

China Monetary Policy Report Quarter Four, 2006

(February 9, 2007)

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

Executive Summary

In 2006, the Chinese economy maintained steady and rapid growth with generally good economic performance. Consumer demand became stronger, fixed-asset investment gradually moderated from a high level, and foreign trade expanded briskly. Household income, enterprise profits, and fiscal revenue all increased substantially. Market prices remained stable. In 2006, the GDP grew 10.7 percent to RMB20.9 trillion yuan and the CPI rose by 1.5 percent year on year.

In 2006, the People's Bank of China continued to carry out a sound monetary policy under the overall arrangements of the State Council to tackle problems such as excessive investment growth, overexpansion of credit, a widening trade surplus, and growing pressure on the environment and resources. A combination of measures was employed to withdraw excess liquidity in the banking system, including three increases in the reserve requirement ratio of financial institutions by 1.5 percentage points and intensified open market operations. As leverage, the benchmark deposit and lending rates of financial institutions were also raised two times to guide appropriate growth of investment and credit. The RMB exchange rate regime reform was further deepened to improve the managed floating exchange rate regime, and the foreign exchange management system reform was accelerated. To optimize the credit structure, efforts were made to strengthen window guidance and credit policy guidance. Meanwhile, financial enterprise reform was promoted steadily to support development of the financial market and direct financing.

Under the combined effect of macro-management policy measures, the relatively fast growth of money and credit was contained to a certain extent, and the credit structure further improved. In the second half of 2006, the growth of money and credit slowed down month by month. In December, growth of broad money (M2) fell to 16.9 percent from the yearly high of 19.2 percent, growth of RMB credits of financial institutions declined to 15.1 percent from the high of 16.3 percent, the relatively fast growth of medium- and long-term loans was also dampened, basically meeting the general requirement for macro-management and contributing to steady and rapid growth and price stability.

In general, due to the effective implementation of various macro-economic control

and structural adjustment policy measures, the imbalances in economic performance have been eased, and the economy is expected to maintain sound and rapid growth. However, moderate investment and credit growth are not solidly based, BOP imbalances are still serious, inflationary pressure is building up, and some deep-rooted structural problems still hamper sustainable economic growth, including the low consumption rate and the high savings rate.

In 2007, guided by a scientific development approach, efforts will be made to speed up the establishment of a harmonious socialist society, to continue enhancing macro-management, to adjust the economic structure, to transform the economic growth mode, to strengthen resource conservation and environmental protection, and to promote reform and opening-up and self-initiated innovation so as to bring the economy on a track of scientific development. Based on the preliminary projection of 8 percent GDP growth and below 3 percent CPI growth in 2007, the expected growth of aggregate money and credit as measured by broad money (M2) will be about 16 percent.

In line with the overall arrangements of the State Council, the People's Bank of China will continue to implement a sound monetary policy to further improve financial macro-management, strengthen liquidity management, and guide money and credit aggregates to grow at an appropriate pace. Efforts will be made to optimize the credit structure and strengthen support to key areas and weak points while maintaining aggregate balances. Meanwhile, efforts will also be made to further improve the RMB exchange rate formation mechanism, strengthen the coordination between quantitative instruments and price instruments, deepen financial reform across the board, accelerate financial market development, improve the monetary policy transmission mechanism, and enhance the forward-looking and scientific nature and effectiveness of monetary policy, so as to promote sound and rapid economic development.

Part 1 Monetary and Credit Performance

In 2006, the national economy continued to grow steadily and rapidly, with the financial industry performing in a sound manner. The momentum of overly rapid money and credit growth has been somewhat checked; as a result, the growth of money and credit has been basically consistent with the general direction of macro-economic management.

1. Growth of the broad money supply slowed down

At end-2006, outstanding broad money M2 amounted to 34.6 trillion yuan, an increase of 16.9 percent year on year, down 0.6 percentage points from the previous year. Narrow money M1 reached 12.6 trillion yuan, an increase of 17.5 percent year on year, up 5.7 percentage points over the growth in 2005. Cash in circulation M0 grew by 12.7 percent year on year to 2.7 trillion yuan, an acceleration of 0.7 percentage points year on year. Net cash injections in 2006 totaled 304.1 billion yuan, 47.8 billion yuan more than in the previous year.

In June 2006, the growth of M2 began to moderate slightly, while that of M1 accelerated, leading to a smaller gap between the two. Starting from November 2006, the growth of M1 overtook that of M2. Several factors may have contributed to the faster growth of M1. Enterprises and other organizations had good market performances and better profits, consequently they were more inclined to make investments and their demand for demand deposits grew dramatically. The growth of banker's acceptance bill issues slowed down after May, and may have prompted enterprises to hold more demand deposits for payment purposes.

II. Deposits of financial institutions increased steadily

At end-2006, outstanding deposits of all financial institutions (including foreign-funded financial institutions, as throughout this Report) denominated in both RMB and foreign currencies increased by 15.9 percent year on year to 34.8 trillion yuan, a deceleration of 2.2 percentage points from 2005, but representing a growth of 4.95 trillion yuan from the beginning of the year and an acceleration of 529.1 billion yuan over that recorded a year earlier. In particular, outstanding RMB deposits rose by

16.8 percent year on year to 33.5 trillion yuan, a growth of 4.93 trillion yuan from the beginning of 2006 and an acceleration of 522.6 billion yuan from the previous year; outstanding foreign currency deposits totaled US\$161.1 billion, a growth of US\$8.9 billion from the beginning of 2006 and an acceleration of US\$2.1 billion from the previous year.

Companies and households had a stronger preference for demand deposits. At end-2006, outstanding household RMB deposits totaled 16.42 trillion yuan, representing a growth of 2.09 trillion yuan from the beginning of 2006 and a deceleration of 112.5 billion yuan from a year earlier. In particular, growth of household time deposits showed a declining trend, while household demand deposits increased steadily. Outstanding corporate deposits stood at 11.32 trillion yuan, representing a growth of 1.74 trillion yuan from the beginning of 2006 and an acceleration of 607.6 billion yuan from a year earlier. In particular, corporate demand deposits built up at an apparently higher pace while the growth rate of corporate time deposits slightly declined. Outstanding fiscal deposits amounted to 1.09 trillion yuan, representing an increase of 291.9 billion yuan over the beginning of 2006 and an acceleration of 116.1 billion yuan from a year earlier.

III. Loans of financial institutions decelerated

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 23.8 trillion yuan at end-2006, representing a growth of 14.6 percent year on year and an acceleration of 1.8 percentage points from 2005. In particular, outstanding RMB loans grew by 15.1 percent year on year to 22.5 trillion yuan, an increase of 3.18 trillion yuan over the beginning of the year and an acceleration of 826.5 billion yuan. In 2006, lending declined quarter after quarter, registering 1.26 trillion yuan, 920.8 billion yuan, 578.7 billion yuan, and 424.7 billion yuan, respectively. Outstanding foreign currency loans rose by 10 percent year on year to US\$166.4 billion, representing an increase of US\$16.8 billion over the beginning of 2006 and a deceleration of US\$0.3 billion from the previous year. RMB lending by major financial institutions accelerated from 2005, while the share of foreign financial institutions in lending experienced a large increase.

Table 1 : RMB Lending by Financial Institutions in 2006

	2006		2005	
	New Loans (100 million yuan)	Share in Total New Loans (%)	New Loans (100 million yuan)	Share in Total New Loans (%)
Policy banks	3418	10.9	3379	14.4
State-owned commercial banks	12199	38.8	7621	32.4
Joint-stock commercial banks	7358	23.4	5965	25.3
City commercial banks	2773	8.8	1832	7.8
Rural financial institutions	4277	13.6	3451	14.7
Foreign financial institutions	969	3.1	421	1.8

Note: Rural financial institutions include rural cooperative banks, rural commercial banks, and rural credit cooperatives.

Source: The People's Bank of China.

In terms of the sectoral distribution and maturity of RMB loans, outstanding loans to households, non-financial companies, and other sectors all grew at a greater pace than in 2005. In 2006, loans to households increased by 611.9 billion yuan, 546.9 billion more than the growth in 2005. In particular, short-term consumer loans and medium- and long-term business loans rose rapidly. Loans to non-financial companies and other sectors increased by 2.57 trillion yuan, 279.6 billion yuan more than the growth in 2005; the growth rate of bill financing gradually declined month after month from a peak in April, before rising slightly in December; short-term loans grew steadily; and medium- to long-term loans accelerated but moderated at end-2006.

