

China Monetary Policy Report
Quarter Four, 2005

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

Executive Summary

China's economy yielded good performance in 2005 in terms of rapid growth, good returns, stable prices, and enhanced vitality. Economic performance became more stable and economic growth was more balanced. GDP grew by 9.9 percent and the CPI increased by 1.8 percent on a year-on-year basis.

In 2005, under the guidance of the CPC Central Committee and the State Council, the People's Bank of China (PBC) continued to pursue a sound monetary policy by strengthening aggregate control and improving the credit structure with market instruments. It steadily promoted the market-based interest rate reform and the exchange rate regime reform, pushed forward the reform of financial enterprises and the build-up of the financial market infrastructure, and improved foreign exchange management. Efforts were also made to perfect the monetary policy transmission mechanism and to ensure sound performance of the financial system and steady and relatively fast development of the national economy. 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. Various import and export enterprises adapted themselves relatively smoothly to the new RMB exchange rate regime. From a macroeconomic perspective, the national economy maintained a fairly rapid and sound growth momentum after the exchange rate regime reform, reflecting improved resilience against external shocks and the dynamics of the economy as a result of many years' efforts in economic reform and building a socialist market economy.

The financial system performed soundly in 2005. The growth of monetary aggregates and credit was moderate, with the credit structure further improved, broadly in line with the general goal of macroeconomic management. As of end-2005, broad money reached 29.9 trillion yuan, increasing by 17.6 percent over the same period of the last year; base money amounted to 6.4 trillion yuan, a year-on-year growth of 9.3 percent; and RMB loans extended by financial institutions grew by 13.0 percent year-on-year to 19.5 trillion yuan, an increase of 2.4 trillion yuan over the beginning of the year. Interest rates in the money market moved steadily at a low level. At end-2005, foreign

exchange reserves reached US\$818.9 billion, US\$208.9 billion more than that recorded at the end of 2004. On December 31, 2005, the central parity of the exchange rate of the RMB against the US dollar stood at 8.0702 yuan per US dollar, appreciating accumulatively by 0.49 percent after the initial adjustment on July 21, 2005.

The year 2006 is the first year for China to achieve the targets set out in the Eleventh Five-Year Program, and it also marks the last year of the transitional period after China's accession to the WTO. In general, the overall domestic environment is conducive to the steady and sound development of the national economy. However, some deep-rooted problems are yet to be addressed and new problems may emerge. First, the economic structure and economic growth pattern urgently need to be adjusted. Second, the imbalance of international payments is posing challenges to the effectiveness and flexibility of the monetary policy. Third, China's commitment to the WTO has imposed higher requirements on China's financial development.

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 the policy, coordinate policies on domestic and foreign currencies, enhance the initiative and effectiveness of monetary policy, maintain steady growth of money and credit, steadily advance the financial reform and opening up, actively develop the financial market, safeguard the stability of the financial system, and further improve foreign exchange management and financial services, so as to promote the sustained, coordinated, rapid, and sound development of the national economy. 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 steadily advance the market-based interest rate reform and improve the mechanism for interest rate determination. Third, the role of window guidance and credit policy in promoting economic restructuring will be enhanced. Fourth, the development of financial markets and the innovation of financial products will be actively promoted. Fifth, the financial system reform will be accelerated. Sixth, continued efforts will be made to promote the reform of foreign exchange management and improve the RMB exchange rate regime so as to keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

Contents

<u>Part 1 Monetary and Credit Performance</u>	1
<u>I. Growth of monetary aggregates remained moderate</u>	1
<u>II. Deposits of financial institutions increased at a stable pace</u>	1
<u>III. Loans of financial institutions expanded steadily</u>	2
<u>IV. Base money grew steadily</u>	4
<u>V. The RMB interest rate remained stable while the foreign currency interest rate continued to climb</u>	7
<u>VI. The balance of payments maintained a surplus, and the RMB exchange rate regime functioned smoothly</u>	9
<u>Part 2 Monetary Policy Conduct</u>	10
<u>I. Flexible Open Market Operations (OMOs)</u>	10
<u>II. Make Full Use of the Interest Rate in Macroeconomic Management and Steadily Promote Market-based Interest Rate Reform</u>	12
<u>III. Make Use of Credit Policy in Economic Structural Adjustment</u>	13
<u>IV. Steadily Promote Financial Enterprise Reform</u>	13
<u>V. Reform of the Exchange Rate Regime Produced Fairly Good Results</u>	15
<u>VI. Speed Up the Foreign Exchange Management System Reform and Promote the Basic Equilibrium of the BOP</u>	19
<u>Part 3 Financial Market Performance</u>	21
<u>I. An Overview of Financial Market Performance</u>	21
<u>II. Financial Market Institutional Building</u>	27
<u>Part 4 Analysis of Macroeconomic Development</u>	31
<u>I. The global economic and financial situation and the forecast for 2006</u>	31
<u>II. Analysis of China's macroeconomic performance</u>	33
<u>Part 5 Monetary Policy Stance to be Adopted in 2006</u>	49
<u>I. Macroeconomic prospects</u>	49
<u>II. Monetary Policy Stance to be Adopted in 2006</u>	50

Box:

<u>Box 1: Correctly Understand the “Excess of Deposits Over Loans” Phenomenon of Financial Institutions.....</u>	<u>4</u>
<u>Box 2: Foreign Exchange Swap.....</u>	<u>11</u>
<u>Box 3: Enterprises Adapted Relatively Smoothly to the New Exchange Rate Regime</u>	<u>15</u>
<u>Box 4: The National Economic Census: The Size, Growth, and Structural Changes of GDP.....</u>	<u>35</u>
<u>Box 5: Further Improving Rural Financial Services and Strengthening Support to the Rural Economy.....</u>	<u>38</u>
<u>Box 6: Problems of China’s Resources Prices and Analysis of Their Impacts.....</u>	<u>43</u>

Table:

<u>Table 1: The Shares of Loans with Falling Rates in Various Ranges.....</u>	<u>8</u>
<u>Table 2: Average Interest Rates of Large-value US\$ Deposits and US\$ Loans in 2005</u>	<u>8</u>
<u>Table 3: Financing by Domestic Non-financial Sectors, 2005.....</u>	<u>21</u>
<u>Table 4: Fund Flows Among Financial Institutions in the Inter-bank Market, 2004 & 2005.....</u>	<u>23</u>
<u>Table 5: Use of Insurance Funds at end-2005.....</u>	<u>27</u>

Figure:

<u>Figure 1: Measures Taken by Enterprises after the Reform of the RMB Exchange Rate Regime.....</u>	<u>17</u>
--	---------------------------

Part 1 Monetary and Credit Performance

In 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 and credit aggregates was moderate, with the credit structure further improved, and basically commensurate with the requirements of macroeconomic management.

I. Growth of monetary aggregates remained moderate

Broad money M2 reached 29.9 trillion yuan at end-2005, a growth of 17.6 percent y-o-y, representing an acceleration of 2.9 percentage points over 2004. Narrow money M1 reached 10.7 trillion yuan at end-2005, increasing by 11.8 percent y-o-y, 1.8 percentage points lower than 2004. Cash in circulation M0 amounted to 2.4 trillion yuan, increasing by 11.9 percent y-o-y. Cash put into circulation in 2005 totaled 256.3 billion yuan on a net basis, 84.1 billion yuan more than that recorded for 2004, among which, net cash injections in the fourth quarter reached 175.9 billion yuan, 81.5 billion yuan more than in the same period of 2004, which can be attributed to the early arrival of the Spring Festival in 2006.

In 2005, the growth of money supply remained low, then climbing up later in the year. After declining to 14 percent in March, the lowest level in 2005, the growth of broad money M2 accelerated gradually and reached 18.3 percent in November, the highest in the entire year, and then fell somewhat in December. The growth trend of narrow money M1 was in line with that of broad money M2 in general, but the gap between the growth of M2 and M1 widened since the growth of M2 continued to exceed that of M1. The relatively fast growth of M2 mainly resulted from the rapid increase in the RMB counterpart in foreign exchange reserves due to the enlarged payments imbalance, leading to a large increase in bank deposits from both households and enterprises. In terms of the composition of broad money, the proportion of M0 and corporate demand deposits grew steadily, while the increase in households' deposits and corporate time deposits also contributed to the relatively fast growth of M2.

II. Deposits of financial institutions increased at a stable pace

Outstanding deposits of all financial institutions (including foreign-funded financial institutions) in both RMB and foreign currencies increased by 18.2 percent y-o-y to

30 trillion yuan at end-2005, a growth of 4.4 trillion yuan from the beginning of the year or an acceleration of 1 trillion yuan. In particular, RMB deposits rose by 19.0 percent y-o-y to 28.7 trillion yuan, up 4.4 trillion yuan over the beginning of the year or accelerating by 1.1 trillion yuan. Foreign currency deposits totaled US\$161.6 billion, increasing by 5.6 percent y-o-y or by US\$6.8 billion over the beginning of the year, a deceleration of US\$2.92 billion.

Corporations and households' preference for time deposits strengthened. At end-2005, corporate RMB deposits increased by 13.6 percent y-o-y to 9.6 trillion yuan, representing a growth of 1.14 trillion yuan from the beginning of the year and a deceleration of 28.7 billion yuan. In particular, corporate time deposits increased by 770.6 billion yuan from the beginning of the year, an acceleration of 305.2 billion yuan. Households' RMB deposits expanded by 18.0 percent y-o-y to 14.1 trillion yuan, increasing by 2.1 trillion yuan over the beginning of the year, an acceleration of 556.7 billion yuan, with an increase in time deposits registered at 1.4 trillion yuan from the beginning of the year and an acceleration of 448.7 billion yuan. Fiscal deposits increased by 28.1 percent y-o-y to 799 billion yuan, representing a growth of 175.2 billion yuan over the beginning of the year or an acceleration of 118.8 billion yuan.

III. Loans of financial institutions expanded steadily

Outstanding loans of financial institutions in both RMB and foreign currencies reached 20.7 trillion yuan at end-2005, a growth of 12.8 percent y-o-y, or increasing by 2.5 trillion yuan over the beginning of the year, a deceleration of 56.3 billion yuan. In particular, RMB loans grew by 13.0 percent y-o-y to 19.5 trillion yuan, an increase of 2.4 trillion yuan over the beginning of the year, accelerating by 87.1 billion yuan. Foreign currency loans rose by 12.0 percent y-o-y to US\$150.5 billion, a growth of US\$17.1 billion over the beginning of the year, accelerating by US\$400 million. In most months of 2005, the registered growth of RMB loans was around 13 percent, maintaining the momentum of steady expansion. Diversified corporate financing, such as short-term financing bills, to some extent reduced the reliance of enterprises on bank credits.

The loan structure was further improved. Working capital loans witnessed marked growth. In 2005, short-term working capital loans and commercial paper financing increased by 1.12 trillion yuan, an acceleration of 269.4 billion yuan over 2004. The proportion of working capital loans to total new loans was 47.7 percent, 10.1

percentage points up compared with the previous year. The fast growth of commercial paper financing played an important role in easing the financing difficulties of SMEs. In 2005, commercial paper financing grew by 40.9 percent, up 12.5 percentage points from the previous year.

The faster-than-desired growth of medium- and long-term loans was contained. In 2005 RMB medium- and long-term loans increased by 17.2 percent y-o-y, down 7.0 percentage points over the previous year and increasing by 1.2 trillion yuan over the beginning of the year, a deceleration of 201.2 billion yuan. Capital construction loans rose by 617.5 billion yuan from the beginning of the year, decelerating by 9.3 billion yuan. In terms of loan destination, medium- and long-term loans by major financial institutions (state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) were extended to support the transportation, energy, real estate, environment, infrastructure, and manufacturing industries, with the growth of medium- and long-term loans to the manufacturing industries decelerating compared with the accelerated growth of loans to education.

The growth of consumer loans slowed down. At end-2005 the outstanding balance of consumer loans totaled 2.2 trillion yuan, increasing by 10.4 percent y-o-y, down 16 percentage points from 2004, or increasing by 199.6 billion yuan from the beginning of the year and representing a deceleration of 233.1 billion yuan. In particular, consumer housing loans increased by 244.4 billion yuan over the beginning of the year, a deceleration of 162.9 billion yuan; automobile loans decreased by 50 billion yuan from the beginning of the year, 24.8 billion yuan more than the contraction recorded in 2004. The deceleration in the growth of consumer loans, especially housing loans, reflected both the adjustment after the high growth recorded for the past several years and the result of macro-control measures dedicated to the real estate industry. Given the important role of consumption demand in national economic development, great attention should be paid to consumption in future development.

Broken down by institutions, except for the RMB loans of the wholly state-owned commercial banks, RMB loans of all other financial institutions accelerated. In 2005, RMB loans of the wholly state-owned commercial banks increased by 762.1 billion yuan, a reduction of 260.1 billion yuan from 2004. Lending of policy banks, joint-stock commercial banks, city commercial banks, and rural financial institutions (including rural credit cooperatives, rural cooperative banks, and rural commercial banks) expanded by 337.9 billion yuan, 596.5 billion yuan, 183.2 billion yuan, and 345.1 billion yuan respectively, accelerating by 66.7 billion yuan, 127.5 billion yuan, 43.7 billion yuan, and 81.7 billion yuan respectively. Loans of foreign-funded

financial institutions added 42.1 billion yuan, an acceleration of 20.4 billion yuan.

Box 1: Correctly Understand the “Excess of Deposits Over Loans” Phenomenon of Financial Institutions

The deposits loans difference is the difference between the total amount of deposits and the total amount of loans of financial institutions. If the amount of deposits is larger than the amount of loans, there is an excess of deposits over loans; otherwise, there will be an excess of loans over deposit.. The loan-deposit ratio is the proportion of total loans to total deposits of a financial institution, i.e., loan deposit ratio= total loans/total deposits. Since 1978, the loan-deposit ratio of Chinese financial institutions has declined steadily. An excess of deposits over loans first emerged in 1995 and since then has expanded gradually. At end 2005, the excess of deposits over loans of financial institutions reached 9.2 trillion yuan, accounting for 32 percent of total deposits, and the loan-deposit ratio in stock terms stood at 68 percent, while the loan-deposit ratio on a flow basis was 53.6 percent. Broken down by regions, all provinces in China had an excess of deposits over loans. There were different views about the continued gradual growth in the amount of such excess. Some attributed it to the relatively fast growth of deposits along with the slow growth of credits, while others thought it reflected the reality of idle capital or the low efficiency of capital utilization. Some localities even compared the amount of excess of deposits over loans, taking them as a sign of financial support for regional economic development. In fact, all of these views failed to accurately, objectively, and completely explain the real reason behind the existence of excess of deposits over loans in China.

