China Monetary Policy Report
Quarter Three, 2006

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the third quarter of 2006 the national economy maintained steady and rapid growth, with generally good economic performance. Consumption maintained steady and rapid growth. Investment growth tended to slow down but remained high. Foreign trade grew rapidly. Household income, enterprise profits, and fiscal revenues all increased substantially. Market prices were stable. In the first three quarters of 2006 the GDP reached 14.1 trillion yuan, and the consumer price index (CPI) rose by 1.3 percent year on year.

The PBC continued to implement a sound monetary policy in line with the overall arrangement of the central government on strengthening and improving macroeconomic management. A combination of measures was employed to strengthen adjustments of the excess liquidity in the banking system as well as of policy coordination for local and foreign currency so as to optimize the credit structure and guide money and credit aggregates to grow at an appropriate pace. First, open market operations were conducted flexibly by reasonably arranging the combination of instruments; the PBC also managed the pace and amount of central bank bill issuances in an effort to adjust the excess liquidity in the banking system. Second, the interest rate played a leveraging role in macroeconomic management, and benchmark interest rates of RMB deposits and lending of financial institutions were raised. Third, the reserve requirement ratio was raised to enhance the preemptiveness and effectiveness of the central bank in draining excess liquidity. Fourth, 'window guidance' and guidance on credit policy were strengthened to help financial institutions meet the requirements of the central government for macroeconomic management, to appropriately control credit growth, and to adjust the lending structure. Fifth, financial enterprise reform was promoted smoothly. Sixth, a series of supporting measures for reform of the exchange regime was introduced, and the reserve requirement ratio for foreign exchange deposits of domestic financial institutions was raised in order to improve the managed floating exchange rate regime. Seventh, foreign exchange management reform was improved by expanding outward investment channels, strengthening monitoring of cross-border capital flows, and promoting the balance in the external account.

The third quarter of 2006 saw a slowing trend in money supply growth and a slight decline in growth of loans. At end-September, money M2 stood at 33.2 trillion yuan, an increase of 16.8 percent year on year; the outstanding balance of base money stood at 6.6 trillion yuan, an increase of 8.9 percent year on year; outstanding RMB loans grew by 15.2 percent year on year to 22.1 trillion yuan. At end-September 2006,

official foreign exchange reserves totaled US$987.9 billion, up US$169.0 billion over end-2005, and the central parity of the RMB against the US dollar was 7.9087 yuan per US dollar.

Preliminary forecasts show that the national economy will continue to maintain a steady and rapid growth momentum in the fourth quarter. However, it is necessary to further consolidate the basis for the decline in the growth of fixed-asset investment, money, and credit, and to address the growing BOP imbalances and the grim situation with respect to energy conservation, energy efficiency, and pollution reduction.

In line with the spirit of the Sixth Plenary Meeting of the Sixteenth CPC Central Committee and the State Council's plans and decisions on economic work, the PBC will continue to pursue a sound monetary policy by applying a mix of monetary policy instruments to strengthen liquidity management and maintain appropriate growth of money and credit. Meanwhile, medium- and long-term measures should be taken to speed up economic restructuring, to implement policies to expand domestic demand, and to promote a BOP equilibrium.

Part 1 Monetary and Credit Performance

In the third quarter of 2006 the national economy continued to grow steadily and rapidly, with the financial industry performing in a sound manner. The growth of money and credit aggregates slowed down, basically consistent with the general direction of macroeconomic management.

I. The growth of the money supply slowed down

At end-September 2006 broad money M2 stood at 33.2 trillion yuan, an increase of 16.8 percent year-on-year, down 1.1 and 0.7 percentage points from the same period of the previous year and end-2005 respectively and a record low since the beginning of 2006. The deceleration of M2 was mainly caused by a decline in credit growth. Narrow money M1 reached 11.7 trillion yuan, an increase of 15.7 percent year on year, up 4.1 and 3.9 percentage points over growth in the same period of 2005 and end-2005 respectively, hitting its highest level of the year. This was mainly due to the accelerated growth of enterprises' demand deposits and cash in circulation. At end-September, the growth discrepancy between M2 and M1 narrowed 6.28 percentage points from the same period of the last year to 1.13 percentage points. Cash in circulation M0 grew by 15.3 percent year on year to 2.6 trillion yuan. Net cash injections in the first three quarters of 2006 totaled 165.6 billion yuan, 85.1 billion yuan more than that recorded in the same period of the previous year.

Box 1: Liquidity and liquidity management by the central bank

In economics or commercial activities, we often use the word "liquidity" to express a series of related but not identical meanings. For instance, liquidity originally referred to the ease with which a certain asset can be converted into a payment and settlement instrument. Since cash can be directly used for purchases without being converted into other assets, it is deemed to be the asset with the strongest liquidity. On this basis, two definitions, namely market liquidity and liquidity at the macro level, came into being.. Liquidity in a market may refer to the capability of making a deal promptly with almost no impact on prices, which often relates to such factors as market trading volume, transaction costs, and transaction time. At the macroeconomic level, we usually define liquidity as money and credit aggregates with different statistical coverages. Household and enterprise deposits at commercial banks, bank acceptance drafts, short-term treasury bonds, policy financial bonds, money market funds, and other highly liquid assets can be incorporated into different liquidity categories at the macro level according to specific analytical needs. The form the liquidity takes is affected by the changes in the financial institutions and the way they do their business. This complex and changing nature may upset the stable relationship between money and the economy in the traditional quantitative theory of money.

As the monetary authority responsible for maintaining the balance at the aggregate level, whether the central bank can conduct effective liquidity management is of great significance for monetary policy implementation. The liquidity managed by the central bank mainly refers to a narrow range of liquidity at the macro level. Normally, it refers in particular to liquidity in the banking system, i.e., deposits of deposit-taking financial institutions in the central bank, including required reserves and excess reserves. The central bank regulates money and credit aggregates by adjusting the liquidity in the banking system.

The central bank's liquidity management is based on analysis and prediction of liquidity demand and supply in the banking system. Liquidity demand in the banking system mainly refers to a demand for required reserves and excess reserves, with the former being the reserve requirement set by the central bank and the latter being that held by commercial banks on a voluntary basis to satisfy their payment and settlement needs. The factors affecting the liquidity supply in the banking system can be divided into autonomous factors and monetary policy factors. Autonomous factors include items such as cash in circulation and government deposits on the central bank's balance sheet, which are the outcome of the behavior of the public and the government, and are beyond the control of monetary policy. These factors are the main source of uncertainties affecting liquidity in the banking system. Monetary policy factors are the liquidity supply factors that can be directly controlled by the central bank, which mainly refer to open market operations, such as repo and reverse repo agreements, the sale and purchase of government bonds, the issuance of central bank bills, etc. Imbalances between the demand for and the supply of liquidity hinder the realization of monetary policy objectives. Excess liquidity in the banking system may lead to market expectations of lower interest rates or may stimulate banks to issue more credit, and vice versa. The central bank normally uses open market operation instruments to balance liquidity demand and supply in the banking system, and to manage liquidity by adjusting the reserve requirement ratio when necessary. Maintaining liquidity at a stable and appropriate level will reduce the volatility of short-term interest rates and help create a sound environment for economic agents to make decisions. In addition, through liquidity management the central bank can help financial institutions deal with temporary liquidity fluctuations so as to ensure their day-to-day payments and smooth money market operations. With monetary policy transformed from direct control to indirect management, liquidity management increasingly has become a key component in the implementation of the central bank's monetary policy.

The relationship between liquidity and economic and financial performance is complicated. On the one hand, monetary policy operations by the central bank directly affect the liquidity in the banking system, while financial institutions, enterprises, and households also play an important role in this regard. On the other hand, the liquidity in the banking system does not move in parallel one on one with the economic cycles. Various economic variables, including expectations, willingness to invest, and the consumption propensity of enterprises and households, also need to be observed to judge the "temperature" of the economy. Under some circumstances, the central bank will take the initiative to provide liquidity in the open market to meet the growing liquidity demand in the banking system; in other cases, for instance when foreign exchange inflows increase and the liquidity injected in the banking system through the central bank's purchase of foreign exchange exceeds the growth of demand, an important task of the central bank is to absorb the resultant excess liquidity. Since the day-to-day management of banking liquidity by the central bank is not directly related to the level of the economic variables, such as fixed-asset investment growth, it is inappropriate to judge whether there is excess liquidity in the banking system simply by looking at the level of investment growth in the corresponding period, and it is improper to conclude that liquidity should be tightened or loosened simply based on a temporary volatility in investment growth. In general, the interaction and causality between liquidity and various economic variables need to be carefully studied and prudently judged.

II. Deposits of financial institutions increased steadily

At end-September, outstanding deposits of all financial institutions (including foreign-funded financial institutions) denominated in both RMB and foreign currencies increased by 16.4 percent year on year to 34 trillion yuan, a deceleration of 1.6 percentage points from the same period of last year but growth of 4.2 trillion yuan from the beginning of the year, an acceleration of 538 billion yuan over that recorded a year earlier. In particular, RMB deposits rose by 17.2 percent year on year to 32.8 trillion yuan, a growth of 4.2 trillion yuan from the beginning of the year and an acceleration of 490.4 billion yuan from the previous year; foreign currency deposits totaled US$160.6 billion, an increase of 2.0 percent year on year and US$8.3 billion more than that at the beginning of the year, an acceleration of US$5.6 billion from the increase recorded in the same period of last year.

Corporations and households continued to prefer demand deposits. At end-September, outstanding corporate RMB deposits increased by 15.1 percent year on year to 10.7 trillion yuan, representing growth of 1.14 trillion yuan from the beginning of the year and an acceleration of 303.4 billion yuan over the previous year. In particular, the growth of corporate demand deposits accelerated by 471.7 billion yuan from that recorded a year earlier, while the growth of time deposits decelerated by 168.3 billion yuan over the same period of 2005. RMB savings deposits increased by 16 percent year on year to 15.8 trillion yuan, an increase of 1.71 trillion yuan over the beginning of the year, 30.3 billion yuan more than the growth in the same period of the previous year. In particular, the growth of demand deposits accelerated by 163.2 billion yuan from the previous year, while the growth of time deposits decelerated by 132.9 billion yuan. At end-September, outstanding fiscal deposits increased by 39.5 percent year on year to 1.48 trillion yuan, representing an increase of 680.1 billion yuan over the beginning of the year and an acceleration of 242 billion yuan compared with the increase recorded a year earlier. The increase in demand deposits suggests a strengthened liquidity of currency and more frequent economic activities.

III. Loans of financial institutions decelerated

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 23.4 trillion yuan at end-September, representing a growth of 14.6 percent year on year, an acceleration of 1.1 percentage points from the same period of last year, and an increase of 2.8 trillion yuan over the beginning of the year, accelerating by 762 billion yuan compared with the growth in the same period of last year. In particular, outstanding RMB loans grew by 15.2 percent year on year to 22.1 trillion yuan, an increase of 2.76 trillion yuan over the beginning of the year, an acceleration of 798.7 billion yuan. New loans extended in the third quarter of 2006 totaled 573.3 billion yuan, a deceleration of 597.1 billion yuan and 317.5 billion yuan from that recorded in the first and second quarters respectively. Outstanding foreign currency loans rose by 7.6 percent year on year to US$161.5 billion, representing an increase of US$11.9 billion over the beginning of the year and a deceleration of

US$4.3billion on a year-on-year basis. Interest rates in the money market tended to be stable.