In terms of loan destinations, the bulk of RMB medium- and long-term loans went to infrastructure sectors, the real estate industry, and the manufacturing sector. In 2006, the RMB medium- and long-term loans of major financial institutions (including policy banks, state-owned commercial banks, joint-stock commercial banks, and city commercial banks) rose by 1.73 trillion yuan from the beginning of the year, accounting for 91 percent of the new RMB medium- and long-term loans in all financial institutions. Among the new medium- and long-term RMB loans, the shares of the infrastructure sectors (transportation, storage and postal services, production and supply of power, gas, and water, water conservancy, and the environmental and public facility management sector), the real estate industry, and the manufacturing sector were 37.6 percent, 19.7 percent, and 8.3 percent respectively.

IV. Base money grew at a stable pace

In 2006, base money grew in a steady manner. Growth in the first eleven months averaged 10 percent, and the outstanding balance of base money stood at 6.9 trillion yuan at end-November. In December, due to fiscal appropriations and other factors, base money grew at a slightly higher speed. In December, fiscal deposits declined by 0.5 trillion yuan month on month; at end-December, the outstanding balance of base money surged 20.9 percent year on year to 7.8 trillion yuan, representing a growth of 1.34 trillion yuan from the beginning of 2006 and an acceleration of 793.6 billion yuan from a year earlier. The excess reserve ratio of financial institutions averaged 4.8 percent at end-2006, up 0.6 percentage points from end-2005. In particular, the excess reserve ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 3 percent, 7.2 percent, and 10.8 percent respectively.

V. Lending rates of financial institutions rose slightly

Affected by two benchmark lending rate hikes in 2006, the lending rates of commercial banks continued to rise. According to the latest statistics, in the fourth quarter the lending rates commercial banks edged up by a small margin. The weighted average interest rate of 1-year RMB loans of commercial banks was 6.58 percent, 1.08 times the benchmark rate and up 0.22 percentage points from the previous quarter. In particular, the weighted average interest rate of fixed interest-rate loans, which accounted for 75.18 percent of the one-year RMB loans, stood at 6.59 percent, up 0.2 percentage points from the previous quarter; the weighted average interest rate of floating interest-rate loans, accounting for 24.82 percent of the one-year loans, was 6.54 percent, up 0.35 percentage points from the previous quarter. Among all loans issued by financial institutions in the fourth quarter, the share of loans with interest rates floating downward from the benchmark rates increased by 0.40 percentage points from the third quarter, while the share of loans with interest rates at or floating upward from the benchmark rates declined by 0.03 and 0.37 percentage points respectively.

Table 2: Share of Loans with Floating Rates in Various Ranges in the Fourth 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	25.81	26.63	47.56	27.90	7.32	10.63	1.71
State-owned commercial banks	100	31.52	29.96	38.52	35.48	2.54	0.49	0.02
Joint-stock commercial banks	100	40.75	30.21	29.03	28.56	0.42	0.05	0.00
Regional commercial banks	100	24.34	18.73	56.93	41.60	10.71	4.20	0.43
Urban and rural credit cooperatives	100	1.51	4.62	93.86	17.16	23.67	45.49	7.55
Policy banks	100	26.43	72.15	1.42	1.42	0.00	0.00	0.00

Note: The interest rate floating range for urban and rural credit cooperatives is (0.9, 2.3]

Source: Lending rate reports of commercial banks.

In 2006, the interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) increased in all four quarters, with the exception of during the second quarter when the rates slightly declined. Due to the benchmark deposit rate hike, the interest rates of negotiable deposits moved up in the second half of 2006. In the fourth quarter, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 4.17 percent, up 0.16 percentage points from the previous quarter; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 4.19 percent, up 0.47 percentage points over the previous quarter.

In 2006, affected by the interest rate movements in the international financial market, the interest rates of large-value foreign currency deposits and foreign currency loans in China generally displayed an upward trend.

Table 3: Average Interest Rates of Large-value Dollar Deposits and Loans in 2006

Unit: percent

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
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	4.81114	8.0444	0.482
3-6 months	4.6609	4.5713	4.7528	4.8992	4.9897	4.9406	5.4003	5.3248	5.0753	5.19804	9.7435	2.001
6-12 months	4.5001	4.7217	3.6802	4.9552	4.9579	5.3003	5.3429	5.1749	4.9716	4.99554	9.9655	1.651
1 year	4.2042	4.587	4.6506	4.7946	4.7055	5.3986	5.3652	5.1975	5.0555	3.23384	8.7995	2.184
II. Loans:												
1 year (fixed)	5.1379	5.6163	5.5822	6.0507	5.8239	6.345	6.0619	6.4336	6.3881	6.16396	2.0446	2.126
1 year (monthly floating)	5.5756	5.5904	5.6562	5.9982	6.0307	6.2311	6.5046	6.2893	6.2501	6.28246	0.4526	1.985

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

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

In 2006, the RMB exchange rate appreciated by a small margin, and the fundamental role of market supply and demand was further enhanced. At end-2006, the central parity of the RMB against the US Dollar was 7.8087 yuan per US Dollar, appreciating by 2615 points or 3.35 percent over the beginning of 2006; the RMB depreciated by 5.43 percent against the Euro and appreciated 5.95 percent against the Japanese Yen. From the exchange rate regime reform on July 21, 2005 to the end of 2006, the RMB cumulatively appreciated by 5.99 percent, 2.46 percent, and 11.32 percent respectively against the US Dollar, the Euro, and Japanese Yen.

In 2006, the elasticity of the RMB exchange rate was obviously strengthened, and the linkage of the RMB exchange rate with the major currencies was strong. The peak and bottom central parities of the RMB against the US Dollar were 7.8087 yuan per US Dollar and 8.0705 yuan per US Dollar respectively. Among the 243 trading days in 2006, the inter-bank foreign exchange market saw RMB appreciations for 135 days

and RMB depreciations for 108 days. The largest appreciation and depreciation of the central parity against the US Dollar in a single business day was 124 basis points and 203 basis points respectively; the daily fluctuation of the central parity averaged 40 basis points, much larger than the average of 17 basis points recorded in the post-exchange rate regime reform period of 2005.

Part 2 Monetary Policy Conduct

In 2006, given the excessive investment and credit growth, the widening trade surplus, and the increased pressure on the environment and natural resources, the PBC, according to the State Council's overall arrangements, continued to implement a sound monetary policy. A comprehensive package of policies was launched to withdraw excessive liquidity from the banking system. Among these efforts, the PBC used the interest rate instrument as leverage, strengthened the adjustment of monetary aggregates, guided financial institutions to optimize the credit structure, improved the managed floating exchange rate regime, improved foreign exchange management, supported development of the financial market and direct financing, and promoted the reform of financial enterprises. These actions have contributed to relatively smooth and rapid development of the economy and fundamental price stability.

I. Take comprehensive measures to strengthen liquidity management

In 2006, due to persistent pressures of excessive liquidity caused by the balance of payments surplus, the PBC carried out monetary policy mainly by strengthening management of banking liquidity by means of open market operations and reserve requirement policies in an effort to drain liquidity. On the one hand, the PBC intensified open market operations by issuing central bank bills and making repurchases. The issuance of central bank bills totaled 3.65 trillion yuan in 2006, up 860 billion yuan from the previous year, with outstanding central bank bills amounting to 3.03 trillion yuan at year-end. Meanwhile, the issuance interest rate of one-year central bank bills grew smoothly by 90 basis points over the year, which led to a gradual increase in money market interest rates. The market interest rates played a role in adjusting fund supply and demand. In the first half of 2006, the issuance interest rate rose smoothly, with the 1-year rate up from 1.9 percent at the beginning of the year to 2.64 percent at the end of June; in the second half of the year, affected by a variety of factors, money market interest rates fluctuated by a larger measure. The PBC therefore flexibly switched between price bidding and quantity bidding. The issuance interest rate of 1-year central bank bills stood at around 2.80 percent, playing an active role in stabilizing market expectations and promoting the smooth movement of money market interest rates. On the other hand, with the approval of the State

Council, the PBC increased the reserve requirement ratio of financial institutions by 0.5 percentage points on four occasions, on July 5, August 15, November 15 of 2006, and on January 15, 2007 respectively. By adjusting the reserve requirement ratio, the central bank made its macro-economic management operations more preemptive and effective. Moreover, to strengthen foreign currency credit management, the PBC increased the foreign exchange reserve requirement ratio by 1 percentage point, effective September 15, 2006.