To discover the general mechanism behind the excess of deposits and further understand the causes of such excess in various regions, macro-level analysis must examine the banking system as a whole. If we observe and analyze this phenomenon from the perspective of a single bank or part of the banking system, we inevitably will derive some implausible conclusions. In a banking system based on credit money, all money, including deposits and cash, is created by the central bank and commercial banks through loans and bond purchases, and then held by economic entities, such as enterprises and individuals. From the point of view of the banking system, assets, such as loans, are created before liabilities, such as deposits. In terms of the changes in the balance sheet, when issuing a loan, both the loans on the asset side and the deposits on the liability side increase by the same amount at the same time, realizing an equal increase on both sides. The process of lending is also a process of deposit creation. An excess of loans over deposits dominated Chinese financial institutions before 1995 due to the simplified asset structure of the banking system. As bank loans were the only channel for the use of funds, money was composed of deposits and cash in circulation, therefore resulting in loans exceeding deposits. As more cash was put into circulation, the excess of loans over deposits grew larger.

In 1995, financial institutions began to have an excess of deposits over loans. Since

then, the excess of deposits over loans has increased continually, with the loan-deposit ratio declining gradually. The main reasons can be summarized as follows: **First, the holdings of bonds issued by non-financial institutions in the banking sector continued to increase.** With strengthened risk-management awareness and requirements imposed on the capital adequacy ratio, commercial banks abandoned their conventional profit mode that overly relied on income from the interest spread and increased the proportion of low risk-weighted assets, including bonds, so as to diversify their assets structure, as the development of the financial market has promoted creation of many new financial products in recent years. In 1995, securities and portfolio investment accounted for only 5.7 percent of the total fund uses in commercial banks in 1995, but the ratio reached 26.1 percent in 2005. According to the money creation theory, purchasing bonds has the same effect as issuing loans, as both would derive equal amount of deposits, so the excess of deposits over loans increases and the loan-deposit ratio declines. **Second, in recent years, commercial banks have made great efforts to dispose of and write off NPLs.** NPLs disposals and write-offs will change the asset-liability structure of a commercial bank and reduce the amount of total loans by increasing the same amount of high quality assets with good credit or guarantees or by reducing the same amount of equity, but they will not affect the total deposits on the liability side, so the excess of deposits over loans will increase accordingly. As of end-2005, nearly several trillion yuan worth of NPLs had been transferred, written-off, or converted into equity. **Third, the foreign assets of the financial system increased at a brisk pace.** Sustained “twin surpluses” in the balance of payments in recent years caused both enterprises and residents to exchange a huge volume of foreign exchange into RMB deposits, which was reflected in the increase of foreign assets on the asset side and the increase of RMB deposits on the liability side of the Banking Survey.¹ As funds were provided to the enterprises and residents not in the form of bank loans, the excess of deposits over loans increased while the loan/deposit ratio decreased. **Fourth, the increase in cash demand slowed down.** Cash injections can offset the growth of the excess of deposits over loans. With the development of electronic money and payment, demand for cash in China tended to decline, with the ratio of M0 to M2 declining year-by-year from 17.3 percent in 1990 to 8 percent in 2005. The weakened role of cash in circulation in offsetting the expansion of the excess of deposits over loans therefore became the main reason for the fast growth of the latter.

The above analysis shows that the growing excess of deposits over loans is the result of assets diversification of the banking system and it is in line with the process of market-oriented financial development. Simultaneously, financial management and banking reform measures at a certain period of time were also relevant. The growth of

¹The Banking Survey is compiled from the balance sheets of the central bank, deposit money banks, and special depository institutions. The asset side of the Banking Survey is composed of net foreign assets (NFA) and domestic credit (DC). The liability side is composed of broad money (M2) and other items net (OIN) (including foreign currency deposits, bonds, central bank bonds, paid-in capital, etc. in China). In terms of the assets liability equation, $NFA+DC=M2+OIN$.

other assets apart from loans in the banking system provided another channel for financing of economic entities. Although this channel caused the excess of deposits to expand, it is unlikely to give rise to a decline of fund use efficiency or reduced financial support to economic development. The loan-deposit ratio of Chinese financial institutions is still higher than that in the United States and other developed nations.

As to the excess of deposits over loans or loan-deposit ratio in the localities, the causes are much more complex. On one side, the excess of deposits over loans in a region was affected by the same factors as the excess of deposits over loans in the whole financial system. On the other side, excess of deposits over loans in a region was also influenced by the inter-regional movement of deposits. Therefore, the excess of deposits over loans in a region may not be simply attributed to certain factors, nor should it be applied to judge financial support to the regional economy. For example, the loan-deposit ratios in Beijing and Guangdong province are lower than the national average. In 2005, the difference between the purchase and sale of foreign exchange in Guangdong province was much larger than the national average and other export-oriented developed regions, including Shanghai, Jiangsu and Zhejiang provinces. So the large amount of RMB counterparts of foreign exchange reserves was the main reason for larger amount of deposits exceeding loans in Guangdong. In contrast, Beijing registered a foreign exchange deficit, but had almost the lowest loan-deposit ratio, as most of the national corporations and institutions were headquartered in Beijing and centralized the use of financial resources of their branches across the nation. If the excess of deposits over loans or loan-deposit ratio is used to evaluate financial support to regional economic development, the conclusions are incomplete, or sometimes contradictory or wrong.

To sum up, an excess of deposits over loans does not mean that bank funds are left idly unused, and there is no direct linkage between such an excess and banking liquidity. Issuing more loans and encouraging consumption are unlikely to reduce the excess. At present, it is improper to stress the concept of an excess of deposits over loans since it does not serve as a good indicator for policy purposes. The concept of deposit loan difference was developed in the past in the (all-in-one) mono-bank system under the planned economy, when credits were the only assets and liabilities were composed only of deposits and cash. At that time an excess of deposits over loans or loans over deposits could play a certain role in analyzing the funds distribution and movement trends in the system. However, as China has transformed to adopt a two-tier banking system, the deposits loans difference has lost its basis for existence and cannot be applied to explain banking fund uses since its formation mechanism has become much complicated. Furthermore, an excess of deposits over loans also may not be used as an accurate indicator to measure the role of finance in economic development as it may be misleading or even produce other errors. To promote the virtuous interaction between finance and real sectors, local government should make efforts to build a good financial eco-environment, and not control the

deposits loans difference or loan-deposit ratio artificially.

IV. Base money grew steadily

In end-2005, the outstanding balance of base money grew by 9.3 percent y-o-y to 6.4 trillion yuan, down 3.3 percentage points from the previous year, representing an increase of 547.9 billion yuan, 112.7 billion yuan less than the growth recorded at end-2004. At end-December, the excess reserve ratio of financial institutions averaged 4.17 percent, among which, the wholly state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives recorded a ratio of 2.7 percent, 4.81 percent, and 11.28 percent respectively. The monthly excess reserve ratio of financial institutions fluctuated between 2.99 percent and 4.37 percent in 2005, a marked narrowing from the previous two years.

V. The RMB interest rate remained stable while the foreign currency interest rate continued to climb

In the fourth quarter of 2005, the weighted average interest rate of one-year RMB loans of financial institutions was 6.07 percent, which was 1.09 times the benchmark rate, down 0.07 percentage points from the previous quarter. In particular, the weighted average interest rate of fixed interest rate loans, which accounted for 88.8 percent of total loans, was 6.08 percent, down 0.09 percentage points from the previous quarter; and that for floating interest rate loans, which accounted for the other 11.2 percent of total loans, was 6.02 percent, up 0.15 percentage points from the previous quarter.

Among the loans issued by commercial banks in the fourth quarter, loans with interest rates floating downward against the benchmark took up 24.99 percent, up 2.53 percentage points over the previous quarter; loans charged at the benchmark rate made up 26.47 percent, up 1.83 percentage points over the previous quarter; and loans with interest rates floating upward against the benchmark accounted for 49.24 percent, down 4.36 percentage points from the previous quarter.

In the fourth quarter, the interest rate of negotiable RMB deposits (above 30 million yuan) declined slightly. In particular, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 3.25 percent, down 0.64 percentage points from the previous quarter or 1.21 percentage points from the beginning of the year. The weighted average interest rate of negotiable deposits with a maturity of 37

months was 3.07 percent, down 1 percentage point from the previous quarter or 1.25 percentage points from the beginning of the year.

**Table 1: The Shares of Loans with Falling Rates in Various Ranges
in the Fourth Quarter of 2005**

Unit: %

	Sum	(0.9, 1]	1.0	Upward Adjustment				
				Sum	(1, 1.3]	(1.3, 1.5]	(1.5, 2]	above 2
Sum	100	24.29	26.47	49.29	26.87	8.27	11.37	2.73
State-owned commercial banks	100	30.62	28.29	41.09	34.61	5.27	1.14	0.07
Joint-stock commercial banks	100	33.44	31.49	35.07	33.55	1.07	0.11	0.34
Regional commercial banks	100	27.05	21.01	51.94	36.45	8.69	5.36	1.44
Urban and rural credit cooperatives	100	3.13	5.28	91.60	14.56	22.40	44.07	10.57

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

Source: Reports of lending rates of commercial banks.

Affected by persistent interest rate hikes by the US Fed and an interest rate rise in international financial markets, the interest rates of domestic foreign currency loans and large-value deposits (above US\$3 million) continued to rise. In December 2005, the weighted average interest rate of three-month large-value US dollar deposits (accounting for 95 percent of all large-value US dollar deposits of financial institutions) stood at 4.05 percent, 0.83 and 2.77 percentage points higher than the previous month and the beginning of the year respectively; the weighted average fixed interest rate of one-year US dollar loans was 5.44 percent and the weighted average floating interest rate of US dollar loans was 5.52 percent, up 0.01 and 0.25 percentage points respectively over the previous month, or 2.01 and 2.14 percentage points respectively over the beginning of 2005.

Table 2: Average Interest Rates of Large-value US\$ Deposits and US\$ Loans in 2005

Unit: %

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.
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	3.3292	3.2197	4.0510
3—6 months	2.1102	2.2490	2.5353	2.9351	2.7800	3.3701	3.5642	3.5427	3.8602	4.1846	4.1862	4.5035
6—12 months	2.4450	2.2419	2.6527	3.3083	2.3960	3.4914	3.4038	3.0301	3.5390	3.9526	3.9924	4.5472
1 year	2.3039	2.3694	3.3022	2.7471	3.5035	3.7372	3.9109	3.8578	4.1357	4.5044	4.0716	3.9522
II. Loans												
1 year (fixed)	3.5366	3.7720	4.2393	4.0664	4.5367	4.5664	4.6544	4.8904	5.1665	5.1389	5.4252	5.4437
1 year (monthly floating)	3.3315	3.6771	3.7462	4.0724	4.1575	4.2477	4.4853	4.6744	4.8872	5.0651	5.2672	5.5167

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

VI. The balance of payments maintained a surplus, and the RMB exchange rate regime functioned smoothly

According to preliminary estimates, the balance of payments in 2005 continued to register “twin surpluses,” with the current account surplus accounting for the main sources, and the capital and financial account surplus displaying a decline.

The growth of the external debt slowed down, with the share of short-term external debt climbing. At end-September, the balance of external debt in China amounted to US\$267.5 billion, increasing by 8 percent from the end of 2004, down 7 percentage points. In particular, medium- and long-term debt totaled US\$123.5 billion, decreasing by US\$0.8 billion from the beginning of the year; short-term external debt stood at US\$144 billion, up US\$20.8 from the beginning of the year and accounting for 53.8 percent of the total, up 4 percentage points from the end of 2004. Trade finance was claimed to be an important factor behind the relatively fast growth of short-term external debt due to the rapid development of foreign trade.

Foreign reserves continued to grow rapidly despite a slight deceleration of the growth. At end-2005, official foreign exchange reserves reached US\$818.9 billion, increasing by US\$208.9 billion from end-2004 or 34.3 percent y-o-y, down 17 percentage points from one year earlier. The growth in each quarter of 2005 registered US\$49.2, US\$51.9, US\$58 billion, and US\$49.9 billion respectively.

Since July 21, 2005, the new RMB exchange rate regime has functioned smoothly, with the elasticity of the RMB exchange rate strengthened. As of December 31, 2005, the central parity of the RMB against the US dollar once topped at 8.0702 yuan per US dollar, and touched the lowest at 8.1128 yuan per US dollar. In 67 trading days, the RMB saw an appreciation and in 46 trading days it saw a depreciation. The largest appreciation and depreciation recorded in a single business day was both 0.07 percent. On December 31, the central parity of the RMB against the US dollar, euro, and Japanese yen stood at 8.0702 yuan per US dollar, 9.5797 yuan per euro, and 6.8716 yuan per 100 Japanese yen respectively. After the initial adjustment, the RMB exchange rate against the US dollar appreciated accumulatively by 0.49 percent, or by 4.53 percent and 6.32 percent against the euro and Japanese yen respectively.

Part 2 Monetary Policy Conduct

In 2005, the PBC, under the leadership of the central government, continued to implement a sound monetary policy by strengthening aggregate control and enhancing the credit structure with market instruments. It steadily promoted the market-based interest rate reform and the exchange rate regime reform, pushed forward the reform of financial enterprises and the build-up of financial market infrastructure, and improved foreign exchange management. Efforts were also made to perfect the monetary policy transmission mechanism and to ensure sound performance of the financial system and the overall economy.

I. Flexible Open Market Operations (OMOs)

In 2005, the PBC closely monitored the economic and financial situation by following and analyzing the impact of the exchange rate regime reform, the increase of foreign exchange reserves, the change of fiscal treasury balances, and currency in circulation on the liquidity of the banking system. On that basis, the PBC made flexible use of multiple OMO instruments with varying maturities, maintained appropriate strength and frequency of OMOs, and fully utilized their preemptive and fine-tuning roles. As a result, the increase in foreign exchange reserves was effectively sterilized and the money market interest rate ironed out. In January and February, the PBC promptly ironed out the short-term fluctuation of liquidity around Spring Festival by using a number of instruments and maintained the strength of OMOs. In March and April, it strengthened sterilization by increasing the size of central bank bill issuance. From May through August, with a number of monetary policies adopted before and after the reform of the exchange rate regime, the PBC appropriately adjusted the strength of OMOs and allowed the market interest rate to move slightly downward, creating a favorable low-interest rate environment for the exchange rate regime reform. From September through December, given the smooth performance of the new exchange rate regime and widened interest rate spread between China and America as a result of the consecutive rate increases by the US Fed, the PBC appropriately strengthened OMOs, controlled the growth rate of the money supply, and reasonably pushed the money market interest rate upward. In general, the operational targets of the OMOs were achieved.

In 2005, the PBC made 125 issuances of central bank bill, totaling 2.7882 trillion yuan.

By the end of 2005, the outstanding amount of central bank bills stood at 2.0662 trillion yuan; The PBC made 62 repos, withdrawing base money of 738 billion yuan; It also made 3 reverse repos, injecting base money of 36.8 billion yuan. In the whole year, the PBC cumulatively withdrew base money 3.5924 trillion yuan and injected 2.2076 trillion yuan. In net terms, the withdrawal of base money reached 1.3848 trillion yuan, more than twice the amount of 2004.