In terms of the sectoral distribution of RMB loans, at end-September outstanding loans of non-financial companies and other sectors amounted to 18.4 trillion yuan, an increase of 2.2 trillion yuan from the beginning of the year; outstanding household loans reached 3.7 trillion yuan, 524.7 billion yuan more than at the beginning of the year. In particular, consumer loans registered 2.3 trillion yuan, representing a growth of 102.5 billion yuan from the beginning of the year; individual auto loans amounted to 95.1 billion yuan, accounting for 4.1 percent of the total consumer loans. Outstanding individual auto loans issued by state-owned commercial banks, joint-stock commercial banks, city commercial banks, and finance companies totaled 85.7 billion yuan, including 11 billion yuan of NPLs, 1.98 billion yuan more than that recorded at the beginning of the year, resulting in a NPL ratio of 12.86 percent, 3.88 percentage points higher than that at beginning of the year.

In terms of loan destinations, in the first three quarters RMB medium- and long-term loans rose by 1.51 trillion yuan, an acceleration of 642.9 billion yuan year on year, with the growth in infrastructure loans increasing by 225.2 billion yuan from the previous year. Short-term RMB loans increased by 1.07 trillion yuan, an acceleration of 433.5 billion yuan year on year. In particular, commercial paper financing increased by 136.2 billion yuan from that at the beginning of 2006, decelerating by 261.1 billion yuan compared with the corresponding period of 2005. Since May, commercial banks have reduced paper discount and rediscount business to control credit growth, resulting in a decrease of 205.9 billion yuan in paper financing in the third quarter compared with that recorded at the end of the second quarter. At end-September, long- and medium-term RMB loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) increased by 1.39 trillion yuan from the beginning of the year, accounting for 92 percent of the new long- and medium-term loans of all financial institutions. New long- and medium-term loans issued to the manufacturing sector, real estate sector, and infrastructure sector (transportation, storage and postal services, water conservancy, environmental and public facility management, power, gas, and water production and supply industries) respectively accounted for 10.6 percent, 20.2 percent, and 35.5 percent of the new long- and medium-term loans of the major financial institutions.

In terms of the breakdown by financial institutions, in the first three quarters of 2006 growth of RMB loans of all financial institutions (excluding policy banks) accelerated compared with the same period of last year, with those of foreign-funded financial institutions witnessing the fastest growth. RMB loans of the four state-owned commercial banks increased by 12.6 percent year on year, or 1.12 trillion yuan from that at the beginning of the year, accelerating by 540.9 billion yuan year on year. RMB loans of joint-stock commercial banks, city commercial banks, rural financial institutions (including rural cooperative banks, rural commercial banks, and rural credit cooperatives) and foreign-funded financial institutions increased by 587.9 billion yuan, 236.2 billion yuan, 450.1 billion yuan, and 60.4 billion yuan respectively, accelerating by 87.5 billion yuan, 87.1 billion yuan, 91.9 billion yuan, and 31.8 billion yuan respectively compared with the increase recorded in the same period of last year and representing a year-on-year growth of 20.8 percent, 26.3 percent, 18.6 percent, and 77.4 percent. RMB loans of policy banks increased by 12.6 percent year on year, or 217.1 billion yuan over that at the beginning of 2006, representing a deceleration of 38.4 billion yuan from the growth recorded in the same period of 2005.

IV. Base money grew at a stable pace

At end-September, the outstanding balance of base money stood at 6.6 trillion yuan, an increase of 8.9 percent year on year, decelerating by 5.4 percentage points or 7 billion yuan from the previous year, 184.4 billion yuan more than that at the beginning of the year. The excess reserve ratio of financial institutions averaged 2.52 percent at end-September, down 0.58 percentage points from end-June. In particular, the excess reserve ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 2.06 percent, 3.04 percent, and 5.31 percent respectively.

V. Lending rates of financial institutions rose slightly

Affected by the benchmark lending rate hike, the lending rates of commercial banks increased slightly. In the third quarter, the weighted average interest rate of 1-year RMB loans of commercial banks was 6.36 percent, 1.04 times the benchmark rate and up 0.31 percentage points from the previous quarter. In particular, the weighted average interest rate of fixed interest-rate loans, which accounted for 85 percent of the one-year RMB loans, stood at 6.39 percent, up 0.34 percentage points from the previous quarter, and the weighted average interest rate of floating interest-rate loans, accounting for 15 percent of the total one-year loans, was 6.19 percent, up 0.18 percentage points from the previous quarter. Among all the loans issued by financial institutions in the third quarter, the proportion of loans with interest rates at the benchmark rate, or floating downward, increased by 0.13 and 0.74 percentage points respectively from the second quarter, while the proportion of loans with interest rates floating upward from the benchmark rate declined by 0.87 percentage points over the second quarter.

Table 1: Share of Loans with Rates Floating against the Benchmark in Various Ranges in the Third Quarter of 2006

Unit： percent

	Sum	Floating downward	At Bench-mark	Floating upward				
		[0.9,1.0）	1.0	Sum	（1.0,1.3]	(1.3,1.5]	（1.5,2]	above 2
Sum	100	25.41	26.66	47.93	27.61	7.12	10.93	2.27
State-owned commercial banks	100	33.16	31.15	35.7	33.52	1.9	0.27	0
Joint-stock commercial banks	100	36.53	32.44	31.02	30.37	0.49	0.05	0.11
Regional commercial banks	100	23.18	14	62.82	45.45	11.36	5.41	0.6
Urban and rural credit cooperatives	100	1.91	4.32	93.76	16.08	23.17	45	9.51
Policy banks	100	24.37	74.39	1.24	1.24	0	0	0

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

Source: Reports of lending rates of commercial banks.

In the third quarter of 2006, the interest rate of negotiable RMB deposits (above 30 million yuan in one deposit) increased slightly. In particular, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 4.01 percent, up 0.37 percentage points from the previous quarter; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 3.72 percent, flat with that recorded in the previous quarter.

Affected by the suspension of the interest rate hikes by the Federal Reserve and lower rates in the international financial market, the domestic interest rates on US dollar loans and large-value foreign currency deposits declined. In September 2006 the weighted average interest rate on large-value US dollar deposits with a maturity of up to 3 months (accounting for 73 percent of all large-value US dollar deposits of financial institutions) was 4.11 percent, a decrease of 0.51 percentage points from a month earlier. The weighted average rate on one-year US dollar fixed-rate loans was 6.39 percent and the weighted average rate on US dollar floating-rate loans was 6.25 percent, down 0.05 and 0.04 percentage points respectively from the previous month.

Table 2: Average Interest Rates of Large-value US$ Deposits and US$ Loans in the First Three Quarters of 2006

Unit: percent

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.
I. Large-value Deposits:									
Within 3 months	2.9947	3.6879	3.4049	4.0769	4.2816	4.391	4.6285	4.6200	4.1126
3-6 months	4.6609	4.5713	4.7528	4.8992	4.9897	4.9406	5.4003	5.3248	5.0753
6-12 months	4.5001	4.7217	3.6802	4.9552	4.9579	5.3003	5.3429	5.1749	4.9716
1 year	4.2042	4.587	4.6506	4.7946	4.7055	5.3986	5.3652	5.1975	5.0555
II. Loans:									
1 year (fixed)	5.1379	5.6163	5.5822	6.0507	5.8239	6.345	6.0619	6.4336	6.3881
1 year(monthly floating)	5.5756	5.5904	5.6562	5.9982	6.0307	6.2311	6.5046	6.2893	6.2501

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

VI. The elasticity of the RMB exchange rate was further strengthened

The RMB exchange rate appreciated by a small margin, and the fundamental role of market supply and demand was further enhanced. At end-September, the central parity of the RMB against the US dollar was 7.9087 yuan per US dollar, appreciating by 869 points or 1.1 percent over end-June. The RMB exchange rate appreciated by 0.75 percent and 3.26 percent against the Euro and Japanese Yen respectively. The RMB to dollar exchange rate cumulatively appreciated by 2.04 percent in the first three quarters of 2006 and by 4.65 percent in the entire post-reform period.

The elasticity of the RMB exchange rate was further strengthened, and the linkage of the RMB exchange rate with the major currencies was strong. In the third quarter, the peak and bottom central parities of the RMB against the US dollar were 7.8998 yuan per US dollar and 8.0024 yuan per US dollar respectively. In the 65 trading days of the third quarter, the inter-bank foreign exchange market saw an appreciation in the RMB in 35 days, and a depreciation in 30 days; the largest fluctuation in a single business day was 0.254 percent, with the daily volatility averaging 42 basis points, 7 basis points more than that recorded in the first half of 2006.

At end-September, the discount of one-year US dollar against RMB non-deliverable forward contracts (NDF) in the overseas market was stable around 2500 points. The negative interest rate spread between China and the US imposed an interest rate cost constraint on the arbitrage of capital inflows and to some extent restrained such inflows, creating a favorable external environment for the reform of the exchange rate regime.

Part 2 Monetary Policy Conduct

In the third quarter of 2006 the PBC continued to implement a sound monetary policy in line with the overall arrangements of the central government. A combination of measures was employed to drain excess liquidity in the banking system, and interest rates played a leveraging role in macroeconomic management to guide money and credit aggregates to grow at an appropriate pace. Meanwhile, the PBC promoted financial enterprise reform, increased the flexibility of the RMB exchange rate, and improved foreign exchange management.

I. Flexible Open Market Operations

In the third quarter, in order to implement the decisions adopted at a State Council meeting and to control money and credit injections, the PBC continued to use open market operations as the major sterilization instrument, and flexibly managed the pace and amount of central bank bill issuances in an effort to adjust the excess liquidity in the banking system. In July, the PBC, while maintaining the amount of market-based central bank bill issuances, for a third time issued central bank bills specifically targeting primary dealers whose loans had increased relatively rapidly and whose liquidity was abundant. This not only achieved the operational goal of withdrawing the excessive liquidity in the banking system, but also played a signaling role. In August, to support the hike in the reserve requirement ratio and the benchmark interest rate of deposits and loans, the PBC flexibly conducted bidding in different forms to iron out market volatility and guide market expectations. In September, given the generally lax liquidity and relatively stable market expectations, the PBC further strengthened open market operations for the purpose of sterilization, with the average issuance of central bank bills exceeding 100 billion yuan per week. In the third quarter, the PBC issued a total of 816.2 billion yuan in central bank bills, and at end-September the outstanding amount of central bank bills was 3078 billion yuan. In the first three quarters, the PBC drained 645 billion yuan of base money on a net basis through RMB open market operations.

The issue rates of central bank bills generally moved upward. At end-September, the interest rates of 3-month and 1-year central bank bills were 2.46 percent and 2.79 percent respectively, up 73 and 89 basis points compared with the beginning of 2006. Since April, market expectations of a tightening were strengthened with the adoption of a series of macroeconomic management policies. Moreover, because new IPOs were allowed at the end of May, uncertainties about banking liquidity increased. The issue rates of central bank bills moved upward month by month and money market rates became more volatile. To stabilize market expectations and foster sound performance of the market, the PBC used quantity-bidding to issue 1-year central bank bills three consecutive times in the first three weeks of August; after the benchmark deposits and lending rates hikes on August 19, the PBC promptly switched to price-bidding to issue 1-year central bank bills. As a result, the issue rate of 1-year central bank bills declined slightly after reaching a peak of 2.89 percent. At the end of September, the rate was stabilized at 2.79 percent, with the money market rates becoming stable.