Excess banking liquidity is not a simple domestic problem. Since the second half of 2002, due to the combined effect of international and domestic factors, a growing surplus in both current and capital accounts led to a rapid buildup of foreign exchange reserves. To maintain a balance at the aggregate level and an appropriate growth of credit, the PBC began to use a variety of monetary policy instruments in 2003 to intensify liquidity management. The PBC started to issue central bank bills in April 2003 and increased the reserve requirement ratio by 1 percentage point in September 2003. From 2003 through 2006, the PBC sterilized about 3 trillion yuan on a net basis through central bank bill issuances, and “deeply” froze about 1 trillion yuan through five reserve requirement ratio increases by a total of 3 percentage points. In recent years, base money grew at an appropriate pace and the money market interest rates moved in a stable manner. Meanwhile, the liquidity demand of commercial banks was met for lending and settlement purposes. The persistently large BOP surplus is caused by various domestic and external factors. Absent significant change in domestic and external conditions, the balance of payment account will remain in surplus for some time to come. Hence, the PBC will have to face an excessive supply of liquidity in the banking system for the next period of time. An important task of the monetary policy will be to sterilize the excess liquidity.

II. Let interest rates play a leveraging role and promote market-based interest rate reform

To curb excessive investment and guide appropriate growth of investment and credit, the PBC raised the benchmark interest rates on loans and deposits twice in 2006. The first hike was made on April 28 when the 1-year benchmark lending rate was raised by 0.27 percentage points from 5.58 percent to 5.85 percent. The second hike was on August 19. The benchmark interest rate on deposits was increased from 2.25 percent

to 2.52 percent and the benchmark lending rate was increased from 5.85 percent to 6.12 percent, each by 0.27 percentage points.

Higher benchmark interest rates on loans and deposits are conducive to guiding the appropriate growth of investment and credit and prompting enterprises and financial institutions to properly measure risks; they also help maintain a generally stable price level, promote transition of the economic growth mode, and contribute to sound and rapid growth of the economy. In the fourth quarter, the lending rates of various maturities gradually moved up, creating favorable conditions for appropriate credit growth in 2006.

In 2006, market-based interest rate reform continued to advance. First, the program of developing a money market benchmark interest rate system was initiated. After a three-month trial operation starting from October 2006, the Shanghai Inter-bank Offered Rate (Shibor) was formally launched on January 4, 2007. Second, the floor interest rate of commercial housing mortgage loans for individuals was lowered from 0.9 times the benchmark lending rate to 0.85 times the benchmark lending rate so as to expand the pricing room for individual mortgages. These measures helped improve the pricing capacity of financial institutions and improved the transmission mechanism of the monetary policy.

Box 1: The Money Market Benchmark Interest Rate

The market benchmark interest rate refers to a system of interest rates that plays a fundamental role in the interest rate system and serves as reference for the pricing of other products. It is usually an arithmetic average of the inter-bank lending rates quoted by banks with good credit standing. At present, the EU, Britain, and Japan, among others, have formed their own money market benchmark interest rate systems. Examples include the London Inter-bank Offered Rate (Libor) and the Euro Inter-bank Offered Rate (Euribor).

The Libor is an arithmetic average of the offered rates quoted by the Contributor Panel Banks at the inter-bank market. Authorized by the British Bankers' Association (BBA), Reuters calculates and publishes the Libor. The Libor is produced by excluding the highest and lowest 25 percent of all quoted rates and taking the arithmetic average of the remaining 50 percent. The Libor is released before noon, London Time, on each business day. The British Bankers' Association's Foreign

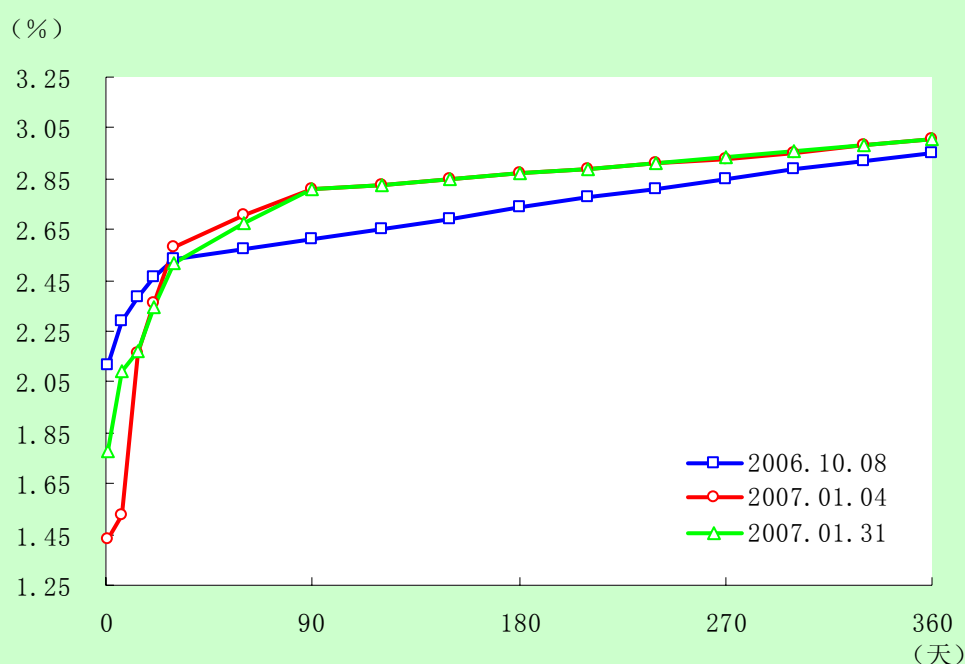
Exchange and Money Market Advisory Panel makes decisions about which banks to invite to become contributors to the BBA Libor Panel, based on market reputation, volume of trading activity, professional strength, and credit ratings, etc. The Libor is fixed for the inter-bank rates of nine currencies that include the British Pound, US Dollar, Euro, Japanese yen, Canadian Dollar, Australian Dollar, Swiss Franc, New Zealand Dollar, and Danish Krona, of 15 maturities ranging from overnight to 1 year. The Euribor is the arithmetic average of the inter-bank term deposits rates quoted by 49 prime banks and serves as the benchmark rate for the money market and capital market in the Euro zone. The Tibor (Tokyo Inter-bank Offered Rate) is the reference interest rate for short-term inter-bank borrowing in Tokyo, and reflects short-term borrowing activities in Japan. It is usually referred to by banks when they provide financing for enterprises.

From the general practice of these benchmark interest rate systems, the features of the money market interest rate can be summarized as follows. First, the fixing of the interest rate is based on quotations. It is the rate quoted by the lending banks rather than the actual rate at which a transaction is made. The benchmark interest rate is produced by eliminating a certain portion of the highest and lowest quotes and taking the arithmetic average of the remaining quotes. Banks that provide the quotes are usually first-class banks with high credit ratings and that have large trading volumes and a strong pricing capacity. Second, the benchmark interest rate refers to an interest rate system for maturities ranging from overnight to 1 year, not just for a specific maturity with the largest trading volume. Third, the benchmark interest rate is usually produced and published by an institution specified by the bankers' association. Fourth, the money market benchmark interest rate is usually named after the city where the financial center is located.

To promote market-based interest rate reform, foster China's money market benchmark interest rate system, strengthen the pricing capacity of financial institutions, guide the pricing of money market products, and improve the monetary policy transmission mechanism, the PBC drew on international experiences and promoted the creation of a quote-based system of money market benchmark interest rates in China, i.e., the Shibor (Shanghai Inter-bank Offered Rate). It is the arithmetic average of the lending rates quoted by a panel of high-rated banks. It is a simple, unsecured, and wholesale rate. At present, the published Shibor rates are overnight, 1 week, 2 weeks, 1 month, 3 months, 6 months, 9 months, and 1 year. The quoting banks include 16 commercial banks that are either primary dealers in open market operations or market makers in the foreign exchange market. These banks trade actively and make relatively sufficient information disclosures. The National Inter-bank Funding Center is authorized to calculate and publish the Shibor. In the calculation process, the Funding Center eliminates the highest and lowest two rates of each maturity and takes an arithmetic average of the remaining quotes for each maturity. The Shibor is published at 11:30am on each trading day on the Web site www.shibor.org.

The Shibor began trial operations on October 8, 2006. Over the following 3 months its performance was orderly. On January 4, 2007, the Shibor was formally launched. At present, the Shibor has a complete and smooth interest rate curve ranging from overnight through 1 year. The Shibor rates of various maturities reflect demand for and supply of funds on the money market and the maturity structure of interest rates, and provide a primary reference for the pricing of money market products. So far, cross-rate swaps and Renminbi interest rate swaps have been carried out based on the 3-month Shibor.

Figure 1: Shibor Curve



Source: National Inter-bank Funding Center.