Box 2: Foreign Exchange Swap

A foreign exchange swap refers to a transaction where two parties agree to exchange currency A for certain amount of currency B and to reverse the transaction at a specified exchange rate at a future date. A foreign exchange swap can take varying forms, but in essence it remains an interest rate product. The party that receives the currency with a high interest rate needs to compensate its counterpart to the extent determined by the interest rate spread. The compensation may be realized through either the future exchange rate or payment of the spread. Since the 1980s, the foreign exchange swap market has developed rapidly, with the global daily transaction volume growing from US\$190 billion in 1989 to US\$944 billion in 2004. The global daily transaction volume of the foreign exchange swap has exceeded that of foreign exchange spot transactions and forward transactions since 1995 and reached 1.5 times that of spot transactions and 4.5 times that of forward transactions in 2004. On August 2, 2005, the PBC released a *Notice on Expanding Designated Banks' Forward Purchase and Sale Business and Launching RMB and Foreign Currencies Swaps* that allowed qualified commercial banks to conduct RMB and foreign currency swaps.

A foreign exchange swap is also used as a monetary policy instrument by central banks to adjust the market liquidity condition. Some countries' central banks (such as in Switzerland, Germany, Britain, Singapore, and Thailand) used or are using foreign exchange swaps as an OMO instrument. For instance, as the fiscal deficit of Switzerland was very small, there was a lack of short-term government bonds for the central bank to use in OMOs. Hence, the central bank used foreign exchange swaps to adjust the liquidity of the banking system. In 1993, the outstanding amount of the foreign exchange swap of the Swiss central bank reached about 50 percent of the base money.

By the end of November 2005, after 12 consecutive increases that raised the federal fund rate from 1 percent to 4 percent, the 1-year Libor of the US dollar had risen to 4.70 percent, 2-3 percentage points higher than the RMB money market rate. Commercial banks with a strong capacity to manage the use of foreign exchange wished to hold more assets denominated by the US dollar so as to enhance profitability and to ease pressures on short-term investment brought about by RMB liquidity. Meanwhile, to manage the exchange rate risk, commercial banks wanted to

obtain RMB assets at the current exchange rate by compensating the counterparts with a portion of the profits generated from the US dollar assets. Under such circumstances, the PBC selected 10 banks including the State Development Bank to conduct a foreign exchange swap as of November 25, 2005 in order to appropriately absorb liquidity and smooth the money market interest rate. In the swap, the central bank sold US dollars in spot transactions, and agreed to buy back US dollars at the same exchange rate in 1 year and collect compensation of the interest rate spread between the US dollar and the RMB. The trading volume of the swap was US\$6 billion and the central bank withdrew 48.483 billion yuan of base money.

At present, the federal fund rate has reached 4.5 percent and the market expects it to rise to 4.75 percent in March. With the further widening of the interest rate spread between the US dollar and the RMB, commercial banks will more strongly wish to purchase US dollars and to invest them abroad to enhance the return on assets and asset allocation efficiency. As a result, compensation of the interest rate spread will increase correspondingly.

II. Make Full Use of the Interest Rate in Macroeconomic Management and Steadily Promote Market-based Interest Rate Reform

First, on March 17, the interest rate on excess reserves of financial institutions deposited with the PBC was lowered to 0.99 percent. Meanwhile, the inter-bank deposit interest rate was liberalized, giving commercial banks more scope in pricing and enhancing their efficiency in using funds and their capacity in managing liquidity. Second, the interest rate on RMB and foreign currencies was managed in a way to ease pressures on the selling of foreign exchange receipts. Given the continual rise of interest rates in international financial markets, the interest rate ceilings on small-value US dollar and Hong Kong dollar deposits were raised 5 times. The interest rate ceiling on 1-year US dollar deposits was cumulatively raised by 2.125 percentage points to 3 percent, and that on 1-year Hong Kong dollar deposits was raised by 1.8125 percentage points to 2.625 percent. Third, financial institutions were allowed to determine the rules to calculate interest on various sorts of RMB deposits and loan interests, except for demand and specified time deposit products, creating favorable conditions for commercial banks to conduct liability management at their own initiative, and to make business innovations to provide better financial services.

III. Make Use of Credit Policy in Economic Structural Adjustment

The PBC strengthened the “window guidance” of the central bank and improved the mode of credit policy implementation in order to strengthen the effectiveness of credit policy implementation, and to promote the rational allocation of credit resource allocation and optimization of national economic structure. First, according to the general requirement of macroeconomic management, the PBC guided financial institutions to follow the principle of differentiated treatment, giving more support to certain sectors, by strengthening credit support to the agricultural sector, job creation, student loans, the non-public sector, and SMEs. The PBC adjusted the regional distribution of central bank lending and increased the quota of PBC lending to the agricultural sector in the west regions and major grain-producing regions. Second, the PBC adjusted the policy regarding the commercial banks’ mortgages by raising its interest rate from a preferential level to an ordinary lending rate of the same maturity on March 17. With respect to the cities or regions with excessive real estate price hikes, the PBC guided commercial banks to raise the minimum down payment ratio in an effort to promote the healthy development of the real estate market. Third, the PBC promoted commercial banks to strengthen early warning analysis on the loan and encouraged maturity mismatch as well as on the structure and flow of credits. The aim is to guide commercial banks to appropriately manage medium- and long-term loans and to increase working capital lending. The PBC conducted a dynamic assessment of credit concentration and credit risk with regard to key industries, key enterprises, and key areas, and promptly released early warning information. The PBC provided positive incentives for financial institutions to improve management by adopting the differentiated reserve requirement ratios and to encourage sound operations on the part of financial institutions.

IV. Steadily Promote Financial Enterprise Reform

The joint-stock reform of state commercial banks gained ground smoothly. With financial restructuring and internal reform advancing, the Bank of China, the China Construction Bank, and the China Industrial and Commercial Bank had significantly better financial positions and profitability, strengthened corporate governance, and basically put in place an independent internal control system and risk prevention system. Meanwhile, progress was made in product innovation and enhancement of service quality. The China Construction Bank was listed on the Hong Kong stock market on October 27 and issued 30.5 billion new shares at HK\$2.35 per share (including oversubscription, accounting for 13.5 percent of the total equity after the

issue), raising HK\$71.58 billion (or US\$9.23 billion). The Bank of China continued to transform its management mechanism and created favorable conditions for its listing. By the end of 2005, it had successfully finished transactions that paved the way for introducing strategic investors. The China Industrial and Commercial Bank was incorporated on October 28, with registered capital of 248 billion yuan. The Ministry of Finance and Central Safe Co. Ltd each hold 50 percent of its shares. As a result, the ownership of the China Industrial and Commercial Bank was made clear and its modern corporate governance structure was established. The Agricultural Bank of China is working on a joint-stock reform plan in line with the reform of the agricultural financial system.

The pilot reform of rural credit cooperatives advanced smoothly. The 8 provinces (and municipalities) that pioneered the pilot reform have made preliminary progress and have continued to deepen the reform. Another 21 provinces (including autonomous regions and municipalities) have had a good start in pushing forward the pilot reform. The financial indicators of the rural credit cooperatives improved significantly. First, various supportive measures were carried out to solve historical problems. At end- 2005, the PBC, together with the CBRC, following strict assessment and examination, made 8 issuances of special bills worth 159.9 billion yuan in 2,263 counties (and cities) in 28 provinces (including autonomous regions and municipalities) aimed at reforming the rural credit cooperatives on a pilot basis, accounting for 94 percent of the counties supported by the PBC in the form of special bill issuances and 96 percent of the total funds raised by issuing special bills. Meanwhile, the PBC made special lending of 260 million yuan to the rural credit cooperatives in Jilin and Shaanxi. Moreover, the central and local governments have also gradually garnered fiscal support and provided tax relief support to the rural credit cooperatives covered by the pilot reform. At end-2005, taking into consideration the special bill exchange, the NPL ratio of rural credit cooperatives stood at 14.8 percent, 22.1 percentage points lower than that at the end of 2002. Second, recapitalization and equity increases speeded up, leading to a rapid increase of the capital adequacy ratio. At end-2002, the capital adequacy ratio of rural credit cooperatives was minus 8.45 percent. At end-2005, the capital adequacy ratios of the rural credit cooperatives, rural cooperative banks, and rural commercial banks were raised to 8.03 percent, 12.93 percent, and 8.78 percent respectively. Third, on a net basis, the rural credit cooperatives in China as a whole made profits, for the first time in 10 years. In 2005, net profits reached 18 billion yuan, 7.5 billion yuan more than that in 2004. Fourth, the size of assets expanded continually, indicating greater strength on the part of the rural credit cooperatives to assist farmers. At end-2005, the

total outstanding deposits of the rural credit cooperatives stood at 3.2573 trillion yuan, up 66 percent from 2002. Outstanding loans were 2.2354 trillion yuan, up 60 percent from 2002. Outstanding agricultural loans stood at 1.0071 trillion yuan, accounting for 46 percent of total loans compared with 40 percent in 2002. Meanwhile, the agricultural loans of the rural credit cooperatives accounted for 87 percent of those issued by all financial institutions compared with 81 percent in 2002.

V. Reform of the Exchange Rate Regime Produced Fairly Good

Results

With the approval of the State Council, the PBC announced on July 21, 2005 that it would adopt a market-based managed floating exchange rate regime with reference to a basket of currencies. According to the estimate of the equilibrium exchange rate level, the exchange rate of the RMB against the US dollar appreciated by 2 percent to 8.11 yuan per US dollar on the day of the announcement. The new regime worked smoothly with the RMB exchange rate moving in both directions in a more flexible manner, reflecting exchange rate changes among major currencies and the characteristics of the new regime based on market supply and demand with reference to a basket of currencies.

With market participants becoming increasingly confident in the new regime and the improvement of the foreign exchange market system, the expectation of RMB appreciation weakened somewhat, as reflected by banks changing from net purchasers to net sellers of foreign exchange in the forward market, a slowdown of foreign exchange inflow, and a significantly lower speed of foreign exchange reserves growth.

As the size of the initial adjustment in the RMB exchange rate and the timing of the reform were appropriate, various types of export and import enterprises adapted themselves relatively well to the new RMB exchange rate regime at a micro level. From a macroeconomic perspective, the national economy maintained a fairly rapid and sound growth momentum, reflecting the improved resilience against external shocks and the dynamics of the economy as a result of many years' efforts in economic reform and building a socialist market economy.

Box 3: Enterprises Adapted Relatively Smoothly to the New Exchange Rate Regime

In November 2005, to further assess the impact of the new exchange rate regime on

enterprises, the PBC conducted survey in the form of a questionnaire on 1,113 enterprises eligible to deal with foreign trade in 19 provinces (municipalities) that led in exports and imports volumes and accounted for over 96 percent of foreign trade in 2004.² According to the survey, various import and export enterprises made positive efforts to adapt themselves to the new regime. After the reform, export value and orders continued to increase and export prices rose. Enterprises were in a better position to deal with exchange rate risk by using a variety of instruments.

1. Exports and Imports Continued to Increase

In November 2005, 72.9 percent of the sample enterprises witnessed increased or unchanged exports over the same period last year. In particular, 16.2 percent of the enterprises had growth rates of over 10 percent accounted for 16.2 percent. 76.3 percent of the sample enterprises witnessed increased or unchanged exports on a month-on-month basis. 78.3 percent of the sample enterprises witnessed expanded or unchanged imports over the same period last year, and 84.4 percent of the sample enterprises witnessed increased or unchanged imports on a month-on-month basis. Enterprises with export growth over 5 percent on a year-on-year basis and a month-on-month basis accounted for 21 percent and 12.2 percent respectively, 3.7 and 3.5 percentage points higher than those with import growth of over 5 percent respectively. Enterprises with a small volume of foreign trade did not experience significant change in the growth rate of exports and imports, while those with a large amount of exports and imports witnessed a positive correlation between the volume of foreign trade and the capacity to expand exports.

2. Export Orders Continued to Increase

In November 2005, 72.7 percent of the sample enterprises witnessed increased or unchanged export orders compared with the same period in 2004, with those posting a growth rate above 5 percent accounting for 17.4 percent. 81.4 percent of the sample enterprises witnessed increased or unchanged export orders on a month-on-month basis, with those reporting a growth rate above 5 percent accounting for 8.6 percent. Enterprises with a small volume of foreign trade did not experience significant change in the growth rate of export orders, while those with a large amount of exports and imports witnessed a positive correlation between the volume of foreign trade and the capacity to win export orders.

3. Export Prices Rose

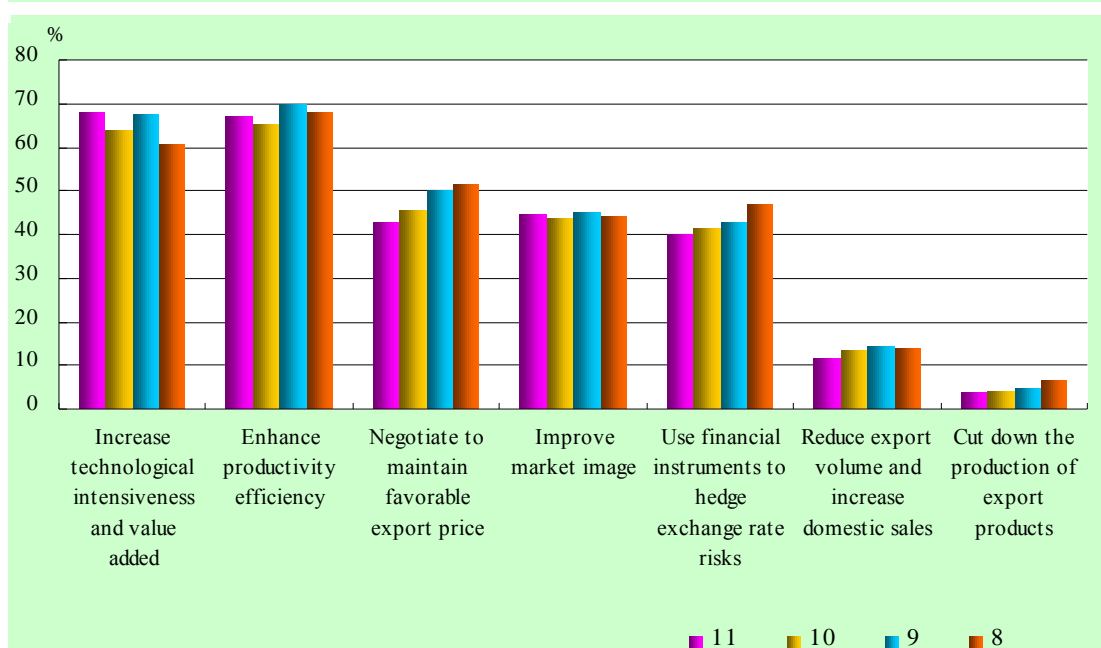
² The survey covered state-owned and state-controlled enterprises, limited companies, companies with investment from Hong Kong, Taiwan, and Macao, and foreign-funded enterprises, involving 13 industries including textiles and apparel, metals, oil and gas, chemicals, metal, smelting and foundries, manufacturing, transportation, and machinery. In the first 10 months of 2005, the exports of the sample enterprises accounted for 11.22 percent of China's total exports, and their imports accounted for 13.38 percent of total imports.