Box 2: Cash Management of the Treasury

Cash management of the central treasury refers to a series of financial management activities aimed at minimizing outstanding cash and maximizing investment returns while meeting the payment needs of the central treasury. As of 1984, the PBC exclusively served as the central bank and was authorized by the State Council to act as the government's fiscal agent. *The Law on the People's Bank of China*, promulgated in 1995, granted the PBC responsibility for managing the treasury. Before 2003 the PBC did not pay interest on fiscal deposits. As of 2003, it began to pay interest on fiscal deposits at the rate of the institution demand deposits.

In recent years, fiscal revenue has surged due to sustained and rapid economic growth. Meanwhile, with promotion of the treasury single account reform, the funds covered by the budget originally held by different institutions were gradually centralized in the treasury. As a result, the amount of cash stored in the treasury is higher and more volatile, making it more difficult to use monetary policy for macroeconomic management. Hence, it is necessary to deepen the reform of treasury management. Moreover, as the money market has become deeper and broader following many years of development, the fiscal authorities are in a better position to forecast the cash flow of the treasury, providing the basic conditions for cash management of the treasury.

After studying the experience of developed countries in managing the treasury cash balance on a market basis and the situation in China, the Ministry of Finance and the PBC jointly released the *Provisional Regulation on Central Treasury Cash Management* in June 2006. In September 2006, the Ministry of Finance and the PBC jointly released the *Operational Rules on Commercial Bank Time Deposits for Central Treasury Cash Management*, indicating a gradual change to market-based treasury management. The Ministry of Finance and the PBC have established a special coordination mechanism whereby the former is responsible for forecasting treasury cash movements and formulating operation programs while the latter is charged with monitoring money market developments; the Ministry assigns operational orders after consulting with the PBC and the orders are executed by the PBC.

According to the *Provisional Regulation on Central Treasury Cash Management*, treasury cash management shall be conducted in a prudent and orderly manner, from easy to more difficult and based on the principles of safety, liquidity, and profitability. The methods of treasury cash management include commercial bank time deposits, buy-backs of treasury bonds, and repo and reverse repo of treasury bonds. At the preliminary stage, central treasury cash management mainly takes the form of commercial bank time deposits and buy-backs of treasury bonds, both of which are conducted through public bidding. Cash management in the form of commercial bank time deposits refers to cases where treasury cash is deposited in a commercial bank, which, in turn, uses the treasury bonds as deposit pledges and pays interest to the Ministry of Finance. The maturity of the deposits is usually no more than one year. The buy-back of treasury bonds refers to cases where the Ministry of Finance buys back treasury bonds on the market and either writes them off or holds them to maturity. Both forms of cash management inject liquidity into the banking system and increase the supply of base money.

At present, the macroeconomic management has produced initial results. However, the BOP imbalance remains and banking liquidity is generally lax. Hence, liquidity management needs to be further strengthened. The Ministry of Finance and the PBC need to further intensify coordination, strengthen the analysis and forecasting of liquidity movements and macroeconomic development, and prudently and smoothly conduct treasury cash management.

II. The Interest Rate as a Leverage in Macroeconomic Management

To guide appropriate growth of investments as well as money and credit and to safeguard general price stability, the PBC decided to raise the benchmark interest rates of RMB deposits and lending of financial institutions as of August 19, 2006. The benchmark interest rate of 1-year deposits was increased by 0.27 percentage points, from 2.25 percent to 2.52 percent. The benchmark lending rate of 1-year loans was increased by 0.27 percentage points, from 5.85 percent to 6.12 percent. The benchmark interest rates on deposits and loans of other maturities were also raised, with those of longer maturities raised by a larger margin than those of shorter maturities. Meanwhile, to further promote the market-based reform of the individual mortgage rate, the lower limit of the rate was changed from 0.9 times the benchmark lending rate to 0.85 times the benchmark lending rate. The lower limits of other lending rates remained at 0.9 times the benchmark lending rate. Observation of the actual lending rates in the third quarter indicates that the lending rates of various loans have gradually moved upward, suggesting the combined effects of the two interest rate hikes. Favorable conditions have been created for appropriate growth of money and credit.

III. Upward Adjustment of the Reserve Requirement Ratio

To strengthen liquidity management, promote sound adjustment of lending activities by commercial banks, and reasonably control the growth of money and credit, the PBC, as approved by the State Council, announced an increase in the reserve requirement ratio of financial institutions by 0.5 percentage points on three occasions, June 16, July 21, and November 3, which went into effect on July 5, August 15, and November 15 respectively. Following the increases in the reserve requirement ratio on July 5 and August 15, the financial market performed smoothly, with slight upward movements of money market interest rates, and the stock market continued to rally.

IV. Strengthening of 'Window Guidance' and Guidance on Credit Policy

The PBC made efforts to implement the macroeconomic policies set by the central government, strengthening guidance on credit policy, and enhancing communication with financial institutions through window guidance to help them meet the requirements of the state for macroeconomic management, and reasonably control credit growth and adjust the lending structure. First, importance was attached to providing good financial services for rural migrant workers. Second, coordination between credit policy and industrial policy was strengthened. Financial institutions are required to strictly control infrastructure and other medium- and long-term loans and to guide an appropriate flow of funds in an effort to promote economic structural adjustments and industrial upgrading. Meanwhile, monitoring, analysis, and regulation of the real estate market have been strengthened. Third, the PBC will guide commercial banks to further implement regional economic development policies so that the banks can make appropriate lending in light of the needs of local economic development. Fourth, credit policy will continue to "assist the weak." Financial institutions will be guided to provide student loans and other loans to support job creation, the non-public economy, small- and medium-sized enterprises, the development of poor and ethnic minority areas, and so on.

V. Smooth Advance of Financial Enterprise Reform

The joint-stock reform of the state-owned commercial banks progressed smoothly. The Industrial and Commercial Bank of China (ICBC) was listed simultaneously on the Hong Kong Stock Exchange and the Shanghai Securities Exchange on October 27, leading to a successful IPO. Before the greenshoe option was adopted, the ICBC issued A-shares and H-shares totaling US$19.1 billion, the world's largest ever IPO. In the IPO, H-shares and A-shares were priced equally, issued and offered simultaneously, providing a nice investment opportunity for investors and boosting the sound development of the domestic capital market. The banks undergoing reform became more influential in the market. The China Construction Bank was included on the Hang Seng Index as of September 11, and became the first H-share company ever included on the Index. Following its IPO, the Bank of China was also included on important stock indices such as the Shanghai Stock Index 50 and the H-Share Index. After the strategic investors were introduced, full-fledged cooperation was launched to bring in advanced management experience and techniques in an effort to enhance competitiveness in key areas. According to its strategic cooperation agreement with the Bank of America, the China Construction Bank acquired 100 percent of the shares of the Bank of America (Asia) Ltd., a subsidiary of the Bank of America, for HKD 9.71 billion to expand overseas business. Relevant agencies are working on a joint-stock reform program of the Agricultural Bank of China in line with the needs of building a socialist new countryside and the rural financial system reform program.

The pilot reform of rural credit cooperatives moved forward smoothly with obvious progress. First, the reform of property rights advanced with the basic establishment of a new management system. At end-September 2006, rural credit cooperatives formed a total of 85 banking institutions, including 12 rural commercial banks and 73 rural cooperative banks and 674 legal entities at the county (city) level. In all provinces (and municipalities) involved in the pilot reform, regulatory agencies at the provincial level were set up and the responsibility of the provincial governments to regulate the rural credit cooperatives within their jurisdiction was clarified. Second, the quality of assets and the financial situation improved. The non-performing loan ratio stood at

12.1 percent, down 24.8 percentage points from the end of 2002. The rural credit cooperatives raised adequate capital ratios through equity expansion. Since profits were realized in 2004 for the first time in ten years, profits have been increasing year by year. Third, financial support for the pilot reform was disbursed gradually to ease the historical burdens. The PBC, together with the China Banking Regulatory Commission (CBRC), has completed 11 issuances (at a pace of 1 issuance per quarter) of special bills, totaling 165.5 billion yuan and covering 2,396 rural credit cooperatives at the county level to support the pilot reform. Meanwhile, from the second quarter of 2006 the PBC has paid 4.56 billion yuan to qualified rural credit cooperatives that hold special bills.

Box 3: Appropriate Understanding of the Criteria for Special Bill Redemption in Support of the Pilot Reform of the Rural Credit Cooperatives

Thus far, progress has been achieved in the reform of the rural credit cooperatives. However, the majority of rural credit cooperatives have not made breakthroughs in improving corporate governance, transforming the operational mechanism, and, in particular, in strengthening internal control. Therefore, the rural credit cooperatives have to make great efforts to carry out key reforms in order to achieve sustainable development. In order for financial support to provide positive incentives for the pilot reform, various institutions and agencies need to fully understand the intended purpose and mechanism arrangement of the financial support and the criteria for the special bill redemption.

First, the policy intention of purchasing a good mechanism with money should be correctly understood. According to the overall requirements of the State Council to deepen the pilot reform of the rural credit cooperatives, the PBC issued special bills and arranged special lending amounting to 165.6 billion yuan to cover 50 percent of the gap between their assets and liabilities at end-2002 so as to alleviate the historical burdens of the rural credit cooperatives; provided exemptions of the business tax and income tax totaling 9.9 billion yuan; and disbursed 6.9 billion yuan to subsidize the interest payments of the rural credit cooperatives incurred for value-maintenance savings. If recovery of impaired assets is calculated by 50 percent of the lower limit set by the asset management companies, recovery of the problem assets replaced by the special bills may exceed 5 billion yuan, and can be used to supplement the provisions of the rural credit cooperatives; rural credit cooperatives are subject to a relatively low reserve requirement ratio, adding another 80 billion yuan to their usable funds; moreover, rural credit cooperatives holding special bills receive interest payments of 5.7 billion yuan. The above financial supports total about 273.1 billion yuan. Meanwhile, the local governments attach importance to the pilot reform of the rural credit cooperatives and have taken effective measures to help them reduce their historical burdens. In general, the above policies have played an important role in launching the reform and creating conditions for the various involved parties. However, to realize the reform objectives, it is essential for the rural credit cooperatives to grasp the spirit of the reform and to make concrete efforts to improve corporate governance, transform the operational mechanism, and strengthen internal control. This is the purpose of purchasing a good mechanism with money.

Second, the reason for setting criteria for financial support in the pilot reform should be well understood. The historical burdens of the rural credit cooperatives were caused by complicated factors, including poor management of these institutions and external factors such as administrative interventions. According to the overall requirements of the State Council, the PBC, together with the CBRC, formulated the criteria and procedures for financial support to strengthen the positive incentives and to encourage the financial support to effectively play a guidance role. Rural credit cooperatives are significantly different from other depository institutions, state-owned commercial banks in particular. With financial restructuring and IPOs, state-owned commercial banks have established a relatively complete external constraint mechanism. Nevertheless, adopting a different method of financial support for the rural credit cooperatives is conducive to ensure burden-sharing and encourage local governments to take active measures aimed at reducing the historical burdens of the rural credit cooperatives. It also encourages the rural credit cooperatives to transform operational mechanism, strengthen management, improve performance, and increase the accumulation of profits, leading to a gradual resolution of their historical burdens and to sustainable development. The experience of the pilot reform has shown that reform of the rural credit cooperatives involves many aspects and is an arduous task. It is essential that central and local governments provide policy support and work together with the efforts of the rural credit cooperatives to strengthen management and transform the operational mechanism.