III. Strengthen window guidance and credit policy guidance

Since the beginning of 2006, the PBC has convened a series of window guidance meetings to alert commercial banks of the risks arising from an excessively rapid growth of loans and to warn them against blind credit expansion in pursuit of profit. The PBC encouraged commercial banks to establish a philosophy of sustainable and sound operations, to lend in a reasonable and balanced manner, to strengthen capital constraints, to improve risk control capacity, and to enhance the credit structure adjustment in accordance with the country's macro-economic and industrial policies. The commercial banks were also requested to strictly control lending to over-invested

sectors, to intensify their management of real estate credits, and to stop providing package loans and credit lines to local governments. Furthermore, the PBC encouraged financial institutions to boost credit support for small and medium-sized enterprises, job creation, student loans, migrant workers, and non-public sectors through institutional and instrument innovation, and guided the commercial banks to expand their fee-based businesses and to adjust their profit structures in an effort to improve the sustainability of profits.

Window guidance, as an important monetary policy instrument, can be combined with others instruments to guide market expectations. Many developed countries have adopted a similar approach. By communicating with the commercial banks and other financial institutions on a regular basis, the central bank is in a better position to have the market anticipate its monetary policy and thus to make its policy more effective. China's experience in recent years indicates that improving policy transparency through window guidance is not only conducive to reducing costs of monetary policy operations, but also to helping the central bank realize its policy objectives and enhance the effectiveness of monetary policy.

IV. Smoothly promote reform of financial enterprises

Breakthroughs were made in the joint-stock reform of state-owned commercial banks. The Bank of China successfully issued its H shares in Hong Kong and its A-shares in Shanghai on June 1 and July 5, 2006 respectively, and raised HK\$ 86.7 billion and 20 billion yuan. The Industrial and Commercial Bank of China issued A-shares and H-shares in Hong Kong and Shanghai on October 27, 2006 simultaneously, collecting HK\$ 124.9 billion and 46.4 billion yuan, and making the world's largest IPO. Since the IPOs, the share prices of the China Construction Bank, the Bank of China, and the Industrial and Commercial Bank of China have increased steadily, and their global rankings in terms of price value have moved up to surpass those of many banks. Their shares are also included on important indices such as the Hang Seng Stock Index and the Shanghai Stock 50 Index. The three banks continued to improve corporate governance, strengthen internal control, transform the management mechanism, and enhance comprehensive risk management in 2006. Meanwhile, the three banks intensified the internal restructuring of their branches, units, and business procedures. Implementation of contracts with strategic investors strengthened strategic cooperation in such areas as product innovation and risk management. Following these reforms, the capital adequacy, asset quality, profitability, and other financial

indicators of the three banks witnessed a significant improvement. The Agricultural Bank of China initiated preparatory work for the proposed joint-stock reform. The relevant agencies have been working hard on the reform scheme on the basis of the strategy of establishing a socialist new countryside and the overall arrangements for the reform of the rural financial system.

The pilot reform of rural credit cooperatives (RCCs) also experienced important advances and produced results. First, with the burdens accumulated in the past preliminarily dissolved, their asset quality improved markedly. At end-2006, the PBC, together with the CBRC, issued 165.6 billion yuan in special bills to RCCs in 2,396 counties (cities) in 29 provinces to replace 135.3 billion yuan of non-performing assets and to cover 30.3 billion yuan in losses. The PBC also provided special lending of 140 million yuan to RCCs in Shaanxi province. The issuance of special bills and lending accounted for 99 percent of the planned volume of financial assistance. So far, the PBC has redeemed 9.46 billion yuan in special bills from RCCs in 160 counties (cities) in pilot provinces such as Jiangsu. According to data from the supervisory agency that included the special bills issuance, the non-performing loan ratio of the rural cooperative financial institutions on the basis of the three-category loan classification system was 11.56 percent (13.73 for the rural credit cooperatives), down 25.37 percentage points from end-2002. Second, their capacity to support rural economic activities was enhanced significantly as reflected in the rapid growth of credit to the rural areas. By end-2006, outstanding deposits with RCCs stood at 3884.3 billion yuan and their capital registered 189.8 billion yuan, up 95 percent and 293 percent respectively from the end of 2002. Their outstanding loans reached 2.6236 trillion yuan, up 88 percent from the end of 2002. In particular, the outstanding agricultural loans posted 1210.5 trillion yuan, up 117 percent from the end of 2002, a growth rate higher than that of the other loans by 29 percentage points. Agricultural loans accounted for 46 percent of the total loans issued by the rural credit cooperatives, compared with 40 percent at the end of 2002. The RCCs' share of agricultural loans issued by all financial institutions nationwide increased from 81 percent at the end of 2002 to 91 percent. Third, the RCCs' property rights system reform advanced smoothly, and a new management system was established. At the end of 2006, as a result of the reorganization of the RCCs, 93 banking institutions had been established nationwide, including 13 rural commercial banks and 80 rural cooperative banks, and a county-wide single legal person structure had been put in place by RCCs in 1,201 counties. Some rural credit cooperatives have made initial progress in clarifying property rights, improving corporate governance, and

strengthening internal management. All the provinces (municipalities) that joined the pilot reform have established a provincial-level RCC association, and clarified and preliminarily realized the provincial government's administrative responsibility over the RCCs within its respective jurisdiction. By the end of 2006, a pilot reform of rural credit cooperatives in Hainan province was formally launched, indicating the unfolding of a nationwide pilot RCC reform (except in Tibet where there are no RCCs).

V. Deepen reform of the exchange rate regime and improve the managed floating RMB exchange rate regime

In 2006, the PBC launched a series of supporting measures in the exchange rate regime reform to further improve the managed floating exchange rate regime. First, market makers and OTC transactions were introduced and the way the RMB central parity was formed was refined, leading to an improvement in the foreign exchange market system. The trading hours of OTC and spot quotation transactions on the inter-bank foreign exchange market were unified to facilitate the financial institutions to timely cover their foreign exchange positions. Second, the business range of the forward foreign exchange purchase and surrender was expanded to facilitate exchange rate risk management by market participants. RMB foreign exchange swap transactions were launched to diversify foreign exchange market products and provide more choices for enterprises, households, and financial institutions to manage the exchange rate risks. Meanwhile, accrual based position management was adopted by foreign exchange designated banks for their foreign exchange sales to and purchases from individuals and enterprises. The pricing mechanism on the RMB forward market was improved. Consequently, the domestic RMB forward market plays a dominant role in RMB forward exchange rate pricing, placing prices back on to a rational track and providing a favorable market environment for the healthy and orderly development of the domestic foreign exchange market. Third, new members were added as market makers and participants in the China Foreign Exchange Trade System to make it a more active trading market. At end-2006, 22 banks were market makers, 262 banks were members of the spot market, 76 banks were members of the forward market, and 62 banks were members of the swap market.

VI. Acceleration of the reform of the system of foreign exchange management

In 2006, in order to promote a BOP equilibrium and accelerate the foreign exchange

management system reform, the authorities put in place a series of major policy adjustments in a sequenced and focused manner. Annual cumulative amount limits were adopted for foreign exchange purchases by residents and for individuals' sales of foreign exchange. Individuals are allowed to open foreign exchange settlement accounts for foreign exchange receipt and payment for foreign trade purposes. Individuals' foreign exchange payments and expenditures under the capital account were further regulated. The prior examination and approval system for opening current account foreign exchange accounts was abolished. The limit on foreign exchange retention for a domestic institution's foreign exchange account under the current account was raised. Foreign exchange receipt and payment management were improved for the services trade. Second, the channels for capital outflow were expanded in an orderly manner. Banks are allowed to pool domestic foreign exchange or to purchase foreign exchange to invest in external financial markets. Support is given to securities institutions to pool the domestic foreign exchange owned by institutions and individuals to invest in external securities markets. Insurance institutions are encouraged to use, within a certain proportion, their own or purchased foreign exchange to make outward financial investments. The quota limit for foreign exchange purchases for outward direct investment was abolished. Advance foreign exchange payments to cover early period expenditures for such investments are allowed. The administrative policies related to QFIIs were improved to promote development of the domestic capital market. Third, management of capital inflows and foreign exchange sales was strengthened and improved. Trade-related foreign exchange receipts and sales are managed based on different categories to provide convenience to enterprises that operate legally and to allow strict examination of enterprises "of concern." Management over external debt and foreign exchange sales of foreign real estate enterprises was strengthened. An actual need and self-use principle was imposed on foreign capital purchases of domestic real estate. Short-term external debt management was strengthened.

Part 3 Financial Market Performance

I. An overview of financial market performance

In 2006, the financial market continued to operate in a sound and steady manner, featuring brisk trading activities on the money market, smooth bond issuances, launching of product innovations, greater progress in institutional building, and a further improvement in the market operation mechanism.

In 2006 there was stable and rapid growth of the national economy and a strong demand for loans, especially a large increase from 2005 in loan financing by the domestic non-financial institution sector, including households, enterprises, and the government sector. After resumption of IPOs on the equity market, enterprises expedited their financing activities on the stock market, and market shares of stock financing apparently increased. Due to the continued implementation of a sound fiscal policy, the volume of government securities financing decreased. Corporate bonds expanded steadily.