In November 2005, 84.8 percent of the sample enterprises witnessed raised or unchanged export prices on a year-on-year basis. In particular, 12.1 percent of the enterprises had export prices rising by more than 3 percent. Enterprises of various sizes all had a certain capacity to raise prices. 74.2 percent of the enterprises witnessed raised or unchanged import prices on a year-on-year basis.

4. Enterprises Took Positive Measures to Cope with the Exchange Rate Regime Reform

From August through November, enterprises that made endeavors to “increase technological intensiveness and value added,” “enhance productivity efficiency,” “improve market image,” “negotiate to maintain favorable export prices,” and “use financial instruments to hedge exchange rate risks” accounted for more than 40 percent of the sample enterprises, and the share of those choosing to “upgrade their technological level” has been rising steadily, becoming their first choice in November. The share of those choosing to “cut down on the production of export products” or to “reduce export volume and increase domestic sales” was low and displayed a declining trend.

Figure 1: Measures Taken by Enterprises after the Reform of the RMB Exchange Rate Regime



Source: Survey of the People's Bank of China.

5. A Mix of Instruments Was Used to Hedge against Exchange Rate Risk

To better understand the enterprises' practices in hedging exchange rate risk, the PBC conducted special research about practices to hedge exchange rate risk on 323 enterprises (including domestic enterprises, foreign-funded enterprises, manufacturers,

and foreign trade companies) in 10 provinces (municipalities) where the external sector accounted for a relatively high share of the economy. According to the research findings, in August and September 2005, trade financing was the primary instrument to hedge exchange rate risk, accounting for 30.8 percent, which, however, was slightly lower than the proportion registered during the same period in 2004. In terms of trade finance structure, the share of using factoring, a medium- to long-term trade finance instrument to hedge exchange rate risk, increased significantly by 5 percentage points, and the share of applying other trade finance instruments such as package loans also increased, indicating an improved capacity of enterprises to cope with long-term exchange rate risk.

Meanwhile, enterprises also used a larger variety of instruments. In particular, the shares of enterprises using financial derivatives, non-US dollar settlements, and investment in foreign exchange products were 28 percent, 6.1 percent, and 0.8 percent respectively, up by 0.8 percentage points, 1.6 percentage points, and 0.5 percentage points respectively. As the size and coverage of forward transactions increased and the inter-bank forward sale and purchase of the foreign exchange market was established after the reform of the exchange rate regime, enterprises were in a better position to engage in forward transactions, and the use of forward purchases and sales of foreign exchange transactions overwhelmingly surpassed that of other financial derivatives. Moreover, enterprises using a foreign exchange swap, which was newly introduced in August, accounted for 3.3 percent, reflecting the strengthened adaptability of enterprises to new hedging instruments and improved sense to manage exchange rate risk.

The survey indicated that there remained some problems regarding the enterprises' response to the new exchange rate regime. Some domestic enterprises dealing with foreign trade lack both professionals and knowledge to manage exchange rate risk. Financial institutions do not have sufficient motivation to develop new risk hedging instruments. The use of risk hedging instruments by enterprises remains small compared with the volume of China's foreign trade. All these issues should be addressed by further improving the exchange rate regime, developing the foreign exchange market, strengthening micro incentives for financial institutions, and so on.

Reform of the exchange rate regime is conducive to promoting equilibrium of the BOP. However, China's BOP surplus, given its size and the long process of build-up, has deep-rooted and complicated external and internal causes. The large size of the BOP surplus is not only a feature of China's economic development at a certain stage, but also a result of the rapid integration of the Chinese economy into the process of globalization. Meanwhile, it also reflects imbalances of economic development in China, among which, the current account surplus indicates relatively slow growth of domestic consumption and the fact that savings have consistently exceeded

investment. In addition, policy and institutional factors have also enlarged the BOP surplus to a certain extent. For instance, the policy framework and management guidelines that was established during the period when foreign exchange was in short supply in China that made capital inflow easy and outflow difficult and aimed at establishing all kinds of industries and sectors; domestic prices do not fully reflect the scarcity of resources; labor security and an environmental conservation system are not complete; thus, the prices of export products do not fully reflect compensation for resources, labor, and environmental pollution, thus virtually strengthening the price competitiveness of export goods. While the exchange rate may play a role in adjusting the balance of payments, it is not sufficient to solely rely on the exchange rate to adjust the balance of payments. Hence, it is important to implement a scientific development approach and promote institutional reform of foreign trade, resource prices, foreign exchange management, labor security, and environmental compensation according to the requirements of a comprehensive, coordinated, sustainable development strategy whereby a large country's economic development should be based on domestic demand, have all policy measures working together, and give the market mechanism full play in the adjustment of the balance of payments.

VI. Speed Up the Foreign Exchange Management System Reform and Promote the Basic Equilibrium of the BOP

First, trade investment shall be facilitated. Verification procedures have been further simplified. The enterprises' foreign exchange account limit under the current account and the guidance limit of individuals' purchase of foreign exchange for private use have been increased. Examination procedures and document requirements with respect to individuals' purchase of and payment with foreign exchange have been substantially simplified. Centralized foreign exchange management was established for large enterprise groups on a pilot basis. Pudong New Area of Shanghai has pioneered in adopting 9 foreign exchange management measures on a pilot basis. Overseas equity financing and backward investment by domestic institutions and individuals in the form of a special purpose company³ were regulated and guided. Second, comprehensive position management was adopted with regard to commercial banks' purchase and sale of foreign exchange. The exchange rate management system was improved by expanding the movement band for non-US dollar currencies at the inter-bank market and widening the spread of quotations of the US dollar exchange

³ This refers to overseas companies directly or indirectly established by a domestic resident (legal person or natural person) for the purpose of overseas equity financing (including convertible bonds) on the basis of the domestic company's assets or equity held by the domestic resident.

rate offered by commercial banks to their clients. Third, channels of capital inflow and outflow were expanded. The coverage of the overseas investment foreign exchange management pilot reform was extended and domestic banks were endorsed to provide financing guarantees for enterprises investing abroad. At the border areas, a more flexible overseas investment policy was carried out. In 2005, domestic enterprises were approved by the SAFE to transfer US\$4.56 billion abroad, with US\$2.66 billion purchased, growing by 2.9-fold year-on-year. The size and coverage of QFII were further extended to boost the development of the domestic capital market. In 2005, 17 institutions newly gained access as QFIIs or were allowed to supplement funds, with the approved quota reaching US\$2.22 billion. Fourth, the authorities strengthened monitoring and management of cross-border capital flows such as short-term external debt. The authorities intensified management and oversight on trade credit funds, such as deferred payment of foreign exchange for imports and collection of payment before exports. The authorities also strictly controlled short-term debt indicators of domestic and foreign banks, regulated borrowings of special categories of foreign-funded enterprises, and included fund transfers of cross-country companies through their associate companies into the external debt management framework. The authorities also strengthened work in foreign exchange inspection and anti-money laundering, cracked down on illegal foreign exchange transactions through underground banks, and promoted the development of a credit system on the foreign exchange market.

Part 3 Financial Market Performance

I. An Overview of Financial Market Performance

The year 2005 saw sound financial market performance, featuring brisk activities and sufficient liquidity in the money market, a growing variety of bond instruments, fairly frequent overseas financing by enterprises, and major progress in institutional development of the financial market.

In 2005, the financing structure of domestic non-financial institutions, including households, enterprises, and government sectors, changed remarkably with the share of debt financing by enterprises on the rise and that of loans and government securities declining. The share of bank loans to non-financial sectors, equity, government securities, and corporate bonds in total financing was 78.1, 6.0, 9.5, and 6.4 percent respectively.

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

	Volume of Financing (100 million yuan)		As a percentage of total financing (%)	
	2005	2004	2005	2004
Financing by Domestic Non-Financial Institutions	31507	29023	100.0	100.0
Bank loans	24617	24066	78.1	82.9
Equity	1884	1504	6.0	5.2
Government securities	2996	3126	9.5	10.8
Corporate bonds	2010	327	6.4	1.1

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

1. Trading at the inter-bank market was brisk. The inter-bank borrowing rate and repo rate remained stable and at a low level

In 2005, the turnover of bond repo at the inter-bank market grew by 6.46 trillion yuan over that of 2004 to 15.90 trillion yuan, averaging 63.4 billion yuan per day, a year-on-year growth of 69.2 percent; the bond pledged turnover increased by 6.37 trillion yuan to 15.68 trillion yuan, with the daily average turnover increasing by 69.1 percent, a growth that is 90 percentage points higher than that of last year; the turnover of outright bond repo totaled 222.3 billion yuan. The accumulated turnover of government securities repo at organized exchanges was 2.36 trillion yuan, down 46.4 percent from 2004.

Because financial institutions had plenty of funds, repo transactions were brisk. As a result of the market rate decline following the excess reserve rate cut on March 17, financial institutions increased their use of short-term funds. In April, the monthly turnover of the bond pledged overnight repo exceeded that of the bond pledged 7-day repo for the first time, reflecting a trend of shortening maturity in financing.

In 2005, inter-bank borrowing totaled 1.28 trillion yuan, down by 177.2 billion compared with that of 2004, and the daily average turnover was down by 11.8 percent to 5.09 billion yuan. The lion's share was short-term instrument, i.e., 7-day and overnight, accounting for 70.1 percent and 17.5 percent respectively.

The inter-bank market was characterized by a stable yet low level of interest rates and an abundant supply of liquidity. In March, the flow of funds back into financial institutions after the Spring Festival and the excess reserve rate cut on March 17 pushed down money market interest rates. In June, the monthly weighted average rates of inter-bank borrowing and bond pledged repo reached their lowest level in several years, at 1.46 percent and 1.10 percent respectively, 0.52 and 0.6 percentage points lower than their March levels respectively. After that, interest rates at the inter-bank market stabilized. In the fourth quarter, intensified open market operations and greater demand for funds in the run-up to the Spring Festival caused interest rates to rise. From June to December, the inter-bank borrowing rate and bond pledged repo rate moved up by 0.26 and 0.44 percentage points respectively to 1.72 percent and 1.54 percent.

With respect to fund flows on the market, state-owned commercial banks were still the net fund providers for both bond pledged and outright bond repo, with net lending in 2005 increasing by a large margin over the previous year. Net recipients were other financial institutions⁴ other commercial banks⁵, and foreign financial institutions, by an amount in a descending order. Among other financial institutions, the net amount received by insurance companies, securities firms, and fund management companies increased rapidly. As for inter-bank borrowing, other commercial banks as a group have become a larger net fund provider than state-owned commercial banks for the first time since 2002. On the demand side, the net amount received by other financial institutions⁶ declined due to decreased borrowing by securities companies; the net

⁴ Other financial institutions include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies.

⁵ Other commercial banks include joint stock commercial banks and city commercial banks.

⁶ Other Financial institutions include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies and securities companies.

amount received by foreign financial institutions increased by a large margin.

Table 4: Fund Flows Among Financial Institutions in the Inter-bank Market, 2004 & 2005

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	2005	2004	2005	2004
Wholly State-Owned Commercial Banks	-87894	-45958	-3367	-4913
Other Commercial Banks	36096	28608	-4125	-2865
Other Financial Institutions	46553	16816	6076	7175
Of which, securities and fund management companies	14485	4492	3772	6532
Insurance companies	9296	1661	—	—
Foreign Financial Institutions	5245	533	1417	604

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.

In general, state-owned commercial banks were the major suppliers of funds in the money market. On the one hand, due to the rise of real deposit rates and various other factors, the state-owned commercial banks, which took the bulk of deposits, had much more funds than before; on the other hand, joint-stock reform by state-owned commercial banks that started in 2004 and heightened capital adequacy management had a large impact on their behavior in fund use and slowed down the growth of their lending. On the demand side, due to the relatively low market interest rates in 2005 and the large amount of available low-cost funds, major fund recipients actively engaged in financing. In particular, insurance companies and foreign financial institutions have become important participants in the money market, due to the development of the money market and the further opening of financial markets.

2. The bond market grew larger and transactions were brisk

In 2005, because financial institutions had sufficient funds and the CPI declined steadily, the bond market saw very active transactions. In 2005, the accumulated turnover of spot transactions in the inter-bank bond market increased by 3.51 trillion yuan over the previous year to 6.01 trillion yuan, while the daily average turnover soared by 1.4-fold to 24.0 billion yuan. The turnover of government bond spot transactions at organized exchanges totaled 278.1 billion yuan, 18.6 billion yuan less than that of 2004.

In the inter-bank spot market, state-owned commercial banks, as the net buyers, made a net purchase of 299.9 billion yuan, representing a growth of 6.2-fold over the

previous year. Other commercial banks, as the net sellers, made a net sale of 330.6 billion yuan, up 87.8 percent from that of 2004; securities companies and fund management companies made a net sale of 36.2 billion yuan and 66.0 billion yuan respectively, up 1.7-fold and 1.4-fold from that of 2004; foreign financial institutions, that were net buyers and made a net purchase of 35.8 billion yuan last year, became net sellers in 2005 and made a net sale of 22.4 billion yuan.

In 2005, due to various factors including macroeconomic developments and the fund supply situation, prices at the bond market showed an upward trend while the yield-to-maturity along the yield curve declined. In the beginning of Q4, due to a stronger expectation of a market interest rate rise and the tightening liquidity situation before the New Year, the bond indices at the inter-bank market and stock exchanges moved downward appreciably before gradually stabilizing. The bond index at the inter-bank market rose by 9.21 points, or 8.85 percent, from 104.02 points at the beginning of 2005 to 113.23 points at year-end. The government securities index at the organized exchanges rallied by 13.37 points, or 13.97 percent, from 95.69 points at the beginning of 2005 to 109.06 points at year-end.

In the period under review, yields of bonds of various maturities declined slightly. The yield curve of government securities at the inter-bank market shifted downward. In particular, the drop in the yield of bonds of middle- and long-term maturities caused the yield curve to flatten. In the beginning of Q4, the bond market stabilized before softening to some extent; thus, the yield curve recovered slightly to its level in mid-July. As prices in the bond market surged toward year-end, the yield curve again shifted downward slightly.

The bond market expanded considerably and a greater variety of instruments were introduced to the market, offering more financing channels to all kinds of institutions. In 2005, a total of 1.6298 trillion yuan worth of bonds (excluding central bank bills) was issued, up 32 percent year-on-year. With the adoption of a sound fiscal policy, government securities issues grew at a markedly slower pace while policy financial bonds and corporate bonds increased by a much higher rate than the last year. A total of 704.2 billion yuan worth of government securities was issued, a year-on-year increase of 1.7 percent, which is 8.6 percentage points lower than that of 2004. A total of 585.2 billion yuan worth of policy financial bonds was issued, an increase of 170.4 billion over that of last year. A total of 204.7 billion yuan worth of corporate bonds (including short-term corporate financing bills worth 139.3 billion yuan) was issued, representing a 5.3-fold increase over that of last year. Subordinated debts issued by financial institutions totaled 96.6 billion yuan, financial bonds 27 billion yuan, asset-

backed securities 7.1 billion yuan, short-term bills issued by securities companies 2.9 billion yuan, while international institutions (including the International Finance Company and the Asian Development Bank) issued 2.13 billion yuan worth of Panda Bonds.