Third, the financial support policy of the pilot reform shall be improved during the course of the reform. State Council Document [2003] No.15 indicates that the redemption of special central bank bills must be linked with the actual results of the reform of the rural credit cooperatives, which shall be examined at the county (city) level based on the criteria of clarified property rights, paid-in capital, and complete corporate governance. The PBC, together with the CBRC, further clarified and improved the criteria for financial support and special bill redemption in PBC Document [2006] No.130. The document stresses that, to apply for special bill redemption, the rural credit cooperatives shall have made significant progress in advancing corporate governance, and the focus of the examination should be their actual progress in strengthening internal control and management. The document has specific requirements for enhancing asset quality, effectively controlling costs, and improving the financial situation. Changes in the above financial indicators can reflect the concrete outcome of the reform and provide a benchmark for deciding whether the criteria for the special bill redemption have been met. In general, strictly carrying out the financial support policy of the pilot reform is conducive to the prompt redemption of the special bills by the rural credit cooperatives, making the policy more transparent, credible, and controllable.

VI. Smooth Advance of the Reform of the Exchange Regime

In the third quarter the PBC launched a series of policy measures to promote the balance of the external account and further develop the foreign exchange market and coordinate demand and supply in the market. First, the PBC further strengthened the infrastructure of the foreign exchange market. The trading hours of automatic matching transactions and OTC transactions on the inter-bank spot foreign exchange market were unified. Trading on the inter-bank foreign exchange market was further regulated. Domestic foreign exchange-designated banks were allowed to offer exchange of the Korean Won. Spot, forward, and swap transactions between the Pound Sterling and the RMB were launched on the inter-bank foreign exchange market. Second, the reserve requirement ratio for foreign exchange deposits of domestic financial institutions was raised to control the growth of credit and ease the tension between supply and demand on the foreign exchange market. Third, the PBC further improved foreign exchange management in an effort to facilitate trade in goods and services and to regulate the management of capital flows.

VII. Acceleration of the Reform of the System of Foreign Exchange Management

To expand outward investment channels, strengthen regulation of cross-border capital flows, and promote the balance in the external account, the authorities launched a series of policy measures to improve foreign exchange management. First, the authorities improved foreign exchange management under the current account to facilitate trade in goods and services. Foreign exchange surrender management associated with exports was reformed and trade-related foreign exchange was managed by different categories. The policy for purchase and sale of foreign exchange associated with certain services trade was adjusted to further simplify the procedure and document requirements for enterprise purchases and sales. Second, management of capital inflows was regulated to promote the sound development of the capital market. Management of foreign exchange in the real estate market and foreign investment access to the real estate market were also strengthened. Furthermore, the authorities intensified management of real estate development by foreign-funded enterprises and purchase of real estate by foreign institutions and individuals. The monitoring of cross-border capital flows was also enhanced. Provisional regulations on the merger and acquisition of domestic enterprises by foreign investors were promulgated. The regulation on QFII activities was amended to further regulate the investment activities of qualified foreign institutional investors on the domestic securities market. Third, to further standardize the operational procedures for outward investment and promote such investment by QDIIs, the authorities have allowed domestic banks, insurance companies, and securities companies to invest abroad. At the end of September, 10 banks including the Industrial and Commercial Bank of China had been approved for foreign exchange purchase quotas totaling USD11.1 billion for overseas wealth management on behalf of their clients, an overseas investment quota of USD3.5 billion had been approved for 11 insurance companies (among which USD 470 million was purchased), and an overseas securities investment quota of USD500 million had been approved for the Hua An Fund Management Company.

Part 3 Financial Market Performance

The first three quarters of 2006 witnessed overall sound financial market performance, featuring sufficient liquidity in the money market, smooth bond issuance, further diversified bond categories, and brisk trading activities on the market. Product innovations in the financial market were frequently launched and great progress was achieved in institutional building of the market.

I. An overview of financial market performance

In the first three quarters of 2006 the financing structure of domestic non-financial institutions (including household, enterprise, and government sectors) changed remarkably. In particular, bank loans and debt financing by enterprises saw a large increase compared with the same period of last year, with the share of enterprise debt financing clearly rising; the stock market traded briskly; while the share of equity financing (excluding the public offering volume by financial institutions) declined modestly; and the share of government securities declined due to continued implementation of a sound fiscal policy. In the first three quarters of the year, the shares of bank loans, equities, government securities, and corporate bonds in the total financing of the non-financial sectors were 85.8, 2.9, 5.7, and 5.5 percent respectively.

Table 3: Financing by Domestic Non-financial Sectors

in the First Three Quarters of 2006

	Volume of Financing (100 million yuan)		As a percentage of total financing (percent)	
	First three quarters of 2006	First three quarters of 2005	First three quarters of 2006	First three quarters of 2005
Financing by domestic non-financial sectors	32894	24468	100	100
Bank loans	28234	20614	85.8	84.2

Equities	969	982	2.9	4.0
Government securities	1883	1896	5.7	7.8
Corporate bonds	1808	976	5.5	4.0

Source: Financial Survey and Statistics Department, People's Bank of China. Equities do not include funds raised through public offerings by financial institutions.

1. Trading in the inter-bank market was brisk, and market interest rates edged up slightly

The first three quarters of 2006 saw brisk transactions in the inter-bank market, a trend of shortening maturities in fund use, and a continued rise in the interest rate. The turnover of bond repo (including bond pledged repo and outright bond repo) in the inter-bank market totaled 18.44 trillion yuan, 6.58 trillion yuan more than that in the same period of 2005, and the daily average turnover posted a year-on-year growth of 55.5 percent to 98.1 billion yuan. Inter-bank borrowing totaled 1.37 trillion yuan, up 406.6 billion yuan year on year, representing a daily average turnover of 7.3 billion yuan and an increase of 42.3 percent compared with the corresponding period in 2005. The turnover of government bond repo on the stock exchanges amounted to 0.79 trillion yuan, down 59.2 percent year on year.

The market share of the transaction volume of overnight products increased remarkably, indicating an evident trend of shortening maturities in fund use. In terms of pledged bond repo maturities, the market share of overnight products reached 51 percent in the first three quarters, up 3.2 percentage points over the corresponding period of last year; the market share of inter-bank borrowing products registered 27.5 percent, a rise of 9.2 percentage points over that in the previous year.

Money market interest rates were generally high. The monthly weighted average rate of bond pledged repo transactions and inter-bank borrowing posted 2.12 percent and 2.32 percent respectively in September, an acceleration of 0.25 and 0.24 percentage points over that in June and up 0.97 and 0.81 percentage points over that in the corresponding period of last year.

Regarding net fund flows in the repo market, there was a large increase in the net lending of state-owned commercial banks, which amounted to 8.63 trillion yuan in the first three quarters, representing an increase of 1.8 trillion yuan year on year. Net borrowing by other commercial banks,[1] other financial institutions,[2] and foreign

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

financial institutions grew rapidly, indicating a strong capital demand. In the inter-bank borrowing market, other commercial banks were the largest net fund providers, while net borrowing by foreign financial institutions rose fairly rapidly and net borrowing by securities companies and fund management companies grew moderately.

Table 4: Fund Flows of Financial Institutions in the First Three Quarters of 2006

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	First three quarters of 2006	First three quarters of 2005	First three quarters of 2006	First three quarters of 2005
Four State-Owned Commercial Banks	-86262.	-68241	-2028	-2703
Other Commercial Banks	38219	30413	-3189	-3092
Other Financial Institutions	39962	34260	3594	4678
Of which: Securities and Fund Management Companies	13602	9902	3085	2998
Insurance Companies	10027	6103	—	—
Foreign Financial Institutions	8081	3568	1623	1118

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

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

2. The spot bond transaction volume expanded with the bond issue rate rising significantly, and market products further diversified

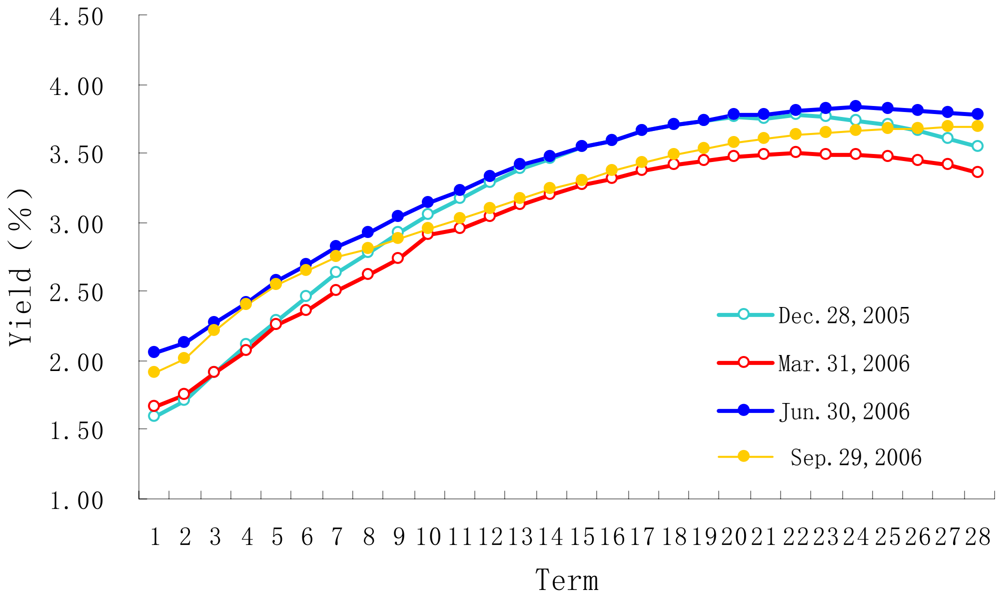
The secondary bond market traded briskly. In the first three quarters of the year, the accumulated turnover of spot transactions in the inter-bank bond market increased by 3.65 trillion yuan over the same period of the previous year to 7.68 trillion yuan, and the average daily turnover jumped by 90.4 percent year on year to 40.9 billion yuan.

[2] 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.

The turnover of government bond spot transactions on the organized exchanges reached 121.37 billion yuan, 94.24 billion yuan less than that in the first three quarters of 2005.

Driven by abundant liquidity in the market, both the inter-bank market bond index and the stock exchanges bond index moved upward. The inter-bank market bond index rose by 2.36 points, or 2.08 percent, from 113.5 points at the beginning of 2006 to 115.86 points at end-September. The government securities index on the organized exchanges rose by 2.43 points, or 2.17 percent, from 112.06 points at the beginning of the year to 114.49 points at end-September.

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



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

The yield curve of government securities in the inter-bank bond market displayed a flattening trend. Compared with end-2005, the prices of short-term bonds at end-September declined slightly, while their yields posted an evident rise; due to the large increase in the prices of long-term bonds, the yields declined and caused the entire yield curve to flatten.

Financing activities were dynamic in the primary bond market, and market products further diversified. In the first three quarters of 2006, a total of 1.5539 trillion yuan of bonds was issued, an increase of 474.0 billion yuan year on year. In particular, a total of 696.7 billion yuan of government securities was issued, with a year-on-year increase of 217.6 billion yuan; a total of 545.2 billion yuan of policy financial bonds was issued, a growth of 143.8 billion yuan year on year; a total of 276.5 billion yuan of corporate bonds (including short-term corporate financing bills worth 219.1 billion yuan) was issued, representing an increase of 175.9 billion yuan year on year. The Industrial Bank issued 4.0 billion yuan of hybrid capital bonds in the inter-bank market in September, indicating a further diversification of market products.