Table 4: Financing by the Domestic Non-financial Sector in 2006

	Volume of financing (100 million yuan)		As a percentage of total financing (percent)	
	2006	2005	2006	2005
Financing by domestic non-financial sectors	39874	30677	100.0	100.0
Bank loans	32687	24617	82.0	80.2
Equities	2246	1053	5.6	3.4
Government securities	2675	2997	6.7	9.8
Corporate bonds	2266	2010	5.7	6.6

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

Although the financial market witnessed significant achievements, some problems

still hinder its development. Structural imbalances in direct and indirect financing are still unresolved, with bank loans taking a lion's share of total financing. Market developments are also imbalanced, with the bond market lagging behind the equity market, and the corporate bond market relatively underdeveloped. Basic market discipline and incentive mechanisms, such as information disclosure and credit ratings, have not fully played a role in promoting market development. Financial products are less diversified in terms of category and layers, and market functions still need improving. Financial market innovations and development remain on the top of the agenda.

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

The year of 2006 saw brisk transactions on the inter-bank market, a trend of shortening maturities in fund use, and an evident rise in the volume of transactions of overnight products. At end-2006, the turnover of bond repo on the inter-bank market totaled 26.59 trillion yuan, an increase of 10.69 trillion yuan from a year earlier, and the daily average turnover posted a year-on-year growth of 67.2 percent to 105.9 billion yuan. Inter-bank borrowing reached 2.15 trillion yuan, up 872.0 billion yuan year on year, with the daily turnover averaging 8.6 billion yuan and a rise of 68.2 percent year on year. The turnover of bond pledged repo overnight products had a market share of 51 percent, an acceleration of 4.6 percent from a year earlier, and the turnover of inter-bank borrowing overnight products had a market share of 29.5 percent of the total, 12 percentage points higher than a year earlier.

Money market interest rates gradually rose after June 2006. The monthly weighted average rate of bond pledged repo transactions and inter-bank borrowing climbed from 1.55 percent and 1.76 percent in May respectively to a peak of 3.05 percent in November, and declined to 2.01 percent and 2.25 percent respectively in December, yet still 0.47 and 0.53 percentage points higher than in 2005. After the IPO resumed on the equity market in 2006, one or two months saw a cluster of IPO share subscriptions, and short-term market interest rates rose noticeably, especially the subscription of big-caps.

Regarding net fund flows on the repo market (including bond pledged repo and outright bond repo), there was a large increase in the net lending of state-owned

commercial banks, which amounted to 12.5 trillion yuan in 2006, an increase of 3.69 trillion yuan from a year earlier. In terms of net fund borrowing, other commercial banks,¹ other financial institutions,² and foreign financial institutions expanded rapidly, indicating a strong capital demand. On 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 clearly grew. After the IPO resumed on the equity market in 2006, securities companies, fund management companies, and insurance companies had a strong demand for funds, and their net repo and inter-bank borrowing accumulated to 4.17 trillion yuan, up 51.3 percent from a year earlier.

Table 5: Fund Flows among Financial Institutions in 2006

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	2006	2005	2006	2005
Four State-Owned Commercial Banks	-124757	-87894	-3168	-3367
Other Commercial Banks	52114	36096	-5218	-4125
Other Financial Institutions	59825	46553	5952	6076
Of which: Securities and Fund Management Companies	17797	14485	5236	3772
Insurance Companies	18664	9296	—	—
Foreign Financial Institutions	12819	5245	2434	1417

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. Brisk bond transactions were accompanied by gradually rising bond issue rates and further diversified market products

The secondary bond market traded briskly. In 2006, the accumulated turnover of spot

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

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.

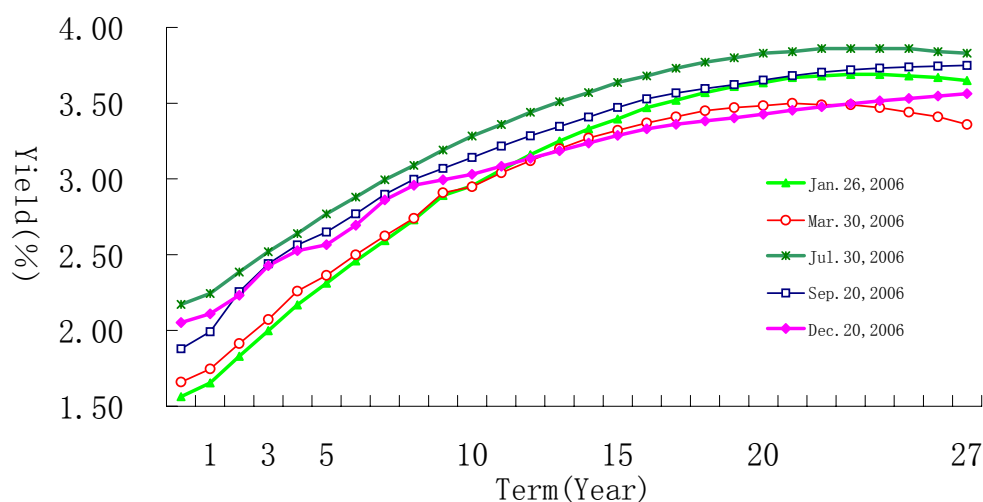
transactions on the inter-bank bond market increased 4.24 trillion yuan from 2005 to 10.26 trillion yuan, and the average daily turnover jumped 70.6 percent from a year earlier to 40.9 billion yuan. The turnover of government bond spot transactions on the organized exchanges registered 154.1 billion yuan.

On the inter-bank spot transaction market, the state-owned commercial banks were the largest net purchasers, with a net purchase of 600.5 billion yuan, double that in 2005. Other commercial banks were still the leading net sellers, with a net sale of 652.0 billion yuan, also double that in 2005. Fueled by the booming domestic stock market, securities companies and fund management companies had a soaring demand for funds. The net sales of securities companies and fund management companies increased rapidly to 209.5 billion yuan in 2006, 5.8 times the level in 2005.

Driven by abundant liquidity in the market, both the inter-bank market bond index and the stock exchanges bond index moved up slightly. The inter-bank market bond index rose 3.32 points, or 2.93 percent, from 113.42 points at beginning-2006 to 116.74 points at end-2006. The government securities index on the organized exchanges rose 2.2 points, or 2.01 percent, to 111.39 points at end-2006 from 109.19 points at beginning-2006.

Affected by multiple factors such as the IPOs and soaring stock indices, the yields of short- and medium-term bonds rose, in contrast to the falling yields of long-term bonds. The yield curve of government securities on the inter-bank bond market displayed an overall flattening trend. Specifically, movements on the yield curve can be divided into three phases. The first phase saw a flattening of the yield curve in the first quarter, in which the gradually declining short-term bond prices led to slightly higher yields and the climbing prices eroded the yields of long-term bonds. The second phase was from the second quarter to the mid-third quarter. During this period, driven by falling bond prices and rising yields-to-maturity across the spectrum, the yield curve moved upward steadily. The third phase was characterized by a moderately falling and further flattening yield curve. From the late third quarter to end-2006, bond prices rebounded, followed by a modest decline in the yield curve. During this period, long-term bond prices rose significantly to surpass the level at beginning-2006, and the yield curve further flattened.

Figure 2 Yield Curve of Government Securities on the Inter-bank Bond Market in 2006



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

Financing activities were dynamic on the primary market, with market products further diversified. In 2006, a total of 888.3 billion yuan in government bonds was issued, an increase of 26.1 from a year earlier. To some extent, the outstanding balance management in the state treasury facilitated the expansion of short-term fiscal bonds. A total of 149.0 billion yuan in government bonds with maturities shorter than one year (excluding one-year) was issued, an acceleration of 107.9 billion yuan from a year earlier. Corporate bonds issuance registered 393.8 billion yuan (including short-term corporate financing bills worth 294.3 billion yuan), up 92.4 percent year on year. A total of 898 billion yuan in policy financial bonds was issued, up 53.5 percent year on year. Commercial banks issued 13.2 billion yuan in subordinated bonds, which was a decrease of 83.4 billion yuan from 2005, 31 billion yuan in common bonds, an increase of 4 billion yuan from 2005, and 8.3 billion yuan in hybrid capital bonds. Securities companies issued 1.5 billion yuan in long-term bonds. A total of 11.58 billion yuan in asset-backed securities was issued, 4.38 billion yuan more than in 2005. International financial institutions issued 0.87 billion yuan in bonds. In particular, hybrid capital bonds issued by commercial banks, as a brand-new bond category and a breakthrough in the bond market development process, widened the financing channels for capital supplementation by commercial banks and further diversified products on the bond market. Also, more bond issuers entered the market. In 2006, the Hangzhou Commercial Bank, the Changsha Commercial Bank, and the Evergrowing Bank issued subordinated bonds, and China Cinda Asset Management

Corporation and China Orient Asset Management Company issued asset-backed securities.