In the first three quarters, the issuing rates of treasury bonds and policy financial debt displayed a declining trend, due to softer inflation expectations. The 7-year book-entry treasury bond issued in August (the ninth issue) offered an interest rate of 2.83 percent, 0.54 percentage points lower than that of the fifth issue book-entry treasury bonds issued in May. The 15-year fixed-rate bonds issued by the State Development Bank in June (the tenth issue) had an interest rate of 3.82 percent, down 1.66 percentage points compared with that of the first issue fixed-rate bonds issued in February. In Q4, against the background of intensified open market operations and a slightly higher issuing rate of central bank bills, the issuing rates of treasury bonds also moved up marginally. The interest rate of 7-year book-entry treasury bonds (the thirteenth issue) issued in November was 3.01 percent, 0.18 percentage points higher than that of the ninth issue book-entry treasury bonds.

3. Commercial paper market saw quick growth

In 2005, a total of 4.45 trillion yuan worth of bills was issued, 1.0 trillion yuan more than that of 2004, or up 30.1 percent; the amount of discount bills totaled 6.75 trillion yuan, up 43.3 percent compared with 2004, while that of rediscount bills reached 2.5 billion yuan, representing a year-on-year decrease of 20.2 billion yuan. At end-2005, the outstanding balance of commercial paper stood at 1.96 trillion yuan, up 32 percent from 2004; the outstanding balance of discount bills was 1.38 trillion yuan, 0.36 trillion yuan more than that in 2004, or up 35 percent; the outstanding balance of rediscount bills was 239 million yuan, 3.1 billion yuan less than that in 2004.

The year 2005 witnessed rapid growth of commercial paper transactions and continued expansion of this market. It has the following features. First, commercial paper financing surged while short-term financing increasingly took the form of commercial paper. Commercial paper financing as a percentage of short-term bank loans has become higher year by year. In 2005, commercial paper financing grew by about 30 percent over that of 2004, 20 percentage points higher than that of bank loans. Secondly, heated competition in the commercial paper market drove down interest rates. Given the limits of direct financing channels, commercial banks moved a large amount of funds to the commercial paper market, causing the interest rates there to drop gradually. Thirdly, affected by factors such as fund supply and demand,

rediscount instruments gradually made their way out of the market.

4. Stock market indices gradually rallied and enterprises increasingly received financing from overseas markets

In 2005, the total turnover of the Shanghai and Shenzhen Stock Exchanges was 3.17 trillion yuan, 1.07 trillion yuan less than the previous year, with the daily average turnover down 24.9 percent from that of 2004 to 13.1 billion yuan. The accumulated turnover of A shares stood at 3.11 trillion yuan, a reduction of 1.05 trillion yuan year-on-year; daily turnover averaged 12.9 billion yuan, 24.9 percent less than that in the previous year.

The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index slid after peaking at 1,329 points in February and at 334 points in March respectively. As market expectations began to stabilize and investor confidence became firm after the substantive measures taken by relevant agencies to implement the State Council's Opinions on Promoting Reform, Opening-up and Stable Development of the Capital Market and expedited short-term financing bills issuing by securities companies, stock indices recovered little by little. At end-December, the Shanghai Stock Exchange Composite Index and Shenzhen Stock Exchange Composite Index closed at 1,161 and 279 points respectively, up 7.4 percent and 6.9 percent from end-June when market confidence was at a low level.

In 2005, a total of 188.4 billion yuan was raised on the equity market at home and abroad, 38.1 billion yuan or 25.3 percent more than that in 2004. A total of 33.9 billion yuan was raised on the A share market, including IPOs, additional offerings and rights issues, down by 45.3 percent from 2004; a total of US\$18.9 billion was raised on the H market (the equivalent of 154.5 billion yuan), up 1.4-fold, or 38.9 percentage points higher than that of the last year and accounting for 82 percent of total financing.

Securities investment funds continued to grow rapidly, with 218 funds launched in the year, 57 more than that at end-2004. The gross volume of funds reached 471.4 billion yuan while net assets expanded by 42.5 percent compared with end-2004 to 469.1 billion yuan.

5. The asset structure of the insurance industry further diversified

The insurance industry continued the momentum of rapid development. At end-2005, there were 93 insurance companies in China (excluding those in the process of

preparing to open), 21 more than that at end-2004. Total assets grew by 28.5 percent year-on-year to 1.52 trillion yuan. The industry's total premium income in 2005 reached 492.73 billion yuan, up 14.1 percent from that of 2004, among which the property insurance premium went up by 12.8 percent to 123.0 billion yuan and the personal insurance premium went up by 14.5 percent to 369.7 billion yuan. Life insurance premium income registered a growth of 13.8 percent, 7 percentage points more than that of 2004 and totaling 324.4 billion yuan. The accumulated insurance claim payments grew by 12.5 percent year-on-year (6.9 percentage points lower than that of 2004) to 113.0 billion yuan.

Assets of insurance companies further diversified. The share of deposits declined markedly while government securities, securities investment funds, and other investment moved up rapidly.

Table 5: Use of Insurance Funds at end-2005

	Outstanding balance (100 million yuan)		As a percentage of total assets (%)	
	End 2005	End 2004	End 2005	End 2004
Total assets	15226	11854	100.0	100.0
Of which, Deposits	5241	4969	34.4	41.9
Investment	8894	5712	58.4	48.2
Government securities	3588	2652	23.6	22.4
Securities investment fund	1099	673	7.2	5.7
Other investment	4207	2387	27.6	20.1

Source: China Insurance Regulatory Commission.

6. Foreign currency pairs and forward transactions were introduced into the inter-bank foreign exchange market

On May 18, spot transactions were launched for 8 pairs of foreign currencies at the inter-bank foreign exchange market. At end-2005, the combined turnover of transactions of all 8-currency pairs totaled US\$52.1 billion. In August, the PBC introduced RMB forward transactions to the inter-bank foreign exchange market. Since then, the market has been operating in good condition with transaction volumes surging and it has acquired price setting power for RMB exchange rate forward transactions.

II. Financial Market Institutional Building

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

First of all, financial product innovation has been encouraged, pilot short-term enterprise financing bill issues and asset-backed securities have been promoted and bond forward transactions have been launched in the inter-bank market. On December 15, the first issue of China Development Bank's asset-backed securities worth 4.17727 billion yuan and China Construction Bank's mortgage-backed securities worth 3.019 billion yuan were issued and traded at the inter-bank bond market. This pilot progress in credit asset-backed securities has laid the ground for further work in asset-backed securities. Secondly, the issuing of financial bonds was regulated and promoted to support the development of the corporate bond market. Thirdly, the financial market opening-up has moved forward, as international development institutions have issued RMB-denominated bonds and the PAIF and ABF2 China Fund were allowed into the inter-bank market, among which the PAIF became the first foreign institutional investor in the inter-bank bond market. Fifth, infrastructure building of the financial market has been strengthened. The trading system of the inter-bank bond market and book-keeping system were connected to achieve straight-through processing.

2. Expedite foreign exchange market development

First, the functions of the foreign exchange market were improved to support the RMB exchange rate regime reform. A larger variety of participants were given access to the spot market and qualified non-bank financial institutions and non-financial companies became participants in the inter-bank foreign exchange market. OTC transactions were introduced in the inter-bank foreign exchange market. More instruments were made available in the market and qualified participants were allowed to conduct foreign exchange forward transactions and RMB-foreign currency swap transactions. Secondly, foreign currency sales and purchases were allowed in the inter-bank foreign exchange market, with spot transactions of eight pairs of foreign currency launched on the spot market, 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. Thirdly, a market maker system was introduced into the inter-bank foreign exchange market to enhance activities in foreign exchange transactions, increase liquidity at the foreign exchange market, give the central bank more flexibility in macroeconomic adjustment, and allow the market a larger role in determining the RMB exchange rate.

3. Non-tradable state share reform and securities company restructuring made headway

On April 29, 2005, the China Securities Regulatory Commission issued, with State Council approval, *Notice on Issues Relating to Reform of Non-Tradable State Shares of Public Companies*, thus launching a pilot reform. By August 19, a total of 46 pilot companies, approved in two batches, had completed the required reform procedures. The China Securities Regulatory Commission, State-owned Assets Supervision and Administration Commission, Ministry of Finance, PBC, and Ministry of Commerce jointly issued *Guidelines on Reform of Non-Tradable State Shares of Public Companies*, a document that provides for institutional improvement on the basis of pilot experiences to tackle the potentially complex situations that might arise in the next stage. Thereafter, the China Securities Regulatory Commission, the Shanghai and Shenzhen Stock Exchanges, the China Securities Depository and Clearing Co. Ltd., and other agencies issued *the Administrative Measures on Reform of Non-Tradable State Shares of Public Companies* and supporting documents. The reform gradually moved forward. By end-2005, about 421 companies had either completed or started reform procedures, accounting for 31 percent of public companies and 35 percent of the gross capitalization of the two stock exchanges.

While properly addressing the risks in securities companies, those securities firms with restructuring potentials that were socially important, such as Galaxy, Huaxia, Guotai Junan, Shenyin & Wanguo, were restructured based on the principle of addressing both the root cause and the symptoms but focusing on the root cause. Problems such as lack of capital and liquidity were solved; furthermore, efforts were made to promote the transformation of the operational mechanism and the establishment of a corporate governance structure and strict internal control system befitting a modern enterprise, to encourage institutional building and innovation, and to adopt third-party custodial services for a securities transaction settlement fund, in order to nurture a contingent of strong securities firms.

4. Further intensify institutional building in the insurance market

More avenues were made available for insurance fund investment and the investment behavior of investment institutions was regulated. The first task was to promote the insurance fund's direct investment in domestic equities. The China Insurance Regulatory Commission issued documents such as *Circular on Issues Concerning Insurance Institutional Investors' Equity Investment Transactions*; the direct investment of investment funds at the securities market reached the operational

stage. The second task was to promote and regulate the foreign exchange component of insurance funds to be invested abroad. The China Insurance Regulatory Commission issued the *Circular on Issues Concerning Overseas Investment of the Foreign Exchange Insurance Fund* to allow investment of the foreign exchange part of insurance funds in shares issued by Chinese enterprises in the overseas market. In addition, the China Insurance Regulatory Commission promulgated the *Implementation Rules for Overseas Use of Foreign Exchange in Insurance Investment*, and effectively made the overseas use of the foreign exchange part of insurance funds operationally possible. The third task was to regulate the bond investment of insurance institutional investors. The China Insurance Regulatory Commission issued the *Provisional Rules on Regulating Bond Investment of Insurance Institutional Investors* to guide insurance institutions to increase bond investment on the basis of effective risk management, in order to enhance asset quality and optimize asset structure.

The institutional building was improved in terms of relevant rules and regulations to reduce control and strengthen supervision. First of all, rules and regulations on the reinsurance business were formulated. According to our WTO accession commitment, the mandatory reinsurance limit will be reduced year by year and will be abolished in 2006. Therefore, the China Insurance Regulatory Commission issued the *Rules on Management of the Reinsurance Business* and provided detailed rules on the repayment capability of foreign reinsurance companies, priority of domestic institutions, and risk concentration control. Secondly, management of property insurance products was reformed. The China Insurance Regulatory Commission issued the *Rules on Management of Policy Terms and Premium of Property Insurance Companies* to ease pre-approval control and strengthen ex-post supervision.

Part 4 Analysis of Macroeconomic Development

I. The global economic and financial situation and the forecast for 2006

In 2005, the global economy grew in a sustained and rapid manner. The US economy witnessed strong growth. The economies in the euro zone saw slow recovery. The Japanese economy apparently showed a momentum of recovery. The major Latin American and Asian emerging economies still maintained a momentum of robust growth. International crude oil prices remained at a high level and trade protectionism gained ground, constituting major risks for global economic growth. According to the International Monetary Fund (IMF) forecast in September 2005: global economic growth in 2006 would remain at the same level as the 4.3 percent recorded in 2005, and the growth rates of the US and the euro zone would reach 3.3 percent and 1.8 percent, down 0.3 and 0.5 percentage points respectively compared with the forecast in April 2005; the growth rate of Japan would remain the same, at 2.0 percent, as the forecast in April 2005.

1. Economic development of the major economies

The US economy continued to maintain strong growth momentum. In 2005, GDP grew by 3.5 percent, with annualized quarterly growth rates posting 3.6 percent, 3.6 percent, 3.6 percent, and 3.1 percent respectively on a year-on-year basis. US employment further improved. The annualized monthly unemployment rates were all below the levels in the corresponding months of 2004, ranging from 4.9 percent to 5.2 percent, with the exception of a yearly high of 5.4 percent recorded in February. Inflationary pressures kept on building up. During the entire year, the consumer price index (CPI) registered 3.4 percent, 0.7 percentage points higher than that recorded in the previous year; the quarterly CPI posted 3.0 percent, 2.9 percent, 3.8 percent, and 3.7 percent respectively on a year-on-year basis. In the 2005 financial year, US fiscal deficits registered US\$319 billion, down US\$93 billion from that recorded in the previous year. US foreign trade deficits further increased to US\$725.8 billion, up US\$108.2 billion. The ratio of trade deficits to GDP increased from 5.3 percent in 2004 to 5.8 percent in 2005.

The economies in the euro zone continued to recover slowly. In 2005, GDP grew by

1.3 percent, with the quarterly growth rates posting 1.2 percent, 1.2 percent, 1.6 percent, and 1.7 percent respectively on a year-on-year basis. The unemployment rate in the euro zone dropped with each passing quarter, with the quarterly unemployment rates registering 8.8 percent, 8.6 percent, 8.4 percent, and 8.3 percent respectively; yet the unemployment rate was still at a high level. The Harmonized Index of Consumer Prices (HICP) was 2.2 percent, up 0.1 percentage points from that recorded in the previous year; the quarterly HICP registered 2.0 percent, 2.0 percent, 2.3 percent, and 2.3 percent respectively on a year-on-year basis. According to the estimation by the European Commission, the fiscal deficits accounted for about 2.9 percent of GDP in the euro zone in 2005.

The Japanese economy showed clear signs of recovery. In 2005, GDP grew by 2.8 percent, an acceleration of 0.5 percentage points; the quarterly growth rates registered 1.0 percent, 2.2 percent, 2.8 percent, and 4.2 percent respectively on a year-on-year basis. The annualized quarterly unemployment rate tended to be dropping, posting 4.6 percent, 4.4 percent, 4.3 percent, and 4.5 percent respectively. The year-on-year CPI decreased from 0 in 2004 to -0.3 percent in 2005. The quarterly CPI registered -0.2 percent, -0.1 percent, -0.3 percent, and -0.5 percent respectively on a year-on-year basis. In particular, the CPI, excluding fresh food, turned from a negative figure to a positive figure in October 2005, but the yearly CPI still posted -0.1, flat with that recorded in 2004. Exports continued to grow. In 2005, the foreign trade surplus was JPY8.78 trillion, down 26.5 percent on a year-on-year basis.