The issue rates of bonds of various categories climbed. In the third quarter, the interest rate of 3-year book-entry treasury bonds was 2.34 percent, up 0.22 percentage points over that in the second quarter; the interest rate of 3-year bearer's treasury bonds was 3.39 percent, a rise of 0.25 percentage points over that in the second quarter. The interest rate of 3-year bonds issued by the Agricultural Development Bank of China was 3.05 percent, 0.45 percentage points higher than that in the second quarter.

3. The commercial paper market fluctuated relatively greatly. The outstanding balance and growth rate of bill financing declined

In the first three quarters of 2006, a total of 4.01 trillion yuan of commercial bills was issued by the corporate sector, up 24.88 percent year on year; the amount of discount bills totaled 6.46 trillion yuan, up 36.31 percent compared with the same period of 2005; and that of rediscount bills reached 2.69 billion yuan, representing a year-on-year increase of 371 million yuan. At end-September, the outstanding balance of commercial paper stood at 2.22 trillion yuan, up 6.86 percent year on year; the outstanding balance of discount bills was 1.76 trillion yuan, up 13.5 percent year on year; and the outstanding balance of rediscount bills was 2.137 billion yuan, 1.483 billion yuan more than that recorded in the last year.

The rapid increase and large fluctuation in bill business imposed a growing influence on the money and credit aggregate. Bill financing, characterized by short maturities, convenient turnovers, controllable risks, and steady costs and benefits, has become an important channel for commercial banks to adjust the asset and liability structure and to manage liquidity. Financial institutions tend to vigorously develop a bill business in times of credit expansion, and turn to cutting down bill acceptances and discounts in times of credit contraction. In the first four months of 2006, the rapid increase of in-bill financing caused a sharp expansion in lending. Bill financing registered y-o-y growth of 53.6 percent at end-April, accounting for 9.6 percent of lending, and the share of new bill financing for new loans was 25.4 percent. Since May, the outstanding balance and growth of bill financing have dropped in each successive month. Bill financing increased by 13.5 percent year on year at end-September, accounting for 7.9 percent of lending, and the share of new bill financing for new loans was 5 percent.

4. The stock market traded briskly, with stock indices reaching a new high for the year

Due to the unfolding positive effects of the non-tradable shares reform on the securities market, sound economic performance, and the listing of quality blue chips like the Bank of China in the A-share market, the securities market traded briskly and stock indices reached a new high for the year. In the first three quarters of the year, the total turnover of the Shanghai and Shenzhen Stock Exchanges reached 5.82 trillion yuan, up 3.31 trillion yuan year on year, with the average daily turnover up 1.3 times year on year to 32.2 billion yuan. In particular, the turnover of A-shares reached 5.74 trillion yuan, 3.28 trillion yuan more than that in the corresponding period of the previous year, with the average daily turnover registering 31.7 billion yuan, 2.3 times that in the same period of the previous year.

In the first three quarters, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index reached a peak of 1757 points and 451 points respectively, the highest levels since May 2004. At end-September, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index closed at 1752 and 439 points respectively, up 50.9 percent and 57.3 percent from end-2005, reflecting an evident strengthening of market confidence.

In the first three quarters of the year, a total of 226.73 billion yuan was raised by Chinese enterprises through IPOs, additional offerings, and rights issues on the equity market at home and abroad, an increase of 110.83 billion yuan or 95.6 percent over that in the corresponding period of 2005, indicating a faster pace of financing. In particular, a total of 86.64 billion yuan and US$17.47 billion was raised in the A-share and H-share markets respectively, and 430 million yuan was raised through convertible bonds.

Securities investment funds continued to grow rapidly. At end-September, the number of securities investment funds totaled 276, 58 more than that at the end of 2005. The volume of the funds declined by 5.3 percent year on year to 455.4 billion yuan, and their net assets expanded by 14.7 percent year on year to 545.6 billion yuan.

5. The insurance industry continued to expand at a fast pace and its asset structure further diversified

In the first three quarters of the year, the total premium income of the insurance industry amounted to 430.9 billion yuan, up 14 percent year on year; accumulated claim payments grew by 20.1 percent to 97.8 billion yuan. At end-September, the total assets of insurance companies grew by 25.9 percent year on year to 1.81 trillion yuan, reflecting continued and rapid growth.

The assets structure of insurance companies further diversified with the expansion of investment channels, the rapid growth of the bond market, and the improvement of the market operation mechanism. Excluding government securities and securities investment funds, other investments (including investments in financial bonds, corporate bonds, and equities) increased significantly to account for 35.2 percent of total assets, a y-o-y growth of 9.6 percentage points.

Table 5: Use of Insurance Funds at End-September 2006

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	End-Sept. 2006	End-Sept. 2005	End-Sept. 2006	End-Sept. 2005
Total assets	18096	14378	100	100
Of which, Bank deposits	5543	4994	30.6	34.7
Investment	10879	8077	60.1	56.2
Government securities	3699	3340	20.4	23.2
Securities investment funds	810	1062	4.5	7.4
Other Investment	6370	3675	35.2	25.6

Source: China Insurance Regulatory Commission.

6. Trading of foreign currency pairs in the inter-bank market was active

In the first three quarters of the year, the combined volume of 8 currency pairs trading in the inter-bank foreign exchange market amounted to US$54.6 billion, with transactions in the currency pairs of USD/HKD, USD/JPY, and EUR/USD accounting for 82 percent of the total trading volume, reflecting active trading in these products. The cumulative volume of RMB forward transactions in the inter-bank foreign exchange market stood at US$11.39 billion.

II. Financial market institutional building

1. Development of the money market and the bond market were actively advanced

First, money brokerage companies were introduced into the inter-bank bond market and the inter-bank borrowing market to launch a brokerage business, in order to improve the market operational framework, enhance market liquidity and transaction efficiency, reduce transaction costs, and strengthen the price formation mechanism. Second, the issuance of hybrid capital bonds by commercial banks was regulated to provide a basis for further expansion of the supplementary capital channels of the commercial banks. Third, in order to advance the development of the inter-bank borrowing market, improve the money market benchmark rate formation mechanism, and diversify the asset and liability management channels of the commercial banks, the maximum maturity of borrowing by deposit-taking financial institutions was extended to 1 year, and the maximum maturity of lending was kept within the maximum borrowing maturity of the counterpart.

2. Major progress was made in the reform of non-tradable shares and the restructuring of securities companies proceeded firmly

Major progress has been made in the non-tradable shares reform as most listed companies have accomplished a non-tradable shares reform (hereinafter shares reform). On September 30, 2006, a total of 1,170 companies listed on the Shanghai and Shenzhen Stock Exchanges had either completed or launched a shares reform, accounting for 86.9 percent in terms of the number and 92.8 percent in terms of the market capitalization of all companies to be reformed. In light of the market situation, the Shanghai and Shenzhen Stock Exchanges respectively issued the *Notification on the Transactions of Non-tradable Shares Reform by Listed Companies* to remove the letter G from the stock names of the companies that have completed the reform, and to add the letter S to the beginning of the stock names of the companies that have yet to launch or finish the reform so as to indicate risks of these companies. To promote the reform of the listed companies, the China Securities Regulatory Commission (the CSRC) promulgated the *Notification on the Interval between the Veto of the Non-tradable Shares Reform Plan by the Shareholders Meeting and the Re-launching of the Non-tradable Shares Reform Procedure*. The *Notification* provides that in the case that the non-tradable shares reform plan of a listed company is vetoed at the shareholders meeting, the non-tradable shareholders can, within one month of the meeting, entrust the board of directors to convene another shareholders meeting on the reform.

Based on the overall arrangement of the State Council, the PBC and other relevant government agencies continued to advance the restructuring of securities companies that had a valuable potential and a social impact. With the approval of the State Council, the PBC and the CSRC, together with the government of Shandong province, the government of Chongqing municipality, and the government of the Xinjiang Uygur Autonomous Region respectively completed the restructuring of Tiantong Securities, Southwest Securities, and Xinjiang Securities respectively. While addressing financial problems such as the inadequate capital and the liquidity difficulties of the securities companies, emphasis was also placed on promoting the transformation of the operational mechanism, establishing a corporate governance structure and a strict internal control system in line with a modern enterprise system, and encouraging the institutional building and innovation of the securities companies.

3. Institutional building of the insurance market was further promoted

The regulations and rules of the insurance market were improved to standardize the insurance business. The China Insurance Regulatory Commission (hereinafter referred to as the CIRC) issued the *Administrative Measures on Health Insurance* to regulate the health insurance business in a comprehensive and systematic manner. The *Measures*, as the first specialized administrative regulation on standardizing commercial health insurance, are very important to advance the professionalism of health insurance, promote product innovation, regulate market behavior, protect the rights and interests of the insured, and improve the external environment.

Regulation of insurance companies was strengthened to facilitate the healthy development of the insurance industry. The CIRC released the *Administrative Measures on the Establishment of Overseas Insurance Institutions by Insurance Companies* to strengthen management of the establishment of overseas insurance institutions by insurance companies, to prevent insurance sector risks, and to protect the rights and interests of the insured. The CIRC also promulgated the *Measures for the Administration of Investment in Overseas Insurance Enterprises by Non-insurance Institutions* to strengthen supervision over investment in overseas insurance enterprises by non-insurance institutions and to advance the healthy development of the insurance industry.

Part 4 Analysis of Macroeconomic Developments

I. The global economic and financial situations

Since the start of 2006 the global economy has continued a momentum of rapid growth. The US economy slowed down in the second and third quarters following strong growth in the first quarter. The economies in the Euro zone and the Japanese economy picked up steadily. The major emerging and developing economies continued to maintain a momentum of robust growth. International crude oil prices fell sharply in August, yet still remained high. Volatile international crude oil prices, rising trade protectionism, and imbalances in the global economy remained the major risks for future global economic growth. According to the International Monetary Fund (IMF) forecast in September 2006, the global economy is expected to grow by 5.1 percent in 2006, up 0.3 percentage points compared with its forecast in April 2006, and global trade in goods and services is expected to grow by 8.9 percent, up 0.9 percentage points over the forecast in April 2006.

1. Economic development of the major economies

The US economy slowed down gradually. Following strong GDP growth of 5.6 percent in the first quarter of 2006, the US economy showed a trend of slowing down, as reflected in growth rates[3] of 2.6 percent and 1.6 percent in the second and third quarters respectively. Due to the impact of the moderation in the economic growth and falling energy prices, inflationary pressures eased. In the third quarter, the consumer price index (CPI) registered 4.1 percent, 3.8 percent, and 2.1 percent respectively in July, August, and September on a year-on-year basis, averaging 3.3 percent, lower than the 3.6 percent and 4.0 percent recorded in the first and second quarters respectively. US employment was broadly stable. The unemployment rate posted 4.8 percent, 4.7 percent, and 4.6 percent respectively in July, August, and September, averaging 4.7 percent, basically unchanged from the level in the first and second quarters. The US trade deficit continued to increase, reaching US$522.8

[3] The growth rates are seasonally-adjusted annualized rates. The year-on-year quarterly GDP growth rates posted 3.7 percent, 3.5 percent, and 2.9 percent respectively in the first three quarters of 2006.

billion in the first eight months of 2006, up US$65.82 billion over that recorded in the same period of 2005. It is noteworthy that in the 2006 fiscal year that ended on September 30, US fiscal deficits decreased substantially to US$247.7 billion, with the ratio of fiscal deficits to GDP dropping from a record high of 3.6 percent in 2004 to a four-year low of 1.9 percent.