The issue rates of bonds edged up. In the fourth quarter, the interest rate of 7-year book-entry treasury bonds was 3.27 percent, up 0.76, 0.65, and 0.38 percentage points from the first, second, and third quarters respectively; the interest rate of 3-year bearer's treasury bonds was 3.39 percent, a rise of 0.25 percentage points from the first and second quarters. The interest rate of 5-year bonds issued by the Agricultural Development Bank of China was 3.10 percent, 0.99 and 0.21 percentage points higher than in the first and second quarters respectively. Climbing financing costs on the primary market and stronger expectations of a rising yield demonstrated the results of macro-economic management.

3. Commercial paper maintained a growth momentum

In 2006, a total of 5.43 trillion yuan in commercial bills was issued by the corporate sector, up 22.0 percent year on year; the amount of discount bills totaled 8.49 trillion yuan, up 25.8 percent from 2005; and the amount of rediscount bills reached 3.99 billion yuan, a year-on-year increase of 1.49 billion yuan. At end-2006, the outstanding balance of commercial paper stood at 2.21 trillion yuan, up 12.8 percent year on year; the outstanding balance of discount bills was 1.72 trillion yuan, up 6.7 percent from a year earlier; and the outstanding balance of rediscount bills was 1.82 billion yuan, 1.58 billion yuan more than in 2005.

The bill business in 2006 had the following features. First, the rapid increase and large fluctuation in the bill business imposed a growing influence on the money and credit aggregate. The bill business has become an important channel for short-term direct financing and has an important impact on the total financing volume and financing structure. Second, bill discount interest rates were relatively sensitive, and re-discount rates moved in parallel with money market interest rates, hence their fluctuation was basically consistent with the intended direction of macro-economic management, as well as with changes in fund demand and supply on the market. Third, the bill business has become an instrument for enterprises to finance at low costs, as well as for commercial banks to manage portfolios and conduct liabilities management. Fourth, depository financial institutions tend to participate in bill business and each takes up a role in the market. The state-owned commercial banks dominate the bill

discount market, and other joint-stock commercial banks lead the bill acceptance market, while rural cooperative financial institutions have expanded rapidly in the bill financing business, with the outstanding bill financing at end-2006 jumping 104 percent from beginning-2006.

4. The stock market traded briskly, with stock indices reaching a new record high and the pace of financing accelerating

Due to a series of favorable factors, such as the unfolding positive effects of the non-tradable share reform on the securities market, strong economic growth over the years, smooth progress in recovering misappropriated funds by listed companies, and the listing of quality big-caps on the A-share market, the securities market traded briskly, with stock indices reaching a new record high and market confidence strengthened remarkably. In 2006, the total turnover of the Shanghai and Shenzhen Stock Exchanges reached 9.05 trillion yuan, up 5.88 trillion yuan from a year earlier, with the average daily turnover up 2.9 times to 37.54 billion yuan from a year earlier. In particular, the turnover of A-shares reached 8.92 trillion yuan, 5.81 trillion yuan more than in 2005, with the average daily turnover growing 2.9 times to 37.02 billion yuan. At end-2006, the Shanghai Stock Exchange Composite Index closed at 2675 points, a soar of 130.4 percent from end-2005, and the Index even reached a record high of 2699. The Shenzhen Stock Exchange Composite Index closed at 551 points, a rally of 97.5 percent from end-2005. At end-2006, the total capitalization of the Shanghai and Shenzhen Stock Exchanges posted 8.94 trillion yuan, 1.8 times that at end-2005.

In 2006, a total of 559.3 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 370.9 billion yuan, or 196.9 percent, from 2005, a new historical high. In particular, a total of 242.2 billion yuan and US\$39.49 billion were raised in the A-share and H-share markets respectively, and 4 billion yuan was raised through convertible bonds.

Securities investment funds grew rapidly. At end-2006, there were 301 investment funds on the market, 83 more than at end-2005. The volume of the funds increased 27.7 percent year on year to 602.2 billion yuan, and their net assets value expanded 74.8 percent year on year to 819.8 billion yuan.

5. The insurance industry expanded in a sound fashion and its asset structure further diversified

In 2006, total premium income in the insurance industry amounted to 564.15 billion yuan, up 14.4 percent year on year. With a large number of life insurance policies coming due, claim payments and benefits witnessed an increase of 26.6 percent from a year earlier to 143.85 billion yuan. At end-2006, the total assets of insurance companies grew 29 percent year on year to 1.97 trillion yuan, representing continued and rapid growth. In 2006, investment profits posted 95.53 billion yuan, representing a yield of 5.8 percent.

The assets structure of insurance companies further diversified with the expansion of investment channels, the rapid growth of the bond market, and the improvement in the market operation mechanism. With the exception of government securities and securities investment funds, investments (including investments in financial bonds, corporate bonds, and equities) increased significantly by 72 percent from a year earlier, accounting for a remarkable rising share in total assets, in contrast to a significant decline of bank deposits in total assets.

Table 6: Use of Insurance Funds at End- 2006

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	End- 2006	End-2005	End- 2006	End- 2005
Total assets	19731	15226	100.0	100.0
Of which, Bank deposits	5989	5241	30.4	34.4
Investment	11796	8894	59.8	58.4
Government securities	3647	3588	18.5	23.6
Securities investment funds	912	1099	4.6	7.2
Other Investment	7237	4207	36.7	27.6

Source: China Insurance Regulatory Commission.

6. The inter-bank foreign exchange market expanded at a rapid and healthy pace

In 2006, the turnover on the inter-bank spot foreign exchange market increased rapidly, with turnover on the OTC market accounting for over 95 percent of the total of the inter-bank foreign exchange market. In 2006, a total of US\$14.06 billion and US\$50.86 was reached on the inter-bank forward market and RMB swap market respectively, a sum of US\$64.92 billion. In particular, the average daily turnover registered US\$0.6 billion on the forward and swap markets in December. At end-2006, the number of members on the inter-bank RMB forward market hit 76, an increase of 62 from the launch of RMB forward market in August 2005; the number of members on the RMB swap market posted 62, a growth of 8 from the introduction of the RMB swap market in April 2006.

In 2006, the combined volume of 8 currency pairs trading on the inter-bank foreign exchange market amounted to US\$75.69 billion, with transactions in the major currency pairs of USD/HKD, USD/JPY, and EUR/USD accounting for 87.1 percent of the total trading volume, reflecting active trading in these products.

II. Financial market institutional building

1. Infrastructure building of the bond market was actively advanced

The introduction of money brokerage companies into the inter-bank bond market played an active role in ameliorating the market operational framework, enhancing market liquidity, reducing transaction costs, and improving price discovery functions. In addition, the PBC authorized the National Inter-bank Borrowing Center to release fixed repo rates on a daily basis, which greatly enhanced price discovery on the inter-bank bond market and improved the market yield curve and the evolution of financial derivatives. Moreover, January 17, 2006 saw the advent of Straight Through Processing (STP) on the inter-bank bond market for ex ante control of spot bond transactions, bond pledged repo and outright bond repo, and bond forward transactions. The processing system has operated smoothly, significantly enhancing market efficiency and risk control measures.

2. Positive efforts were made to boost market innovations and diversify products

and instruments

A pilot program for RMB interest rate swap transactions was introduced on the inter-bank bond market to further diversify the interest-rate risk management instruments. Bond lending and borrowing business was launched to provide investors with a new choice of investment channels and risk-hedging measures, to reduce probabilities of settlement failure, to facilitate the overall sound performance of the market, and to enhance market liquidity. Greater progress was made in promoting the development of the corporate bond market by regulating trade and transfer of corporate bonds and allowing corporate bonds to trade on the inter-bank market. On the inter-bank foreign exchange market, inter-bank RMB swap transactions were launched to supplement the price quotation mechanism on the inter-bank RMB forward market and to diversify the RMB forward transaction portfolios. On August 1, RMB/Sterling spot transactions, forward transactions, and swap transactions were launched. On September 8, RMB forward and swap products with maturities of over one year were successfully introduced to improve the maturity structure of RMB forward and swap transactions.

3. Reform of non-tradable shares was basically completed and the restructuring of securities companies proceeded steadily

At end-2006, a total of 1,301 companies listed on the Shanghai and Shenzhen Stock Exchanges had either completed or launched a split-share reform, accounting for 97 percent of all companies to be reformed, or 98 percent of the market capitalization of all companies to be reformed. Only 40 companies have not begun their reform. On May 6 and 17, 2006, the China Securities Regulatory Commission issued the *Administrative Rules for Securities Issuance of Listed Companies* and the *Administrative Rules for IPOs and Listings*. On May 25, the China International Engineering Co. Ltd. released its prospectus and became the first company to have all IPO shares tradable. The resumption of IPOs on the A-share market indicated that the non-tradable shares reform had achieved the goal of making all new IPO shares tradable.