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

2. Development of international financial markets

The US dollar in general strengthened against other major currencies. On December 30, 2005, the euro and the sterling pound closed against the US dollar at US\$1.1840 and US\$1.7211 respectively and the US dollar closed against the yen at JPY117.92. The dollar strengthened by 12.67 percent, 15.10 percent, and 10.28 percent against the euro, the yen, and the pound respectively over that recorded at end-2004.

Yields in major international bond markets fluctuated within a small range and generally remained at a low level. In 2005, the yields of 10-year government bonds in

the US, the euro zone, and Japan fluctuated within a range of 3.8-4.7 percent, 3.03-3.77 percent, and 1.2-1.6 percent respectively. On December 30, 2005, the yields of 10-year government bonds in the above three regions closed at 4.39 percent, 3.30 percent, and 1.47 percent respectively, up 0.17, -0.39, and 0.03 percentage points on a corresponding year-on-year basis.

The stock markets varied from country to country; in particular the stock markets in the major economies in Europe and Japan apparently showed a clear rising momentum. On December 30, the Dow Jones Industrial Average closed down by 0.61 percent from that recorded at end-2004 and the NASDAQ Composite Index edged up only by 1.37 percent; yet the Financial Times Stock Exchange 100 Index, the Eurozone Stoxx 50, and the Nikkei 225 Stock Average ended up 16.7 percent, 21.27 percent, and 40.24 percent respectively.

3. Monetary policies of the major economies

The Federal Open Market Committee (FOMC) raised the federal-funds target rate to 4.25 percent, by increments of 25 basis points respectively on February 2, March 22, May 3, June 30, August 9, September 20, November 1, and December 13. The European Central Bank (ECB) raised the interest rates of main refinancing operations, deposit facilities, and lending facilities by 25 basis points to 2.25 percent, 1.25 percent, and 3.25 percent respectively, the first hike since June 2003. The Bank of Japan (BOJ) continued to implement the loose monetary policy by maintaining the upper limit of the total current account balance held with the BOJ by commercial banks at JPY30-35 trillion. The Bank of England lowered the repo rate by 25 basis points to 4.50 percent on August 4 against the backdrop of an economic slowdown and deceleration of household consumption and business investment.

II. Analysis of China's macroeconomic performance

In 2005, the national economy yielded good performance in terms of rapid growth, good returns, stable prices, and enhanced vitality. Economic performance became more stable and economic growth was more balanced, and yet there are still problems such as relapse of excessive growth of fixed-asset investment and the imbalance in the international balance of payments. In 2005, GDP realized 18.2 trillion yuan, up 9.9 percent, a deceleration of 0.2 percentage points from that recorded in the previous year; the consumer price index (CPI) rose by 1.8 percent, down 2.1 percentage points; the foreign trade surplus registered US\$101.9 billion, up US\$69.9 billion.

1. Domestic demand was strong and the foreign trade surplus increased substantially

Household income continued to grow rapidly and consumption demand accelerated. In 2005, the per capita disposable income of urban residents reached 10,493 yuan, representing an inflation-adjusted real growth of 9.6 percent and an acceleration of 1.9 percentage points from that recorded in the previous year. The per capita net earnings by rural residents registered 3,255 yuan, representing a real growth of 6.2 percent, a deceleration of 0.6 percentage points. In 2005, the total volume of retail sales was 6.7 trillion yuan, representing a nominal growth of 12.9 percent, an inflation-adjusted real growth of 12.0 percent (in 2005, retail prices rose by 0.8 percent), and an acceleration of 1.8 percentage points.

Investment demand continued to grow; investment by localities, in particular, accelerated. In 2005, total fixed-asset investment posted 8.9 trillion yuan, representing a nominal growth of 25.7 percent, an inflation-adjusted real growth of 23.7 percent (in 2005, prices of fixed-asset investment rose by 1.6 percent), an acceleration of 4.6 percentage points over that recorded in the previous year. Urban fixed-asset investment posted 7.5 trillion yuan, up 27.2 percent on a year-on-year basis. Rural fixed-asset investment registered 1.4 trillion yuan, up 18 percent. Of urban fixed-asset investment, completed investment in projects by localities considerably exceeded that in projects by central authorities in terms of both growth and amount, constituting the major factor for driving the rapid growth of investment. During January-November 2005, completed investment in projects by central authorities grew 14.3 percent, while that in projects by localities increased by 23.6 percent. The number of projects under construction and of new projects continued to grow. By end-2005, the total investment planned for projects under construction amounted to 18 trillion yuan, up 29 percent on a year-on-year basis; the total investment planned for new projects amounted to 6.5 trillion yuan, up 32.4 percent. The funds available for fixed-asset investment totaled 8 trillion yuan, up 28.2 percent. Specifically, self-raised funds accounted for 54 percent, up 36.8 percent; domestic loans accounted for 19 percent, up 18.2 percent; other funds accounted for 18 percent, up 18.6 percent. Generally, the size of fixed-asset investment still remained excessively large, all relevant parties had a strong impetus for fixed-asset investment, and there existed pressures that there would be a relapse of fixed-asset investment.

The trade surplus increased by a large margin, representing an apparent increasing contribution to economic growth. In 2005, total cumulative exports and imports reached US\$1.4 trillion, increasing by 23.2 percent. Specifically, exports

posted US\$762.0 billion, up 28.4 percent, a deceleration of 7 percentage points on a year-on-year basis; imports registered US\$660.1 billion, up 17.6 percent, a deceleration of 18.4 percentage points. The cumulative trade surplus reached a record-high of US\$101.9 billion. In terms of the composition of commodities, industrial finished products accounted for a large trade surplus, while primary commodities maintained large deficits. In terms of trade modes, ordinary trade accounted for US\$35.4 billion or 34.7 percent of the total trade surplus; the trade surplus attributed to ordinary trade increased by US\$40 billion over that recorded in 2004, accounting for 57.2 percent of the total increase in the trade surplus. Thus, ordinary trade constituted the major factor in the increase of the trade surplus in 2005. Actual utilization of FDI maintained stable growth, amounting to US\$60.3 billion in 2005, a decrease of 0.5 percent on a year-on-year basis.

Box 4: The National Economic Census: The Size, Growth, and Structural Changes of GDP

In 2004, China conducted its first national economic census. The reference time of the census was December 31, 2004, and the survey period was the entire year of 2004. The economic census covered all legal person units, establishments, and self-employed individuals that were engaged in the secondary and tertiary industries within the territory of China. The National Bureau of Statistics (NBS) revised the GDP using the results from the economic census. The NBS released the revised 2004 GDP data on December 20, 2005, the revised historical GDP data for 1993-2003 on January 9, 2006, and the revised 2005 GDP data on January 25, 2006. The economic census verified the size of China's GDP, provided a clear understanding of the real situation in the secondary and tertiary industries, and provided more reliable statistics for formulating macroeconomic policies.

1. The size of GDP rose by a large margin. According to an estimation based on results of the economic census, GDP reached 16 trillion yuan in 2004 at current prices, an increase of 2.3 trillion yuan or 16.8 percent over the preliminary estimate using the regular annual statistical data. After conversion based on the average exchange rate of 8.277 yuan per US dollar in 2004, GDP was adjusted from US\$1.7 trillion before the survey to US\$1.9 trillion. The share of GDP in global GDP rose from 3.8 percent to 4.4 percent. The GDP ranking worldwide rose from seventh to sixth. China overtook Italy in GDP ranking, following the US, Japan, Germany, the UK, and France. Per capita GDP, however, accounted for only one-fifth of the global average, with minor change in the global ranking. China was still ranked after 100th in terms of per capita GDP, and was still at the lower end among the middle-income nations.

2. The growth of GDP was generally revised up. In line with the revised GDP statistics, the annual average growth of GDP reached 9.6 percent during 1979-2004,

up 0.2 percentage points over the preliminary estimate using the regular annual data. In addition, nearly half of the years witnessed a growth of over 10 percent. By choosing the trend deviation methods in revising the historical data, the NBS obtained the revised historical data according to the proportional relationship between the trend figures and the real figures in the original historical data during 1993-2003. The method did not change the trend of economic growth.

3. There were changes in some of the data reflecting significant proportions in the national economy, but the changes did not alter judgments on the major structural issues faced by China.

(1) The shares of the primary industries and the secondary industries decreased, the share of the tertiary industries rose immensely but still remained lower than desired. Of the GDP increase of 2.3 trillion yuan as a result of the survey, the value added of the tertiary industries accounted for 2.13 trillion yuan or 93 percent. The share of the value added of the tertiary industries in the GDP rose from 31.9 percent to 40.7 percent, up 8.8 percentage points. Of the tertiary industries, the transport, storage, post and telecommunications industry, wholesale & retail trade and hotel & catering industry, and the real estate industry saw an increase of about 1.5 trillion yuan in the value added over that produced based on regular statistical methods, accounting for 70 percent of the incremental value added of the tertiary industries. Excluded from the economic census, the primary industries still adopted preliminary estimates from the regular annual data. The share of the primary industries decreased from 15.2 percent to 13.1 percent, down 2.1 percentage points. The share of the secondary industries declined from 52.9 percent to 46.2 percent, down 6.7 percentage points. Empirical studies indicated the distribution of labor and capital in the primary, secondary, and tertiary industries would change regularly with economic development and income growth. As income grows, the share of the primary industries decreases, while the shares of the secondary and tertiary industries rise; when a nation reaches a high-income stage, the share of the primary industries decreases, as does the share of the secondary industries, while the share of the tertiary industries increases. According to the results of the census, the share of the tertiary industries rose to 40.7 percent, but the proportions were still below the average level of medium- and low-income nations. According to the statistics of the World Bank, the share of the tertiary industries in the medium- and low-income nations posted 55 percent in 2004. The share of the services industries in GDP were as follows: the US 75.3 percent, the UK 72.6 percent, France 72.4 percent, Germany 69.2 percent, Japan 68.1 percent, Korea 55.1 percent, the Philippines 53.2 percent, India 51.2 percent, and Thailand 46.3 percent.

(2) The consumption ratio increased and the investment ratio dropped, but the investment ratio remained excessively high. As the tertiary industries (i.e., the services industries) basically represent consumption, the proportions of consumption and investment changed to some extent; the contribution of final consumption to GDP

rose by some measure from 36.3 percent to 37.8 percent; the contribution of fixed capital formation to GDP decreased from 52.9 percent to 48.1 percent; the contribution of net exports to GDP dropped from 9.1 percent to 6.3 percent. All of the above indicates that of the three pillars spurring China's economic growth, consumption played a stronger role, but the role was still far less important compared with that in other countries. For example, in the US in recent years, the contribution by individual consumption to GDP growth was kept above 60 percent. Consequently, developing domestic demand, in particular, domestic consumption demand, remains a basic national strategy.

(3). Comprehensive energy consumption per 10,000 yuan of GDP dropped from 1.58 tons of standard coal to 1.39 tons, but the drop did not change the extensive growth mode. In 2004, the census-revised GDP accounted for 4.4 percent of the global GDP, but the consumption of crude oil, crude coal, iron ore, steel products, aluminum oxide, and cement accounted for 7.4 percent, 31 percent, 30 percent, 27 percent, 25 percent, and 40 percent respectively of total global consumption, which indicated that the resource consumption per unit of output was higher in China and that the contradiction in the economic structure remained prominent.

(4). The ratio of M2 to GDP decreased from 1.85 to 1.58, and the ratio of savings to GDP decreased from 46.03 percent to 39.41 percent, which indicated that the financial structure was relatively more rational, but the higher-than-desired savings ratio and excessive indirect investments still were not fundamentally changed.

2. Output increased substantially, profitability was good, and the business confidence index reached a record-high level

In 2005, the agricultural value added posted 2.3 trillion yuan, growing 5.2 percent and contributing 6.3 percent to economic growth; the value added of industry and construction registered 8.6 trillion yuan, growing 11.4 percent and contributing 54.9 percent to economic growth; in particular, the industrial value added grew by 11.4 percent and contributed 48.6 percent to economic growth, hence industry remained the engine of economic growth; and the value added of the services industries grew by 9.6 percent to 7.3 trillion yuan and contributed 38.8 percent to economic growth.

The situation for agricultural production was good and grain production achieved another bumper harvest, but the weak agricultural foundation has yet to be fundamentally changed. The total output of grain reached 484 million tons, up 3.1 percent on a year-on-year basis. The total output of cotton posted 5.7 million tons, down 9.8 percent; the output of both oil-bearing crops and sugar crops was flat with that recorded in the previous year. Animal husbandry and fishery witnessed a good momentum of growth. The total output of pork, beef, mutton, and poultry grew 6.3

percent. As increases in the prices of agricultural produce were consistently lower than the increases in the prices of agricultural production materials; however, the growth of farmers' income slowed down and agricultural production showed signs of unsustainable development. In 2005, the production prices of agricultural products (i.e., the prices at which producers of agricultural products directly sell their products) increased by 1.4 percent, and the production prices of grain and oil-bearing crops decreased by 0.9 percent and 8.7 percent respectively, while the prices of agricultural production materials surged by 8.3 percent. The net income of farmers' household production and operations increased 5.7 percent, a deceleration of 7.6 percentage points from the last year.

Box 5: Further Improving Rural Financial Services and Strengthening Support to the Rural Economy

The sound development of rural finance constitutes an important condition for building a socialist new countryside, developing the rural economy, and increasing farmers' income. In recent years, the PBC earnestly implemented government policies and measures, actively promoted the reform of rural financial institutions, and enhanced the level of serving the rural economy. At present, a rural financial system based on cooperative finance and accompanied by collaboration between commercial finance and policy finance has been formed. Financial services cover most rural areas.

Actively promoting reform of rural financial institutions. First, steadily promote the reform of rural credit cooperatives (RCCs). In line with the arrangements of the State Council, the PBC, in conjunction with China Banking Regulatory Commission (CBRC), developed and implemented a pilot financial support program for the reform of RCCs to "institute a good mechanism with money." At end-2005, the capital adequacy ratio of RCCs nationwide increased to 8.03 percent, with more funds for supporting the rural economy. At year-end, agricultural loans amounted to 1.0071 trillion yuan. Second, actively promote the postal savings reform and adjust the policies for postal savings deposits in the central bank. The PBC stipulated: as of August 1, 2003, the deposit interest rate for incremental postal savings in the central bank would be lowered from 4.131 percent to 1.89 percent; postal savings institutions may use incremental postal savings at their own discretion by means of bond transactions in the inter-bank market, large-value negotiated deposits with domestic-funded commercial banks and RCCs, business cooperation with policy banks, and fee-based businesses. Third, vigorously bring into play the role of policy banks. Reserves loans, loans for the procurement and distribution of grain and cotton, and loans for grain enterprises by the Agricultural Development Bank of China (ADBC) grew rapidly. In 2005, the cumulative reserves loans by the ADBC amounted to 72.25 billion yuan, up 14.77 billion yuan on a year-on-year basis; the cumulative loans for grain procurement reached 208.65 billion yuan, up 47.01 billion yuan. Meanwhile, the

ADBC prudently promoted new businesses like loans to grain enterprises and cumulative loans for leading industrialized grain enterprises, grain processing enterprises and other grain enterprises posted 23.72 billion yuan. Fourth, continue to bring into play the role of the Agricultural Bank of China (ABC) to support the development of agriculture and the rural economy. As of end-September 2005, 61.9 percent of the ABC offices, 51.5 percent of the ABC staff, and 34.9 percent of the loans were distributed in counties and lower levels. In addition to its own major businesses, the ABC provided services and support for other financial institutions, complementing the financial institutions in terms of business networks, technical support, and varieties of business.