The economies in the Euro zone continued to recover. In the first and second quarters of 2006, GDP grew by 2.1 percent and 2.6 percent respectively over the same quarters of 2005. Inflationary pressures continued to persist. The monthly Harmonized Index of Consumer Prices (HICP) registered 2.4 percent, 2.3 percent, and 1.8 percent respectively in July, August, and September year on year, averaging 2.2 percent, down 0.1 percentage points from that recorded in the first quarter and up 0.2 percentage points over the same quarter in the previous year. Employment improved, with the unemployment rate at 7.8 percent all through July, August, and September, markedly lower on a year-on-year basis. During January-August 2006, the trade deficit posted EUR20.1 billion, compared with a surplus of EUR19.8 billion in the same period of 2005.

The Japanese economy picked up steadily. In the first and second quarters of 2006, GDP grew by 3.4 percent and 2.5 percent respectively on a year-on-year basis. Consumer consumption and domestic investment in equipment grew rapidly, and exports saw strong growth. In the third quarter of 2006, the year-on-year CPI registered consecutive positive figures of 0.3 percent, 0.9 percent, and 0.6 percent respectively in July, August, and September. The monthly unemployment rate registered 4.1 percent, 4.1 percent, and 4.2 percent respectively in July, August, and September, almost unchanged compared with that recorded in the previous two quarters. In the third quarter of 2006, the trade surplus was JPY2.1 trillion, up 7.9 percent over that recorded in the same period of the previous year.

Since the beginning of 2006 the major economies in the emerging markets and developing countries or regions have continued to maintain a growth momentum, yet inflationary pressures have built up. In particular, the Asian emerging economies maintained robust growth due to domestic demand and foreign trade support. The Latin American economies slowed down following the rapid growth in the first quarter.

2. Developments in international financial markets

Since the beginning of 2006, in general, the US dollar has weakened against other major currencies. In early May, the US dollar was at a record low since the start of the year, followed by fluctuations and rebounds to varying degrees. On September 29, 2006, the Euro closed against the US dollar at US$1.2671 and the US dollar closed against the Yen at JPY118.17; the dollar depreciated by 6.7 percent against the Euro and yet appreciated by 0.23 percent against the Yen over that recorded at the start of 2006.

The yields of major bonds rose steadily in the first seven months of 2006, yet began to decline in mid-July and showed signs of stabilizing in mid-September. On September 29, 2006, the yields of 10-year government bonds in the US, the Euro zone, and Japan closed at 4.63 percent, 3.71 percent, and 1.67 percent respectively, up 0.26, 0.38, and 0.23 percentage points over that recorded at the start of 2006.

In the first four months of 2006, global stock markets rose to varying degrees. Starting from early May, however, the major stock markets fell sharply due to the rising prices of primary commodities and concerns about inflation. The major stock indices posted losses until July and then began to stabilize and rebound gradually. On September 29, 2006, the Dow Jones Industrial Average closed at 11,679, and the Nasdaq Composite Index closed at 2,258, up 7.67 percent and 0.62 percent respectively over that recorded at the beginning of 2006. The Stoxx 50 closed at 3,551, up 5.68 percent over that at the beginning of 2006. The Nikkei 225 Stock Average ended at 16,128, down 1.4 percent over that at the beginning of 2006.

Due to the impact of the Fed's pause in the rate hike and economic expectations, the London Inter-bank Offered Rate (LIBOR) in US Dollars began to edge down following a record high on June 29 since the start of the year. At end-September, the 1-year LIBOR in US Dollars posted 5.298 percent, down 0.11 percentage points on a month-on-month basis and down 0.4 percentage points over the record high at end-June. Encouraged by the economic prospects and expectations of a European Central Bank (ECB) rate hike, the 1-year LIBOR in the Euro rose steadily and reached a high of 3.716 percent at end-September, up 0.096 and 0.2 percentage points respectively over that recorded in the previous month and at end-June.

3. Monetary policies of the major economies

In 2006 the Federal Open Market Committee (FOMC) raised the federal funds target rate to 5.25 percent by increments of 25 basis points respectively on January 31, March 28, May 10, and June 29. At all three subsequent FOMC meetings, the Fed decided to keep the federal funds target rate unchanged. The ECB raised the interest rate for main refinancing operations to 3.25 percent by 25 basis points respectively on March 2, June 8, August 3, and October 5, rendering the highest rate in the past three-plus years. The Bank of Japan (BOJ) decided on March 9 to end the quantitative easing monetary policy and to change the operational target of the monetary policy from the upper limit of the current account balance held with the BOJ by commercial banks to the unsecured overnight call rate, and raised the rate on July 14 from zero to 0.25 percent, the first rate hike by the BOJ in the past 6 years. The Bank of England also raised the interest rate to 5 percent by 25 basis points respectively on August 3 and November 9.

II. Analysis of China's macroeconomic performance

In the third quarter of 2006 the national economy maintained steady and rapid growth, with generally good economic performance. Consumption maintained steady and rapid growth. Investment growth tended to slow down from a high level. Foreign trade grew rapidly. Household income, enterprise profits, and fiscal revenues all increased substantially. Market prices were stable. Yet problems still persisted such as the yet-to-be solidly based moderation of fixed-asset investment growth, the widening imbalances in the balance of payments, greater difficulties in further increasing the farmers' income, and the serious situation in terms of saving energy and cutting down on resources consumption and pollution. In the first three quarters of 2006, the GDP reached 14.1 trillion yuan, growing 10.7 percent and accelerating by 0.8 percentage points on a year-on-year basis, and decelerating by 0.2 percentage points over that recorded in the first half of 2006; the consumer price index (CPI) rose by 1.3 percent year on year, decelerating by 0.7 percentage points on a year-on-year basis, but identical to that recorded in the first half of 2006; the trade surplus registered US$109.8 billion, up US$41.5 billion over the same period of 2005.

1. Domestic demand grew steadily, and investment growth decelerated; external demand maintained a momentum of growth, and the trade surplus continued to widen

Household income grew rapidly and consumption demand continued to increase. Final consumption contributed more to economic growth. In the first three quarters of 2006, the per capita disposable income of urban residents stood at 8,799 yuan, representing an inflation-adjusted real growth of 10 percent and an acceleration of 0.2 percentage points year on year. The per capita net cash earnings of farmers totaled 2,762 yuan, representing a real growth of 11.4 percent year on year, close to that recorded in the same period of the previous year. With the increase in the income of urban and rural residents, domestic consumer demand expanded, yet the consumption growth of residents in counties was still lower than that in large- and medium-sized cities. In the first three quarters of 2006, the total volume of retail sales was 5.5 trillion yuan, representing an inflation-adjusted real growth of 12.6 percent and an acceleration of 0.5 percentage points year on year. Generally, final consumption contributed more to economic growth. In the first three quarters of 2006, the contribution of final consumption accounted for 35.7 percent of the economic growth, up 9.5 percentage points on a year-on-year basis.

The momentum of excessive fixed-asset investment growth was reined in, yet investment remained at a high level. In the first three quarters of 2006, total fixed-asset investment posted 7.2 trillion yuan, representing a growth of 27.3 percent and an acceleration of 1.2 percentage points on a year-on-year basis, and a deceleration of 2.5 percentage points over that recorded in the first half of 2006. In particular, urban fixed-asset investment reached 6.2 trillion yuan, growing by 28.2 percent on a year-on-year basis and decelerating by 3.1 percentage points over that recorded in the first half of 2006. The total planned investment for new projects was 4.9 trillion yuan, growing by 7.5 percent on a year-on-year basis and decelerating by 14.7 percentage points over that in the first half of 2006. In terms of industrial segmentation, fixed-asset investment in the financial industry, construction industry, the accommodations and catering industry, and the culture, sports, and recreation industry registered the highest growth, all surpassing 40 percent. Fixed-asset investment in mining and manufacturing grew 33.4 percent and 33.8 percent, decelerating by 12.2 and 4.8 percentage points respectively over that in the first half of 2006. Generally, while growth of fixed-asset investment decelerated, the size of fixed-asset investment was still excessively large. The contribution of capital formation still accounted for as high as 49.9 percent of the economic growth, up 9.9 percentage points over the same period of last year.

The growth of exports and imports accelerated, yet the growth of exports continued to be greater than that of imports, and the trade surplus increased. In the first three quarters of 2006, the total cumulative volume of exports and imports reached US$1.3 trillion, up 24.3 percent on a year-on-year basis. Specifically, exports grew 26.5 percent and imports grew 21.7 percent. The trade surplus amounted to US$109.85 billion, surpassing that recorded for the entire year of 2005. In the first three quarters of 2006, net exports of goods and services accounted for 14.4 percent of the economic growth, down 19.4 percentage points on a year-on-year basis.

Box 4: An Analysis of the Sources of China's Trade Surplus

Since China's accession to the WTO, foreign trade has been developing rapidly. During 2001-2005, cumulative exports and imports amounted to US$2.4 trillion and US$2.2 trillion, with the average annual growth rate reaching 30.1 percent and 28.3 percent respectively. According to WTO statistics, in 2005 China's exports and imports accounted for 7.5 percent and 6.3 percent respectively of the world's total, both ranking third worldwide. In 2005 the trade surplus was US$101.9 billion, an increase of 3.5 times over that in 2001; in the first three quarters of 2006 the trade surplus increased to US$109.9 billion, up 60.4 percent on a year-on-year basis.

According to statistics, the processing trade constituted the major source of China's trade surplus. In the mid-1990s the processing trade replaced general trade as the major mode of China's foreign trade. The processing trade profits from the value added between exports and imports, resulting in an inevitable trade surplus. Starting from 2001, deficits and surpluses alternated in the general trade, yet deficits persisted in other trade, and the surpluses widened in the processing trade. During 2001-2005, surpluses in the processing trade increased at an average annual rate of 28 percent and totaled US$438.9 billion, contributing 207 percent to the trade surplus in the same period. In the first three quarters of 2006, the processing trade surplus amounted to US$128.8 billion, contributing 117 percent to the trade surplus. At present, more than 80 percent of China's trade surplus originates in the foreign-funded enterprises, which not only have obtained the bulk of the profits in the processing trade but also have profited from the transfer pricing and so forth. China receives the processing service fees, which only account for a small portion of the total profits.

Foreign direct investment (FDI) grew at a high level, making greater contributions to the trade surplus. Large quantities of foreign capital flowed into the processing and manufacturing industries, spurring the growth of domestic production capacity and the increase of exports. In 2005 actual utilization of FDI amounted to US$72.4 billion, representing a growth of 54 percent over that in 2001, or on average 11.5 percent annual growth from 2001 to 2005. According to statistics, in 2005 the manufacturing industry absorbed 60 percent of FDI inflows; meanwhile, foreign-funded enterprises realized exports and imports totaling US$831.7 billion and produced a trade surplus of US$56.7 billion, accounting for 59 percent and 56 percent respectively of the total foreign trade volume and the total trade surplus, an increase 2.2 times and 6.7 times respectively over that recorded in 2001. According to a survey conducted by the US Chamber of Commerce, in 2004 75 percent of US enterprises in China realized profits, boasting a return on investment (ROI) of 19.2 percent, 9.1 percentage points higher than the global average in the same period. In 2005 foreign-funded enterprises realized a total profit of RMB396.7 billion yuan, up 14.8 percent on a year-on-year basis. In 2005, of the top 100 exporting enterprises in China, 56 were foreign-funded enterprises, 7 more than the number in 2003.

