institutions including micro credit institutions, and developing new types of rural financial products. Individual investors will be encouraged to participate in the restructuring of small- and medium-sized financial institutions. Steps will be taken to guide and regulate private lending activities to enable them to play a positive role in promoting economic development. Work related to the establishment of a deposit insurance system will be accelerated. The PBC will also make efforts to accelerate the establishment of a deposit insurance system, improve market exit of financial institutions with high risk, and seek to set up a long-term mechanism for preventing and resolving financial risks.

6. Keep the RMB exchange rate basically stable at an adaptive and equilibrium level

The fundamental role of market supply and demand in determining the RMB exchange rate will be further strengthened to keep the exchange rate basically stable at an adaptive and equilibrium level. Steps will be taken to speed up the development of the foreign exchange market and to introduce various foreign exchange derivative products to help the enterprises, individuals, and financial institutions hedge foreign exchange risk. Measures will also be made to further improve foreign exchange administration, facilitate trade and investment activities, appropriately guide capital inflows, and broaden the channels of capital outflows, in an effort to promote a balance of payments equilibrium.