Employing monetary and credit policies to support rural economic development.

Agricultural loans and loans to farmers by RCCs grew rapidly, with the growth rate much higher than the rate of other loans. At present, the share of agricultural loans in the total loans by RCCs has increased from 40.3 percent in 1999 to 46.7 percent in 2005. On the basis of fostering credit-worthy farmers and credit-worthy villages and townships, efforts were made to spur development of micro loans. At the end of the third quarter of 2005, farmers with micro loans or loans under cross-guarantees totaled 71,343,613 nationwide, accounting for 32.31 percent of all farmers. Loans for farmers amounted to 567.6 billion yuan, accounting for 37.23 percent of the total loans by RCCs. Farmers with loan certificates totaled 82,191,976, accounting for 25.39 percent of all farmers.

Providing secure, convenient, and efficient payment and settlement services. First, absorb RCCs into the large-value payment system. At present, most RCCs are interfaced with the large-value payment system, and the major channel is smooth for payment and settlement of funds in the rural areas. Second, RCCs are included into the intra-city bills clearing system. At present, there are 1,936 clearing houses for intra-city settlement, basically covering local RCC offices and ensuring timely intra-city payment and settlement for RCCs. Third, the agency system is implemented for RCC payment and settlement. The RCCs, temporarily unable to be interfaced with the large-value payment system and the small-value payment system, may conduct their payment and settlement through agency services by city commercial banks. Fourth, special bank-card services tailored for rural migrant workers have been opened. Rural migrant workers can deposit cash in the China UnionPay bank cards in the place where they work and then withdraw money at the counters of RCC service networks near their hometowns, so as to solve the issue of cash remittances for rural migrant workers.

The Fifth Plenum of the Sixteenth Central Committee of the CPC put forward the significant historical mandate of building a socialist new countryside and proposed the following requirements: “deepen the reform of the rural financial system, standardize development of financial institutions suitable for rural features, explore and develop

agricultural insurance and improve rural financial services.” The PBC will further step up rural financial reform, continuously improve rural financial services, and support the development of the rural economy. In line with the characteristics of rural financial needs, efforts will be stepped up to construct a rural financial system with better functionality, a rational division of responsibility, clear equity ownership, and forceful supervision. Steps will also be taken to solidify and develop the achievements of the pilot RCC reform, and to further improve the corporate governance structure and operational mechanism; bring into better play the functions and role of the Agricultural Development Bank of China (ADBC) in policy finance; to adhere to the orientation of commercialization in the reform of the Agricultural Bank of China (ABC); to actively and safely promote the postal savings reform, expand the scope of independent utilization of postal savings, and guide postal savings back into the rural areas. In terms of the rural financial market, under the condition of strengthening supervision and forestalling risks, innovation of financial institutions and products should be encouraged; guaranteed institutions and modes suitable for the rural areas should be developed; private lending should be guided and standardized; the small-value credit market should be fostered; and agricultural insurance and the futures market for agricultural produce should be developed. Moreover, the rural financial ecology and the rural credit system should be improved; a good rural financial infrastructure system should be built for credit registration, payment and settlement, and so forth; and financial supervision in line with the characteristics of the rural financial institutions should be strengthened and improved.

Industrial production grew rapidly, and profitability was good. In 2005, industrial value added posted 7.6 trillion yuan, representing growth of 11.4 percent and deceleration of 0.1 percentage points on a year-on-year basis. In terms of product segmentation, production of energy and major raw materials continued to grow rapidly, and production of electronic products grew at a high speed. Netting profits and losses, the statistically large industrial enterprises realized a total profit of 1.4 trillion yuan, increasing by 22.6 percent following the high growth rate of 38.1 percent recorded in the previous year, and posting a ratio of profits to costs of 6.3 percent. The 2005 Fourth Quarter Survey on 5,000 Enterprises by the PBC indicated that future economic expectations of enterprises remained good. The business confidence index rose for 6 consecutive months to a record-high level. The Survey also indicated the following: supplies of production factors eased to some extent; domestic and foreign orders increased, and the confidence in sales of small- and medium-sized enterprises was strong; the utilization rate of capacities rose continuously, and investment willingness of large enterprises built up; enterprises had quicker turnover of funds, inventories tended to decline slowly, and performance of enterprises continued to improve.

The services industries grew rapidly. In 2005, the value added of the wholesale and retail trade industry grew by 11.4 percent, that of finance and insurance by 9.8 percent, that of transport, posts, and telecommunications by 12.4 percent, that of real estate by 5.3 percent, and that of other industries by 8.1 percent.

3. Various price indices dropped steadily, and the consumer price index was at a low level

(1) The Consumer Price Index (CPI) was at a low level, but the CPI excluding food tended to rise by a small margin, in particular the prices of such energies as oil and services increased by a large margin. In 2005, the CPI grew 1.8 percent, a deceleration of 2.1 percentage points on a year-on-year basis. Excluding food, the CPI grew 1.2 percent, an acceleration of 0.4 percentage points. The prices of services rose by 3.3 percent, an acceleration of 1.1 percentage points. The quarterly rises of the CPI registered 2.8 percent, 1.7 percent, 1.3 percent, and 1.4 percent respectively on a year-on-year basis, showing a tendency of steady decline.

In 2005, the rise in the CPI decelerated mainly because grain witnessed a sharp deceleration in the rise of prices. In 2005, grain prices rose by 1.4 percent, a deceleration of 25 percentage points from that recorded in the previous year. The deceleration in the rise of grain prices directly drove the deceleration in the rise of food prices, and in turn brought down the CPI. In 2005, food prices rose by 2.9 percent, a deceleration of 7 percentage points. As food accounts for 34 percent of the CPI, a rise of 2.9 percent in food prices contributed 1 percentage point to the CPI, while in the previous year the rise in food prices contributed as high as 3.3 percentage points.

Although the CPI was at a low level, attention should still be paid to inflationary pressures. First, influenced by the surge in the prices of international crude oil and refined oil products, the domestic prices of gasoline, diesel oil, and liquefied gas soared by 15 percent, 14 percent, and 17 percent respectively. Second, the reform of resources prices was already initiated. In 2005, water prices rose by 7.8 percent nationwide; prices of electricity were adjusted by a small margin and rose only 1.9 percent, but there was great pressure for a rise in the prices of electricity with the progress in the market-oriented reform of the prices of electricity and coal. In terms of gas prices, the National Development and Reform Commission (NDRC) decided to reform the discovery mechanism for the factory prices of natural gas and to properly raise the factory prices of natural gas nationwide as of December 26, 2005. In addition, although the prices of gasoline, diesel oil, and liquefied gas rose considerably in 2005,

the rise was still lower than that of crude oil prices, hence forming a price inversion. In 2005, the oil processing and coking industries incurred a net loss of 15 billion yuan, thus there was great pressure to raise their prices. Generally, close attention should be paid to changes in the price indices in order to actively and safely promote the reform of resources prices.

It should be noted that the current Chinese CPI still cannot fully reflect the real inflation, due to price controls and limitations of the statistical method itself. With the progress of the reform of resources prices, the implicit inflation will be gradually revealed; with further improvement in the statistical method of prices, such as the adjustment of weights, the CPI will likely be higher or lower; the above, however, just represents changes in the measure of inflation and does not influence the real extent of inflation, just as the economic census revised the GDP of China but could not change the real size of the Chinese economy. Judgments about inflation and price movements should take into account multiple indicators and warrants a comprehensive analysis.

(2) The Producer Price Index (PPI)⁷ dropped from a high level. In 2005, the purchasing price for industrial raw materials, fuels, and power increased by 8.3 percent and decelerated by 3.1 percentage points over that recorded in the preceding year. In particular, the PPI for fuels and power and the PPI for non-ferrous metal materials rose by 15 percent and 14 percent respectively. The factory prices of industrial products increased by 4.9 percent, decelerating by 1.2 percentage points from the previous year. The rise in the purchasing price of industrial raw materials, fuels, and power exceeded the rise in the factory prices of industrial products by 3.4 percentage points, thus the production costs of enterprises climbed and profits contracted.

In terms of product segmentation, energy products and non-ferrous metals witnessed the largest surges in factory prices. In the international market in 2005 the average Brent, Dubai, and WTI spot crude oil prices soared by 42 percent, 47 percent, and 36 percent respectively on a year-on-year basis. The average spot prices of international gasoline and diesel oil (in Singapore) surged by 33 percent and 40 percent. Yet the domestic crude oil factory price rose by 31.1 percent, and the factory prices of gasoline and diesel oil increased by 21.2 percent and 20.7 percent respectively, representing rises in prices lower than rises in international prices. Coal prices rose by

⁷ The PPI can be divided into the input PPI and the output PPI. In China, the input PPI is called the purchasing price index for industrial raw materials, fuels, and power; the output PPI is called the factory price index for industrial products.

23.3 percent. The prices of steel products first soared and then declined, the prices of products in the ferrous metal smelting and pressing industry rose by 4.7 percent, a deceleration of 14.2 percentage points on a year-on-year basis. The prices of products in the ferrous and non-ferrous metal smelting and pressing industry surged by 11.7 percent.

Box 6: Problems of China's Resources Prices and Analysis of Their Impacts

Influenced by the planned economic system, China's resources prices remained low for a long period of time, which not only led to resources waste and economic growth based on extensive input, but also resulted in exports of highly energy-consuming, and highly-polluting resources products, widening trade surpluses and exaggerating the pressures for Renminbi revaluation. On October 28, 2005, the National Development and Reform Commission (NDRC) pointed out at the National Seminar on Resources Prices Reform: "China's reform of prices of resources products lags relatively behind and restricts to some extent the effective functioning of the market mechanism. Promotion of the reform of the prices of resources products constitutes a pressing requirement for building an economical society and for attaining sustained economic and social development. "

There are two problems in terms of China's resources prices. One problem is that the resources prices are basically decided or guided by the government, and that the prices reflect only resources development costs but do not fully cover costs in terms of environmental damages and safety of production. The resources tax is rather low. More important, the resources prices do not truly reflect market supply and demand and resources scarcity, leading to depressed resources prices. For a long period, the prices of water, electricity, gas, and heating power were decided by the government, while the factory prices of natural gas and refined oil products were guided by the government. In addition, the government could intervene in the prices of coal used for power generation and in the prices of land. Compared with those in foreign countries, the domestic prices of coal, coke, natural gas, water, and electricity were relatively low. In terms of land prices, quite a few areas imposed lower compensation prices on land requisitions for farmers, in order to attract investment. Although the prices of crude oil and refined oil products were adjusted in line with the movements of the oil prices in the international market, there was a time-lag for the adjustment and the range of adjustment was smaller than the rise in the prices of international crude oil and refined oil products. The other problem is that the proportional relationship

between the prices of resources products is not reasonable. In terms of the proportional relationship between the prices of electric power and substitution fuels, the price of one unit (in mega joules) of electric power represents only 70 percent of the prices of fuel oil and natural gas, 67 percent of the price of liquefied gas, and 56 percent of the price of artificial gas.

Low resources prices and an irrational proportional price relationship exert many adverse impacts on China's economic development. First, they are detrimental to optimizing resources allocation, transforming economic growth modes, and building a resources-conserving society. The lower-than-desired resources prices cannot timely and fully reflect market supply and demand and resources scarcity, and cannot impose incentives and constraints on investors, managers, and consumers, which, in turn, exacerbate to some extent the excessive development, excessive demand, and waste of resources. The market mechanism cannot play a fundamental role in resources allocation, resulting in the extensive growth mode and inefficient output from resources. Second, lower-than-desired resources prices worsen the contradiction of supply falling short of demand. From the perspective of demand, low resources prices led to excessive growth of demand on resources, in particular the abnormal speculative demand. From the perspective of supply, low resources prices influence the enthusiasm of resources enterprises in their production. In addition, the resources prices, lower than the prices in the international market, brought about large growth of resources exports, ultimately leading to a domestic supply shortage of resources. Third, distortion of resources prices causes imbalances in the international payments and pressures on the exchange rate revaluation. As domestic resources prices are artificially forced lower than the resources prices of foreign countries, the costs of exports appeared to be very "low," the prices of exports were always kept at globally low levels, enticing rapid growth of exports, widening trade surpluses, and leading to pressures on foreign exchange sales and an expectation for Renminbi revaluation. Consequently, international speculative capital flowed in rapidly, resulting in surpluses in the capital account, and ultimately producing pressures on the balance of payments and Renminbi revaluation.

At the National Seminar on Resources Prices Reform, the National Development and Reform Commission stated that the NDRC would push on with the resources prices reform in the following 5 respects: promote in an all-round way the water price reform, actively promote the electricity price reform, improve the price-setting mechanism for oil and natural gas, fully realize market-oriented coal prices, and improve the land price discovery mechanism. At present, the water price reform has steadily been implemented, the program for the reform of factory prices of natural gas

has successfully been introduced, and a coordination mechanism has initially been established for the prices of electricity and heating power using coal. The next step is to bring into play to a greater extent the fundamental role of the market in resources allocation, and to establish in earnest a price discovery mechanism that will reflect market supply and demand, resources scarcity, and pollution costs.

(3) Prices of both imports and exports tended to grow at a slower pace, and the terms of trade improved compared with those in the previous year. In 2005, the rise in the customs prices of exports posted 2.7 percent, while that in the customs' prices of imports registered 5.4 percent, both decelerating on a year-on-year basis. In the fourth quarter 2005, the terms of trade registered 99.9 percent, up 1 percent over that recorded in the previous year.

(4) The rise in labor compensation accelerated, and labor costs increased. In the first three quarters of 2005, the average salary of employees in urban units was 12,191 yuan, up 13.4 percent on a year-on-year basis. In particular, the average salary of employees in state-owned units posted 12,624 yuan, up 13.1 percent; that in collectively-owned units was 7,234 yuan, up 14.3 percent; and that in other units was 12,605 yuan, up 12 percent.

(5) The GDP deflator decreased markedly. In 2005, the nominal GDP growth rate was 14 percent, while the real GDP growth rate was 9.9 percent. The GDP deflator (the differential between the nominal GDP growth rate and the real GDP growth rate) was 4.1 percent, down 3.5 percentage points from that recorded in the previous year.

4. Fiscal revenues and expenditures were in a good position

Fiscal revenues continued to grow rapidly, with enhanced stability. Fiscal revenues surpassed 2 trillion yuan in 2003, 2.5 trillion yuan in 2004, and 3 trillion yuan in 2005. In 2005, the sound fiscal policy was pursued, focusing on "controlling fiscal deficits, adjusting the fiscal structure, promoting fiscal reform, increasing revenues, and cutting expenditures." Meanwhile, various fiscal and taxation management system reforms were implemented as follows: exemption of the agricultural tax, improving the export tax rebate mechanism, timely adjusting the export tax rebate policies for some resources products, and so forth.