In recent years, excluding the surplus from the comparative advantage in the processing trade, China's foreign trade generally realized deficits. While China is a big country in terms of foreign trade, China is still not a strong trading power due to low technological content and value added in its exports and its weak capability for independent innovation. At present, only three out of ten thousand enterprises in China have core technology with independent intellectual property rights, less than 40 percent of which have trademarks. Eighty percent of the products with high technological content rely on imports. Products with independent brands account for less than 10 percent of total exports. Most exports of electronic products and equipment have a lower unit value compared with similar exports from Korea, Malaysia, and Singapore.

Given the synchronous growth of FDI and the processing trade surplus on the one hand and the total trade surpluses on the other, one of the important factors behind the continual expansion of China's trade surplus remains international industrial transfers, especially manufacturing industry transfers to China from elsewhere. Against the backdrop of economic globalization, China actively takes part in the international division of labor, makes full use of such comparative advantages as cheap labor, and vigorously introduces FDI to develop the processing and manufacturing industries. In recent years, apparent changes have taken place in the regional structure of world trade. China has increasingly become a manufacturing center for the entire world, importing raw materials and semi-finished goods in large quantities from Asian nations such as the ASEAN countries and Korea, and exporting them after processing and assembly to the US and the EU. Thus, some direct exports from Asian countries to the US and the EU have been transformed into indirect exports through China. According to IMF statistics, in 2005 China absorbed 21.8 percent, 11.5 percent, and 8.3 percent respectively of the exports from Korea, Malaysia, and Thailand, and China's exports to the US and the EU accounted for 21.4 percent and 18.9 percent respectively of its total exports. In 2005 the share of ASEAN, Korea, and Taiwan (China) in China's imports increased by 1.8, 2, and 0.1 percentage points respectively compared with that in 2001, while their shares in the imports of the US decreased by 1, 1.1, and 0.7 percentage points respectively. During the same period, China's share in the US import market rose by 5.8 percentage points. All of the above indicates that part of the trade surpluses of some Asian economies with the US was transformed into China's trade surplus with the US.

2. The situation for agricultural production was relatively good, industrial production grew steadily, and enterprise profits further increased

In the first three quarters of 2006 the farming, forestry, animal husbandry, and fishery industries realized a value added of 1.6 trillion yuan, growing 4.9 percent and decelerating by 0.1 percentage points over the same period of the previous year, and they accounted for 5.3 percent of economic growth. The industrial and construction sectors realized a value added of 7.0 trillion yuan, growing 13.0 percent and accelerating by 1.9 percentage points on a year-on-year basis, and they accounted for 59.3 percent of economic growth, constituting the primary driver behind the economic growth. The services industries realized a value added of 5.5 trillion yuan, growing 9.5 percent and accelerating by 1.4 percentage points on a year-on-year basis, and they accounted for 35.4 percent of economic growth. The proportion of the primary, secondary, and tertiary industries in GDP were 11 percent, 49.8 percent, and 39.2 percent respectively.

The situation for agricultural production was good. Grain production achieved another bumper harvest. The total output of summer grain reached 113.8 billion kilos, up 7.4 billion kilos or 7.0 percent on a year-on-year basis. Autumn grain was coming along fine. The total output of pork, beef, mutton, and poultry reached 56.69 million tons, up 4.1 percent on a year-on-year basis. The decrease in the production prices of agricultural products (i.e., the prices at which producers of agricultural products directly sell their products) and the increase in the prices of agricultural production materials presented some difficulties for farmers to further increase their income. In the first three quarters of 2006, the production prices of agricultural products decreased by 0.3 percent on a year-on-year basis. Specifically, the production prices of grain increased by 0.6 percent and the production prices of livestock products dropped by 9.1 percent. The prices of agricultural production materials increased by 1.2 percent. The growth of sales income from agricultural products by farmers was lower than that of salary income and operating income. The growth of investment by farmers was lower than the growth of investment by non-farmers. In the first three quarters of 2006 fixed-asset investment by farmers grew 11.7 percent, decelerating by 4.2 percentage points on a year-on-year basis.

Industrial production grew steadily, and enterprise operational results were generally good. In the first three quarters of 2006, the statistically large enterprises realized a value added of 6.2 trillion yuan, representing growth of 17.2 percent, and an acceleration of 0.9 percentage points on a year-on-year basis and a deceleration of 0.5 percentage points over that recorded in the first half of the year. The ratio of sales to total output by industrial enterprises was 97.8 percent. The statistically large industrial enterprises realized a total profit of 1.3 trillion yuan, an increase of 29.6 percent and an acceleration of 9.5 percentage points on a year-on-year basis. The 2006 Third Quarter Survey of 5,000 Enterprises by the PBC indicates that those enterprises that evaluated their overall business operations to be “good” accounted for as much as

35.2 percent of all the enterprises surveyed, up 2.0 and 0.6 percentage points respectively over that recorded in the same period of last year and in the previous quarter.

3. Price indices displayed an upward trend, and inflationary pressures persisted

(1) The year-on-year rise in the Consumer Price Index (CPI) continued to be stable; the rise of non-food prices and of services stabilized and tended to rise. In the first three quarters of 2006 the cumulative CPI grew 1.3 percent on a year-on-year basis. Specifically, the CPI rose 1.2 percent, 1.4 percent, and 1.3 percent respectively in the first, second, and third quarters of 2006. In terms of segmentation, in the third quarter of 2006, the prices of consumer goods increased by 1.1 percent, the prices of services rose by 2.0 percent, food prices rose by 1.5 percent, and non-food prices increased by 1.2 percent. The year-on-year rise of non-food prices and of services accelerated over that recorded in the first half of 2006.

(2) The rise in the Producer Price Index (PPI) rebounded on a year-on-year basis, and the rise in the purchasing prices of raw materials, fuels, and power remained greater than that of the factory prices of industrial products. The purchasing prices of industrial raw materials, fuels, and power increased 6.3 percent in cumulative and year-on-year terms for the first three quarters of 2006, and posted 6.5 percent, 5.7 percent, and 6.7 percent respectively in the first, second, and third quarters on a year-on-year basis. The factory prices of industrial products increased by 2.9 percent in the first three quarters and registered 2.9 percent, 2.6 percent, and 3.5 percent respectively in the first, second, and third quarters. In the first three quarters of 2006, the differential between the rise in the purchase prices of raw material, fuels, and power and the rise in the factory prices of industrial products was 3.4 percentage points, down 0.4 percentage points over that in the same period of last year, indicating that pressures continued to ease for enterprises to absorb the rise in prices of upstream products.

(3) The differential between the rises in the prices of exports and imports widened. In the first, second, and third quarters of 2006, the rise in the customs prices of exports posted 0.8 percent, 2.6 percent, and 4.7 percent respectively on a year-on-year basis, while the increase in the customs prices of imports registered 1.0 percent, 2.6 percent, and 9.1 percent respectively over the same quarter of the previous year. In the third quarter of 2006, the rise in import prices was far greater than the rise of export prices, and the differential widened.

(4) Labor compensation grew rapidly. In the first three quarters of 2006 the average monthly salary of employees in urban units was 1,559 yuan, up 14.2 percent on a

year-on-year basis. In particular, the average monthly salary of employees in state-owned units posted 1,638 yuan, up 14.7 percent; that of employees in collectively-owned units was 941 yuan, up 16.36 percent; and that of employees in other units was 1,552 yuan, up 12.1 percent.

(5) The GDP deflator continued to decrease. In the first three quarters of 2006, the nominal GDP growth rate was 13.4 percent, while the real GDP growth rate was 10.7 percent. The GDP deflator (the differential between the nominal GDP growth rate and the real GDP growth rate) was 2.7 percent, down 1.6 percentage points on a year-on-year basis and down 0.7 percentage points over that recorded in the first half of 2006.

4. Fiscal revenue grew substantially

Fiscal revenue in the first three quarters of 2006 amounted to 2 trillion yuan, growing 24.6 percent and accelerating by 7.9 percentage points over the same period of the previous year; fiscal expenditures amounted to 2.32 trillion yuan, growing 16.1 percent and decelerating by 2.5 percentage points. Netting revenue and expenditures, fiscal revenue surpassed fiscal expenditures by 646.5 billion yuan, up 264.7 billion yuan on a year-on-year basis. The rapid growth of fiscal revenue was mainly attributed to the continued large increase in major tax categories. In particular, the domestic value-added tax went up by 20.4 percent, the domestic consumption tax by 15.9 percent, the enterprise income tax by 42.9 percent, while the consumption tax and value added tax levied by customs grew by 21.6 percent. Among the fiscal expenditure items, expenditures for capital construction climbed by 10.9 percent, expenditures for education, science, culture, and public health by 15.2 percent, and expenditures for administration and management by 14.2 percent.

5. The balance of payments surplus continued to expand

The growing BOP surplus was mainly driven by the rising surplus in the trade in goods. In the first half of 2006, the BOP surplus rose by 24 percent year on year to US$130.5 billion, including US$91.6 billion of the current account surplus (which grew 36 percent year on year) and US$38.9 billion of the capital account surplus (which grew 2 percent). The surplus of the trade in goods climbed 47 percent year on year to US$80 billion, contributing 65 percent to the growth in the official foreign exchange reserves, accelerating by 11 percentage points compared with a year earlier. Foreign exchange reserves grew rapidly. At end-September 2006, China’s foreign exchange reserves totaled US$987.9 billion, up US$169.0 billion over that at end-2005.

The total external debt continued to increase, but at a slower pace compared with that of the previous year. Short-term debt accounted for a large share of the external debt. At end-June 2006, the total external debt amounted to US$297.9 billion, growing 6 percent over that at end-2005, a deceleration of 1.5 percentage points over that recorded in the previous year. Specifically, the outstanding short-term external debt totaled US$166.3 billion, up 6.5 percent over that at end-2005 and accounting for 55.8 percent of the total external debt, 0.2 percentage points higher than its share at end-2005.

6. Industrial analysis

The major industries performed well, featuring stable growth in output, fairly good sales figures, and continued profit growth in many sectors. Of 39 industries, 22 industries experienced more than 18 percent growth in industrial added value. In particular, the added value of the ferrous metal mining and processing sector grew by 29.8 percent year on year; the profits of 17 sectors rose by more than 30 percent year on year, including in the non-ferrous metal sector whose profits surged by 105.2 percent. Enterprises have been keen to make investments. Twenty-nine sectors saw investment go up by 28 percent or more, and the growth of investment in several raw material and light industries including textiles accelerated rapidly, while investment in some heavy industries began to slump.

Growth in supplies of coal, electricity, and transportation accelerated, further easing the shortage of these goods and services. In the first three quarters of 2006, the output of coal, crude oil, and power generation reached 1.48 billion tons, 140 million tons, and 2 trillion kilowatt-hours respectively, growing 11.7 percent, .7 percent, and 12.9 percent respectively on a year-on-year basis. The volume of rail freight increased by 7.3 percent to 2.13 billion tons; the volume of freight handled by the major seaports rose by 17.5 percent to 2.52 billion tons.

(1) The real estate industry

In Q3, investment in real estate development and commercial housing sales posted steady growth. The area of land under development continued to rise sharply. The rise in housing prices tended to increase steadily, but prices in certain regions moved up by a large margin. The growth of commercial real estate loans accelerated while the growth of housing mortgage loans decelerated slightly.

The growth of real estate investment was steady, with investment in commercial housing being its driving force. In the first three quarters of 2006, cumulative investment in real estate development amounted to 1.3 trillion yuan, growing 24.3 percent and accelerating by 2.1 percentage points over the same period of the preceding year. Specifically, investment in commercial residential housing grew 29.5

percent and accelerated by 8 percentage points on a year-on-year basis; investment in office buildings, in commercial operations space, and in other categories of housing rose by 15.8 percent, 16.9 percent, and 10.1 percent respectively, decelerating by 3.8 percentage points, 7 percentage points, and 15 percentage points.