In June 2006, the non-tradable shares held by share-holders, such as Sany Heavy Industry Co. Ltd., were allowed to be traded on the stock exchanges after the transfer restriction term of those shares expired. The steady movement of these companies' stock prices showed that China's capital market had smoothly entered a period of all shares being tradable on the market. In line with progress in the non-tradable shares

reform, the Shanghai and Shenzhen Stock Exchanges respectively issued a series of notifications to indicate the risks of companies that have yet to launch or complete the reform by adding the letter “S” to the beginning of the stock names of those companies.

According to the overall arrangements 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, completed the restructuring of Tiantong Securities, Southwest Securities, and Xinjiang Securities respectively. While addressing financial problems such as the inadequate capital and liquidity difficulties of the securities companies, priority was given to 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 institutional building and innovation. With restructuring, the risks were effectively addressed and the stability of the securities market was upheld.

4. The insurance industry saw vigorous development

With respect to the expansion of the business scope of the insurance industry, progress was made in agricultural insurance and in pilot programs for new rural cooperative medical insurance. The *Regulations on Compulsory Traffic Accident Liability Insurance for Motor Vehicles* were released to promote innovations in liability products. In terms of institutional building, a series of rules and regulations were issued to strengthen industrial management and advance appropriate asset allocation and structural adjustment of the financial industry, such as the *Eleventh Five-Year Plan for China's Insurance Industry*, the *Administrative Rules for Health Insurance*, and the *Administrative Rules for the Pilot Indirect Investment of Insurance Funds into Infrastructure Projects*. In addition, steady progress was made in the pilot program of state-owned insurance company institutional reform and cross-sectoral operations of insurance companies, reflected in the successful IPO of China Life Insurance Co. Ltd.

Part 4 Analysis of Macroeconomic Developments

I. Global economic and financial situations

In 2006, the global economy continued a momentum of rapid growth. The US economy grew rapidly. The economies in the Euro zone and Japan picked up steadily. The major emerging and developing economies continued to exhibit robust growth. International crude oil prices fell sharply after September, yet remained high and volatile. The major risks for future global economic growth included heightened trade protectionism and serious imbalances. According to the International Monetary Fund (IMF) projection in September 2006, the global economy and trade in goods and services would grow 5.1 percent and 8.9 percent respectively in 2006, up 0.3 and 0.9 percentage points respectively compared with its forecast in April 2006; the global economy and trade in goods and services would grow 4.9 percent and 7.6 percent respectively in 2007, both an upward adjustment of 0.2 percentage points compared with its forecast in April 2006, yet lower than its projection for the year 2006.

1. Economic development of the major economies in 2006

The US economy grew rapidly. GDP growth registered 3.4 percent, an acceleration of 0.2 percentage points over the previous year. Following strong growth of 5.6 percent in the first quarter of 2006, the US economy slowed down gradually to 2.6 percent and 2.0 percent in the second and third quarters respectively, but picked up in the fourth quarter to 3.5 percent. Inflationary pressures eased. The quarterly consumer price index (CPI) registered 3.6 percent, 4.0 percent, 3.3 percent, and 1.9 percent respectively on a year-on-year basis. Employment was broadly stable, with the quarterly unemployment rate posting 4.7 percent, 4.6 percent, 4.7 percent, and 4.5 percent respectively. The trade deficit continued to increase, reaching US\$701.6 billion during January-November 2006, an acceleration of US\$49.052 billion over the same period of 2005. It is noteworthy that in FY2006 that ended on September 30, the fiscal deficit decreased substantially to US\$247.7 billion, and the ratio of fiscal deficits to GDP declined 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 grew steadily. In the first three quarters of 2006, GDP grew by 2.2 percent, 2.9 percent, and 2.7 percent respectively over the same periods in 2005. Inflationary pressures continued to persist. The quarterly year-on-year Harmonized Index of Consumer Prices (HICP) registered 2.3 percent,

2.5 percent, 2.1 percent, and 1.8 percent respectively. Employment improved, and the unemployment rate declined quarter after quarter, registering 8.2 percent, 7.9 percent, 7.8 percent, and 7.6 percent respectively in the four quarters of 2006, reaching a 6-year low of 7.5 percent in December 2006. From January through November 2006, the trade deficit posted EUR12 billion, compared with a trade surplus of EUR17.4 billion in the same period of 2005.

The Japanese economy picked up steadily. After strong growth in the first quarter, the Japanese economy slowed down from the second quarter. In the first three quarters, GDP grew 2.9 percent, 2.1 percent, and 1.6 percent respectively on a year-on-year basis. The CPI registered consecutive positive figures beginning in May, ending the deflationary situation. The quarterly year-on-year CPI was -0.1 percent, 0.2 percent, 0.6 percent, and 0.3 percent respectively. The unemployment rate posted 4.2 percent, 4.1 percent, 4.1 percent, and 4.1 percent respectively, markedly lower than during the same quarters of 2005. In 2006, the trade surplus went down by 7.1 percent from that in 2005 to JPY8.09 trillion.

The major emerging economies and developing countries or regions continued a momentum of rapid growth, yet inflationary pressures built up. In particular, the emerging economies in Asia saw robust growth driven by domestic demand and foreign trade. The Latin American economies slowed down following the rapid growth in the first quarter.

2. Developments in international financial markets

In 2006, the US dollar weakened against the Euro but appreciated against the Yen. On December 29, 2006, the Euro closed against the US dollar at US\$1.32 and the US dollar closed against the Yen at JPY119. The dollar lost 11.86 percent against the Euro and gained 0.93 percent against the Yen over that recorded at the start of 2006.

The yield of major bonds rose steadily in the first half of 2006, but declined slowly in the second half. During June-July 2006, the yields of 10-year government bonds in the US, the Euro zone, and Japan reached yearly highs of 5.25 percent, 4.13 percent, and 2.0 percent respectively. On December 29, 2006, the yields of 10-year government bonds in the US, the Euro zone, and Japan closed at 4.70 percent, 3.96 percent, and 1.68 percent respectively, up 0.33, 0.62, and 0.24 percentage points over that recorded at the start of 2006.

In 2006, the major stock indices increased rapidly. In the first four months of 2006, the major indices rose to varying degrees, but dropped sharply in fluctuations during May-July 2006, followed by gradual rebounds thereafter. On December 29, 2006, the Dow Jones Industrial Average closed at a record high of 12,463 points, up 14.9 percent over that recorded at the beginning of 2006. The Nasdaq Composite Index closed at 2,415 points, up 7.6 percent. The Stoxx 50 closed at 3,697 points, up 10 percent. The Nikkei 225 Stock Average ended at 17,226 points, up 5.3 percent.

In the first half of 2006, due to the rate hikes by the Fed, the London Inter-bank Offered Rate (LIBOR) for the US dollar rose steadily. In the second half of 2006, due to the Fed's pause in the rate hike and expectations of a growth slowdown, the Dollar LIBOR moved down from the yearly high of 5.77 percent registered on June 29. On December 29, 2006, the 1-year Dollar LIBOR posted 5.329 percent, up 0.49 percentage points over that recorded at the start of 2006. Given the strong growth and expectations of a European Central Bank (ECB) rate hike, the Euribor rose steadily in 2006 by 1.17 percentage points, to a high of 4.028 percent on December 29, 2006.

3. Monetary policies of the major economies

In 2006, the Federal Open Market Committee (FOMC) raised the target of the federal funds rate to 5.25 percent by increments of 25 basis points on January 31, March 28, May 10, and June 29 respectively. At all 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 3.5 percent by 25 basis points on March 2, June 8, August 3, October 5, and December 7 respectively, rendering the rate at its highest level in more than three 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. The BOJ raised the rate on July 14 from zero to 0.25 percent, the first rate hike in 6 years. The Bank of England also raised the official interest rate to 5.0 percent by 25 basis points on August 3 and November 9, respectively.

Box 2: Abundant Global Liquidities and Asset Prices Rally

In recent years, activities were brisk in worldwide real estate, securities, and gold and

oil markets. Prices of various assets rose substantially. During 2001-2005, real estate prices doubled in many developed countries, and rose in quite a few developing countries. In 2006, the Dow Jones Industrial Average closed at a record high, surpassing its height during the IT bubble in 2000. Stock markets in many other developed countries and emerging market economies also broke historical records. In May 2006, the international spot gold price topped US\$718 per ounce, a record high since 1980. In mid-July 2006, the international crude oil futures price hit an all-time high of over US\$75 per barrel. Against the backdrop of a surge in assets prices, global liquidities became a hot topic; at present, however, there is not yet an effective approach to measure a reasonable level of global liquidities.