5. Industrial analysis

During January-November 2005, of 39 industries, most industries maintained rapid

growth in production, sales, profits, and investment, with production matching well with sales. The ratio of sales to production was over 99 percent in industries like oil and natural gas exploration, tobacco, gas, and electricity. The ratio of profits over average costs (hereinafter referred to as the profit margin) in 39 industries was 9.3 percent, up 0.8 percentage points over that recorded in the previous year. But returns differed greatly from industry to industry. The average profit margin in the mining industries was 31.8 percent, up 6.9 percentage points; the profit margin in the processing and manufacturing industries was 5.5 percent, down 0.4 percentage points; the profit margin in the water, electricity, and gas industries was 2.4 percent, down 0.4 percentage points. In 2005, the top-five industries with the highest profits were oil exploration, coal, power, general equipment, and agricultural and non-staple food processing. Two industries incurred losses, i.e., the oil processing, coking, and nuclear fuel processing industry and the water production and supply industry. Driven by high profits, industries like coal and oil enjoyed rapid growth in investment. Investment in the coal mining and washing industry grew 65.6 percent, while investment in oil and natural gas exploration grew by 29.7 percent. The reason why the profit margins differed enormously from industry to industry was mainly because of monopolies and distortions of resources prices in some industries.

The supplies of coal, power, oil, and transportation grew rapidly, and thus the shortages eased. In 2005, the output of coal posted 2.16 billion tons, up 8.4 percent. Power generation reached 2.47 trillion kilowatts, up 12.1 percent. The output of crude oil grew by 4.1 percent, crude oil imports grew by 10.3 percent, the volume of crude oil processing increased by 7 percent, and inventories of refined oil products continued to rise. In terms of transport capacity, construction of infrastructure continued to be strengthened, the volume of rail freight increased 6.3 percent to 2.109 billion tons, the volume of freight handled by major ports rose by 18.4 percent to 2.815 billion tons, and the volume of freight handled by the three major shipping companies grew by 11.4 percent to 655 million tons.

(1) The auto industry

Since the reform and opening up to the outside world, China's auto industry has been developing rapidly. Output grew from less than 150,000 units in 1978 to 6.15 million units in 2005. In particular, auto output surpassed 1 million units in 1992, 2 million units in 2000, 3 million units in 2002, and since then has been increasing by an annual average rate of about 1 million units. During 2002-2005, the annual growth of investment in the auto industry was over 40 percent, with that in 2003 even reaching 82.6 percent. In 2005, investment amounted to over 100 billion yuan, more than a

quadrupling of the annual investment within a short period of four years. Accordingly, auto production capacity expanded substantially, increasing from 2.67 million units in 2001 to around 8 million units in 2005.

Gradual structural adjustments were made in the auto industry. In 2005, 27 provinces, municipalities, or autonomous regions manufactured autos, with about 200 auto manufacturers. According to the statistics of the China Association of Automobile Manufacturers, in 2004 the top-10 auto manufacturers accounted for 84 percent in both output and sales, while in the first three quarters of 2005, the top-10 auto manufacturers accounted for as low as 73 percent in terms of sales. Auto sales witnessed high growth during 2001-2003 and then slowed down. Growth of sales revenue decelerated from 45.7 percent in 2003 to about 8 percent in 2005, accompanied by nose-diving profits. Under the pressures of market shares and falling profitability, the auto industry stepped up mergers and acquisitions and restructuring. In addition, with development of the family-use auto market and with efforts to beef up implementation of the “going global” strategy in the auto industry, domestic auto brands achieved steady development. As oil prices continued to rise in recent years, under the guidance of relevant policies to build an economical society, auto consumption was oriented toward economical and energy-saving autos. Thus, energy-saving, environmentally-friendly, and low-emission autos gained a rising market share.

The development of the auto industry serves an important role in promoting adjustment of the industrial structure, the process of urbanization, and the upgrading of household consumption in China. At present, the macro economy and household income continue to maintain rapid growth, and industrial policies have gradually been improving, providing many advantages for the development of the auto industry. The Central Committee of the Communist Party of China put forward the proposal in the Eleventh Five-Year Program on the National Economy and Social Development that efforts will be stepped up to transform the economic growth mode and enhance the capability of independent innovation. Sharpening the competitiveness of domestic auto brands, optimizing the structure of the auto industry, and developing environmentally-friendly and energy-saving products will be important orientations for the development of the auto industry in the future.

(2) The real estate industry

With the implementation of macro-control policies, real estate development investment reached a stable growth stage, and the rise in housing sales prices tended

to stabilize.

The growth in real estate investment decelerated steadily, and the decrease in investment in economically affordable housing dwindled. In 2005, cumulative real estate development investment reached 1.58 trillion yuan, representing a growth of 19.8 percent and a deceleration of 8.3 percentage points from that recorded in the previous year. In particular, commercial housing investment posted 1.08 trillion yuan, up 21.9 percent, a deceleration of 6.8 percentage points; economically affordable housing investment registered 56.5 billion yuan, down 6.8 percent, a contraction of 4.6 percentage points from the decrease recorded at the beginning of the year.

Commercial housing vacancies increased. In 2005, the area of housing sales posted 558 million square meters. In particular, the sales area of “ready-made” homes reached 242 million square meters, the sales area of “off-plan” homes reached 316 million square meters, and the ratio of the sales of “off-plan” homes to total housing sales came to 57.1 percent. At end-December, commercial housing vacancies registered 143 million square meters, up 15.7 percent on a year-on-year basis. In particular, resident housing vacancies stood at 83.19 million square meters, up 12.4 percent.

The growth in the sale prices of housing tended to stabilize. In 2005, the sale prices of housing in 70 large- and medium-sized cities rose 7.6 percent, a deceleration of 2.2 percentage points from that recorded in the previous year. Geographically, in the fourth quarter of 2005, of the 70 large- and medium-sized cities, only Huhhot, Dalian, and Shenzhen saw a year-on-year growth of over 10 percent in the sale prices of housing, while Shanghai and Hangzhou both continued to witness a deceleration in the year-on year growth of housing sale prices.

The growth in real estate loans dropped. At end-2005, commercial real estate loans amounted to 2.77 trillion yuan, up 16.1 percent, a deceleration of 12.6 percentage points on a year-on-year basis. In particular, however, loans to real estate developers increased 17 percent to 914.1 billion yuan, maintaining a steady rising trend since July 2005. Growth of individual housing mortgage loans decelerated. In 2005, individual housing mortgage loans increased 15.8 percent to 1.84 trillion yuan, maintaining the trend of decelerating growth since April 2004.

Part 5 Monetary Policy Stance to be Adopted in 2006

I. Macroeconomic prospects

The year 2006 will be the first year for China to achieve the targets set in the Eleventh Five-Year Program, and it also marks the last year of the transitional period after China's accession to the WTO. In general, the overall domestic environment is conducive to the steady and sound development of the national economy. The rapid growth of household income, the accelerated upgrading of the household consumption structure, and the building of the "socialist new rural areas" will all help boost consumer demand. The results of the survey on urban household savings in the fourth quarter of 2005 showed that the household income confidence index rose by 2.4 percentage points over the previous quarter and by 1.2 percentage points over the same period of last year. With respect to investment demand, uncertainties remain in the growth of fixed-asset investment. On the one hand, the negative effects of overcapacity resulting from heedless and low-level duplicated construction have already emerged; on the other hand, there still exist unduly large amounts of newly approved projects and projects under construction, implying that the high growth of investment is still likely to rebound. What is important is to adjust the investment structure according to the market orientation while promoting the appropriate growth of investment. As to foreign trade, China's exports will continue to be supported by the good momentum of global economic growth, but potential risks still exist as oil prices continue to increase and trade protectionism in some industrial countries has been strengthened.

Moreover, some deep-rooted problems are yet to be addressed and new problems may emerge. First, the economic structure and economic growth pattern urgently need to be adjusted. The extensive economic operation mode featuring high investment, high consumption, high pollution, and low efficiency and the overdependence of economic growth on investment and export expansion have long remained the two major problems that hinder the development of the Chinese economy. Second, the unbalanced development of international payments is posing challenges to the effectiveness and flexibility of the monetary policy. Third, China's commitment to the WTO has imposed higher requirements on China's financial development. By the end of 2006, China will fully open its financial sector to foreign competition, and domestic financial institutions will face fierce pressures, leaving China with the

arduous task of promoting the reform and opening up, and developing its financial sector.

Uncertainties still remain in price movements. The upward risks can be summarized as follows. First, pressures of an investment rebound still exist, with investment growth likely to hover at high levels, which will build pressures on the prices of upstream products and on the purchase prices of raw materials, fuels, and power. Second, due to the fact that some implicit inflationary pressures will be materialized along with the reform of the price determination mechanism for utilities services and resources, the prices of resources including water, electricity, gas, and coal and utilities services such as public transportation are under greater upward pressures. Once released, the inflationary pressures are bound to push up the level of future prices. With respect to the downward risks, considering the steady expansion of the production capacity of consumer goods over recent years, the oversupply of consumer goods is likely to persist in the near term, subjecting the prices of consumer goods, particularly durable consumer goods, to downward risks. The downward pressures on the prices of steel, electrolytic aluminum, cement, and other products in excessive supply are likely to feed through to the PPI. Uncertainties associated with the movement of grain prices will probably lead to a decline in the CPI. According to the survey on urban household savings in the fourth quarter of 2005, 41.7 percent of the respondents expected that prices would go up, 5.5 percentage points higher than in the previous quarter, and 4.3 percent of the respondents expected lower price levels, 1.7 percentage points down from the previous quarter, indicating stronger inflationary expectations.

The main targets for economic and social development in 2006 set by the Central Economic Conference are: GDP will grow by around 8 percent and the CPI will be controlled at around 3 percent. In terms of the money and credit targets set for 2006, narrow money (M1) and broad money (M2) are projected to grow by 14 percent and 16 percent respectively, and RMB loans extended by all financial institutions are projected to increase by 2.5 trillion yuan.

II. Monetary Policy Stance to be Adopted in 2006

As required by the Central Economic Conference and the 5th Plenary Session of the 16th CPC Central Committee, the PBC will continue to pursue a sound monetary policy, to maintain the consistency and stability of the policy, to coordinate policies on domestic and foreign currencies, to enhance the initiative and effectiveness of monetary policy, to maintain steady growth of money and credit, to steadily advance

financial reform and opening up, to actively develop the financial market, to safeguard the stability of the financial system, and to further improve foreign exchange management and financial services, so as to promote the sustained, coordinated, rapid, and sound development of the national economy.

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

The PBC will take concrete measures to improve the monetary policy operation system and to adjust base money timely and appropriately by using a mix of monetary policy instruments to maintain appropriate growth of money and credit. In addition to improving the instruments and methods of open market operations, the PBC will appropriately control the frequency and scale of open market operations, effectively adjust the liquidity of the banking system, and ensure general stability of the money market interest rate so as to let the market play a more effective role in leading market expectations. The PBC will also pay attention to interest rate movements in the international market and coordinate interest rate policies for domestic and local currencies. Efforts will also be made to improve the differentiated reserve requirement system, strengthen positive incentives and disciplines for financial institutions, and enhance coordination among policy tools, including open market operations, the required reserve ratio, and central bank lending, etc.

2. Steadily advance the market-based interest rate reform and improve the mechanism for interest rate determination

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

the interest rate policies.

3. Enhance the role of window guidance and credit policy in promoting economic restructuring

The role of policy and window guidance will be further strengthened to encourage financial institutions to improve their credit structure. The financial ecological environment will be further improved. The commercial banks will be guided in the innovation of credit products, and to adopt different credit policies to different sectors and enterprises to appropriately control the speed of credit expansion and to improve the credit structure. Credit support will be strengthened to promote the development of the weak sectors of the economy such as agriculture, non-public sectors, small- and medium-sized enterprises, employment, and education. Steps will be taken to improve financial services to support the development of the western and central areas as well as the old industrial bases of northeast China. Financial services will also be strengthened to support self-innovation by enterprises. The PBC will support a rational housing demand and guide the commercial banks to improve housing-related financial services and relevant risk management. Continued efforts will be made to promote the development of consumer credit business by improving the pricing mechanism based on an improved individual credit reporting system. The credit management system and the conduct of the credit policy will be improved to enhance the effects of the credit policies.

4. Actively promote the development of financial markets and the innovation of financial products

Active efforts will be made to promote the institutional building of financial markets, expand the direct financing channel, improve the structure of financial assets and financial markets, enrich market products, and actively cultivate institutional investors so as to accelerate the coordinated development of the entire financial market system. While regulating the existing financial products, steps will also be taken to further motivate the enthusiasm of market participants in the innovation of financial products and instruments and to promote the development of financial derivatives so as to meet the diversified needs of the market. In strengthening the market infrastructure, relevant rules and regulations will be formulated to regulate new products, market transparency will be enhanced, and market incentives and disciplines will be improved. 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

Building on the achieved progress, continued efforts will be made to push ahead with the joint-stock reform of the state-owned commercial banks, encouraging them to further improve corporate governance and to establish effective mechanisms for incentives, risk control, and capital constraint. Reform of the policy banks will be deepened by applying different reform schemes to different banks according to their unique circumstances and conducting the reform in a targeted and sequenced way. Steps will be taken to push forward the reform of the rural financial system, to further improve financial services in the rural areas, and to endeavor to set up a long-term mechanism for the sound and sustainable development of the rural credit cooperatives.

The pilot reform to introduce universal banking business in the financial sector will be steadily advanced, and the activities of financial holding companies will be regulated. The PBC will closely monitor the development of the banking, securities, and insurance sectors, financial holding companies, and cross-sector financial instruments to prevent cross-sector and cross-market systemic risks. The building of a deposit insurance system will be accelerated and a risk compensation mechanism in accordance with the requirements of the market economy will be established.

6. Promote the reform of foreign exchange management to improve the RMB exchange rate regime

According to the needs arising in the process of China's economic and financial development and to safeguard economic and financial stability, efforts will be made to improve the managed floating exchange rate regime in a self-initiated, controllable, and gradual way and to enable the market supply and demand to play a fundamental role in the formation of the RMB exchange rate, so as to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. To promote the balanced development of international payments, the PBC will further deepen the reform of the foreign exchange management system. Steps will also be taken to accelerate the reform of export and import documents verification, service trade, and foreign exchange management for individuals to facilitate trade and investment. Efforts will be made to expand the channels of capital inflows and outflows and to steadily advance RMB convertibility under the capital account. In addition, monitoring of statistics associated with capital inflows including the short-term external debt will be strengthened to balance the management of capital inflows and outflows. The PBC will also further promote the development of a multi-tiered, orderly foreign exchange market system featuring the co-existence of various trading modes, actively introduce new foreign exchange products, encourage financial institutions to foster innovation

based on effective control of risks, and enrich financial products for enterprises and individuals to guard against exchange rate risks.