The area of purchased land dropped, but the completed area of land development surged. In the first three quarters of 2006, a total of 241 million square meters of land was purchased, down 3 percent and a deceleration of 6.1 percentage points compared with the same period of 2005; development of 163 million square meters of land was completed, up 34 percent and an acceleration of 34.5 percentage points compared with the same period of 2005.

Growth in the area of commercial housing sales and in vacancies remained basically stable. In the first three quarters of 2006, the area of sold commercial housing grew 10.5 percent year on year to 359 million square meters. At end-September, commercial housing vacancies grew 11.7 percent year on year to 121 million square meters. Specifically, residential housing vacancies increased 9.7 percent year on year to 66 million square meters.

The rise in housing sales prices stabilized, yet some localities saw steep rises in housing prices. In the third quarter of 2006, housing sales prices in 70 large- and medium-sized cities rose by 5.5 percent on a year-on-year basis, a slight acceleration of 0.2 percentage points over that recorded in the previous quarter. In terms of breakdown by category, the sale prices of new commercial residential housing rose by 6.7 percent, an acceleration of 0.3 percentage points over that recorded in the previous quarter. In terms of geographic locations, five cities registered a large year-on-year rise in housing prices, i.e., Shenzhen reaching 12.8 percent, Beijing 9.7 percent, Dalian 8.5 percent, Huhhot 8.3 percent, Dalian 11.7 percent, and Xiamen 8 percent. The housing sales prices in Shanghai have been declining year on year every month since December 2005.

The growth of real estate development loans accelerated, but mortgage loans grew at a slower pace. At end-September, the amount of outstanding commercial real estate loans increased by 607.6 billion yuan over that at the beginning of 2006 to 3.6 trillion yuan, up 24.35 percent on a year-on-year basis and accelerating by 5.54 percentage points over the same period of last year. The amount of outstanding real estate development loans grew by 276.7 billion yuan over that at the beginning of 2006 to 1.38 trillion yuan, representing year-on-year growth of 28.85 percent or an acceleration of 12 percentage points. The amount of outstanding mortgage loans grew by 271 billion yuan over that at the beginning of 2006 to 2.18 trillion yuan, representing year-on-year growth of 17.9 percent and a deceleration of 2.2 percentage points.

The real estate industry is an important pillar industry and a major consumption item in the current stage of economic development in China. Therefore, guiding and promoting sustained, stable, and sound development of this sector contributes to the steady yet fairly rapid growth of the overall economy and helps satisfy the basic housing and consumption demands of the public. In July 2006, in response to the sharp rise in foreign investment in the real estate sector and the purchase of housing by overseas institutions and individuals in China, the Ministry of Construction, the PBC, and 4 other ministries and commissions jointly promulgated the *Opinions on Regulating Access to Foreign Capital of the Real Estate Market and its Management*, in order to regulate foreign investment in China’s real estate market in terms of market access, operations and management, purchase of housing by institutions and individuals, etc. As the next step, measures will be taken to give further play to the readjustment function of taxation, credit, and land policies, to adjust the housing supply structure, and to rein in the excessive price hikes with a view to promoting the healthy development of the real estate sector.

(2) The non-ferrous metal industry

The non-ferrous metal industry engages in the exploration, mining and mineral separation, smelting, and processing of non-ferrous metals, and is an important part of the basic materials sector. Copper, aluminum, lead, and zinc, which are extensively used in machinery, building, electronics, automobiles, metallurgy, packing, defense, and high-tech sectors etc. account for more than 93 percent of the total output of non-ferrous metals in China. China has a fairly full-fledged non-ferrous metal industry system, with a developed smelting sector, a rapidly growing processing sector, and a fairly underdeveloped mining and dressing sector.

In recent years, production, investment, imports, and exports of the non-ferrous metal industry have boomed in China due to the sharp price hikes of these metals and the surging demand both at home and abroad. Profits in the industry have hit a record high. At end-September, the prices of copper, aluminum, lead, and zinc on the London Metal Exchange posted year-on-year increases of 92.5 percent, 38.5 percent, 46.2 percent, and 138.1 percent respectively. In the first three quarters, the spot prices of copper, aluminum, lead, and zinc on the domestic market grew by 77.8 percent, 21.7 percent, 22.1 percent, and 96.3 percent respectively year on year. The combined domestic output of ten types of non-ferrous metals was up 18 percent year on year. The statistically large non-ferrous metal enterprises (excluding independent gold enterprises) registered profits double those during the corresponding period of last year; fixed-asset investment was up 40.6 percent year on year; and exports and imports up 43.7 percent and 30.2 percent respectively. The export of copper, aluminum, lead, zinc and its products increased by 124.3 percent, 50.6 percent, 45.9 percent, and 147.3 percent respectively, and imports increased by 18.9 percent, 26.1 percent, -4.3 percent, and 76.2 percent respectively. Trade of aluminum and lead both showed a surplus while that of copper and zinc showed a deficit.

In the last three months, under the guidance of the macroeconomic management and adjustment policies, China's non-ferrous investment structure generally moved in a good direction. Total investments for new smelting projects clearly declined, and investments for new mining and processing projects increased slightly, but still there were serious problems, including the mismatch between the supply of mineral resources and the rise in smelting capacity and the blind investment in aluminum, copper smelting, lead, and zinc smelting projects with disregard for the resources, environment, and technological factors.

Since the beginning of 2006, on the basis of the macroeconomic management policies adopted in the previous two years, the government has introduced a series of industrial structure adjustments and trade policies to curb the export of high energy-consuming and high-polluting sectors and resources. Many of the measures affect the non-ferrous metal industry either directly or indirectly, such as terminating the export tax rebate for non-ferrous metals and scraps, lowering the export tax rebate rate for certain non-ferrous metal materials, speeding up the restructuring of the aluminum industry, and regulating investment in the lead and zinc industries, etc. These measures will play a positive role in balancing the domestic non-ferrous supply and demand and improving the efficiency of resource development and energy utilization, promoting faster technological upgrading in the industry, energy conservation, and efficiency, and resolving problems such as the excess capacity in primary product processing and the over-reliance on imports of high-end products.

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

I. Macroeconomic outlook

Against the backdrop of the domestic and global economic environment and under the effect of various policy measures for macroeconomic management, economic growth in the coming period is expected to moderate slightly. However, since the forces driving economic growth remain strong, the economy in general will continue to grow at a steady and relatively fast pace. Preliminary forecasts show that the growth of GDP in 2006 will exceed 10 percent and the increase in the CPI will be around 1.5 percent.

Domestic demand will maintain a relatively fast growth momentum. With respect to investment demand, a series of measures introduced over the past few months to strengthen land and credit management and strictly control newly started projects has achieved initial effects, leading to a slowdown in investment growth in the third quarter of 2006. However, factors such as the relatively high savings rate, the large accumulation of enterprise funds, the continued inflow of foreign investment, the accelerated process of industrialization and urbanization, and the implementation of the Eleventh Five-Year Program projects imply that pressures of a rebound in fixed-asset investment merit our attention. Consumer demand continued to rise steadily, with the year-on-year growth of the total volume of retail sales remaining above 13 percent for most of the time since the beginning of 2006. The steady improvements in the public finance system, income distribution system, and social security system will gradually boost household expectations regarding income and expenditures. As to foreign trade, growth of China’s exports will be supported by the expectation of continued strong global economic growth in 2006, but uncertainties will increase due to the large fluctuations in the prices of oil and other raw materials and the potential for moderated US growth.

Upward risks still remain in domestic price movements, leading to continued inflationary pressures. With respect to downward risks, the oversupply of consumer goods is likely to persist in the near term, and the rapid expansion of capacity in production materials in certain sectors and consumer goods will constrain the price rises of relevant products. The upward risks can be summarized as follows. First, the accelerated price reform of resources, including water, electricity, petroleum, gas, and coal, the gradual increase of utility prices, and the high prices of oil and non-ferrous metal in the international market will further push up the PPI and CPI. Second, the government will continue to strengthen its requirements on enterprises in the areas of environmental protection, labor security, and workplace safety, which will contribute to higher costs for enterprises in addressing the issues of pollution, labor security, workplace safety, and salaries of employees, etc. Third, since localities have a strong interest in investment, there is a possibility of an investment growth rebound and the future prices of production materials may be under upward pressures. According to the PBC survey on urban household savings in the third quarter of 2006, 44.2 percent of the respondents expected that prices would go up, 6.8 percentage points higher than the household expectation in the previous quarter, becoming the second highest level on record and indicating a lack of optimism in household expectations on future prices.

In general, with the effective implementation of the macroeconomic management policy measures, prominent imbalances in economic performance have been alleviated and the national economy will continue to maintain a steady and fast growth momentum. However, serious problems are yet to be resolved in economic development since the falls in fixed-asset investment and money and credit growth are not solidly based; the BOP imbalances remain fairly large and the economy still faces inflationary pressures; and the situation remains grim in the areas of energy conservation, energy efficiency improvements, and pollution reduction.

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

In order to promote a steady and balanced development of the national economy, the PBC will continue to pursue a sound monetary policy in line with the State Council's plans and decisions on economic work, will apply a mix of monetary policy instruments to maintain a balance at the aggregate level, and will actively respond to various uncertainties based on close monitoring of changes in the economic and financial market situations. Meanwhile, medium- and long-term measures will be taken to speed up the economic restructuring and to promote a BOP equilibrium so as to move to a domestic demand-led economic development strategy that stresses both domestic and external demand.

The People's Bank of China will continue to strengthen liquidity management and take comprehensive measures to properly control money and credit growth. Experience has shown that under the current liquidity conditions, it is feasible to use central bank bills and the reserve requirement ratio as two sterilization instruments to manage liquidity, and such a combination is a necessary measure to positively and effectively implement monetary policy. Given that commercial banks currently hold a large amount of highly liquid assets, liquidity withdrawals through open market operations work only at a "shallow" level, and the volume and progress of open market operations are affected by the willingness of the commercial banks to make purchases. Use of the reserve requirement instrument enhances the preemptiveness and "depth" of the sterilization. In addition, given the abundant liquidity, an increase in the reserve requirement ratio by a small margin is not a "heavy dose of medicine," but rather a fine-tuning. Appropriate and effective macro management through monetary policy instruments helps to restrain the unhealthy factors in economic performance and fosters the sound development of the financial market, rather than affecting the basic track of overall economic performance. In general, maintaining a certain strength in liquidity management will be conducive to a steady and appropriate growth of money and credit and will help curb over-investment so as to consolidate the macro management effects.

While strengthening liquidity management, measures aimed at the medium and long term will be taken to further accelerate economic restructuring and implement various policy measures to boost domestic demand, in particular, consumer demand. The relationship between initial distribution and re-distribution will be improved to increase household income and enhance household consumption capabilities. Efforts will also be made to reduce future uncertainties of households and stabilize their expenditure expectations through the reform of the pension, medical care, education, and housing systems. Enterprises will be guided and encouraged to appropriately reduce the proportion of retained earnings and increase dividend payments. Moreover, steps will be taken to optimize the fiscal expenditure structure and increase the supply of public goods to strengthen the role of fiscal policy in promoting economic restructuring and intensify support for social undertakings. The transformation of government functions will be accelerated and social management and public services will be strengthened.