Complex factors are behind the current abundance of global liquidities. A popular view is that it is related to the monetary policies of the major economies. For a long time after the 9/11 Incident, the major economies generally implemented an ultra-low interest rate policy. Between January 2001 and June 2003, the Fed slashed the federal funds rate with 12 successive rate cuts from 6.5 percent to 1 percent and maintained an ultra-low rate of 1 percent for as long as one year until June 2004. In the meantime, the ECB began its cycle of rate cuts in 2001, and lowered the rate by altogether 150 basis points in 4 cuts in 2001; starting from June 2003, the ECB maintained a low rate of 2 percent for two and a half years. For 5 years, the BOJ implemented an ultra-loose monetary policy to stimulate economic recovery. Objectively speaking, these monetary policies promoted economic growth and recovery and, to a very large extent, put a premium on the liquidity buildup in all major currencies. Some argue that the abundance of global liquidities has something to do with the rapid development of the international financial derivatives markets. In recent years, various financial derivative products have mushroomed, which helps diversify the credit risks of commercial banks and renders the overall financial system more flexible and stable. However, the leverage of the financial derivatives products prompted the creation of liquidities.

Since the start of 2006, despite the many rate hikes by major monetary authorities, the interest rate was kept at a relatively high level. The tempo of the rate hike is likely to be influenced by expectations of a global slowdown. Consequently, abundant liquidities will probably persist for some time. Against this backdrop, large quantities of short-term capital are seeking speculative and arbitrage opportunities. A massive inflow of short-term capital will further increase liquidities in the recipient countries and lead to an asset price surge; the sudden outflow of international capital will bring shocks to the macro-economy of these countries and even cause financial and economic crises. With respect to the massive inflow of short-term speculative capital,

many scholars have put forward policies and proposals. For example, in 1972, Professor J. Tobin proposed the so-called Tobin Tax, i.e., a tax on all spot securities and FX transactions related to currency exchange. Some countries adopted a policy of zero-interest reserves on short-term capital inflows to curb short-term capital flows and mitigate exchange rate volatility.

II. Analysis of China's macroeconomic performance

In 2006, the national economy maintained steady and rapid growth. The growth of consumer demand accelerated. Fixed-asset investment slowed down from a high level. Foreign trade grew rapidly. Household income, enterprise profits, and fiscal revenue all increased substantially. Price movements were broadly stable. Yet problems still persisted, such as imbalances between investment and consumption, an extensive mode of economic growth, widening BOP imbalances, and a serious situation in terms of energy and resource conservation and pollution control. In 2006, the GDP reached 20.9 trillion yuan, a growth of 10.7 percent and an acceleration of 0.3 percentage points on a year-on-year basis; the consumer price index (CPI) rose by 1.5 percent year on year, a deceleration of 0.3 percentage points year on year; the trade surplus registered US\$177.5 billion, US\$75.5 billion more than in the previous year.

1. Growth of consumer demand accelerated, fixed-asset investment growth fell from a high level, and the trade surplus continued to widen

The growth of household income accelerated and domestic consumer demand was strong. In 2006, per capita disposable income of urban residents stood at 11,759 yuan, a nominal growth of 12.1 percent, an inflation-adjusted real growth of 10.4 percent, and an acceleration of 0.8 percentage points on a year-on-year basis. The per capita net income of rural residents came to 3,587 yuan, a nominal growth of 10.2 percent, an inflation-adjusted real growth of 7.4 percent, and an acceleration of 1.2 percentage points on a year-on-year basis. The steady increase in income supported sustained consumption growth. In 2006, the total volume of retail sales was 7.6 trillion yuan, a year-on-year growth of 13.7 percent and an acceleration of 0.8 percentage points over the previous year. In particular, the volume of urban retail sales grew by 14.3 percent and the volume of rural retail sales grew by 12.6 percent, resulting in a smaller gap than during the preceding year.

The growth of fixed-asset investments fell from a high level. In 2006, total fixed-asset investments posted 11 trillion yuan, a growth of 24 percent and a deceleration of 2 percentage points on a year-on-year basis. In terms of the urban and rural breakdown, urban fixed-asset investment reached 9.3 trillion yuan, a growth of 24.5 percent and a deceleration of 2.7 percentage points; rural fixed-asset investment grew by 21.3 percent, representing an acceleration of 1.8 percentage points. In terms of the geographical distribution of urban fixed-asset investment, growth of fixed-asset investment in central China accelerated by 0.4 percentage points to 33.1 percent, while that in eastern and western China decelerated by 3.4 and 4.7 percentage points to 20.6 percent and 25.9 percent respectively. In terms of industrial allocation, due to the policies for building a socialist new countryside, the primary industries saw the greatest growth in investment. Investment growth of the primary, secondary, and tertiary industries registered 30.7 percent, 25.9 percent, and 23.3 percent respectively, representing an acceleration of 3.2 percentage points, a deceleration of 12.5 percentage points, and an acceleration of 3.3 percentage points respectively over the previous year. In terms of the size of investment projects, the total planned investment for new projects and for those under construction dropped sharply.

Despite the moderation in export growth and acceleration in import growth, exports expanded more rapidly than imports and the trade surplus further widened. In 2006, the total volume of exports and imports reached US\$1.76 trillion, an increase of 23.8 percent and an acceleration of 0.6 percentage points on a year-on-year basis. Specifically, exports posted US\$969.1 billion, up 27.2 percent, a deceleration of 1.2 percentage points on a year-on-year basis; imports registered US\$791.6 billion, up 20.0 percent, an acceleration of 2.4 percentage points. Netting exports and imports, there is a trade surplus of US\$177.5 billion, up US\$75.5 billion over the preceding year.

2. Output grew substantially, and enterprise operational profits continued to improve

In 2006, the primary industries realized a value added of 2.5 trillion yuan, representing a growth of 5 percent and a deceleration of 0.2 percentage points; the secondary industries realized a value added of 10.2 trillion yuan, representing a growth of 12.5 percent and an acceleration of 0.8 percentage points; the tertiary industries realized a value added of 8.3 trillion yuan, representing a growth of 10.3

percent and a deceleration of 0.2 percentage points.

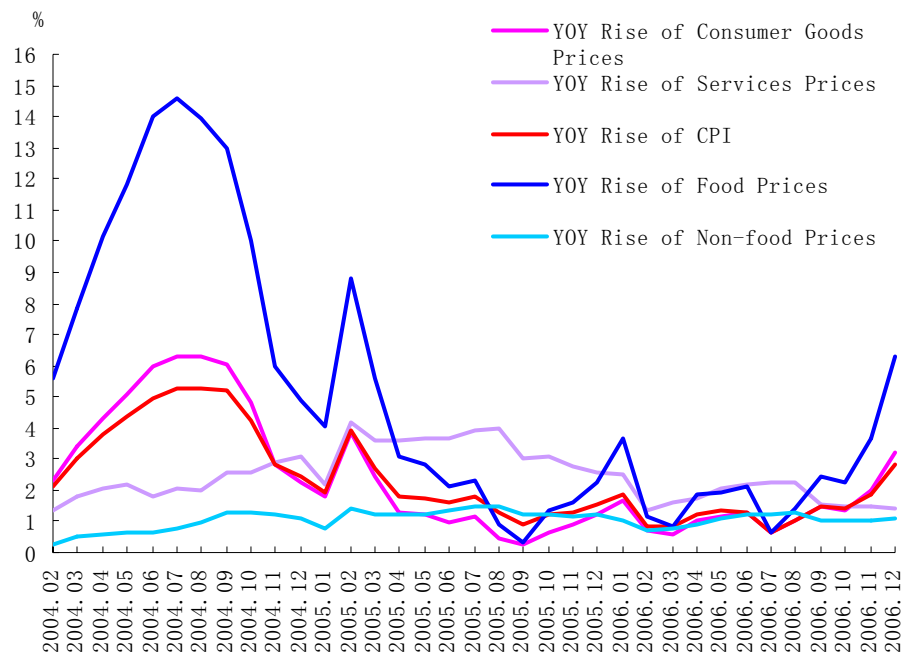
The situation for agricultural production was good. Grain production had another bumper harvest. In 2006, grain output was close to 500 million tons; cotton output was 6.73 million tons, up 17.8 percent over the previous year; the total output of meat and eggs reached 80 million tons and 29.50 million tons respectively, up 4.5 percent and 3.0 percent respectively. The rise in the production prices of agricultural products (i.e., the prices at which producers of agricultural products directly sell their products), however, continued to be less than the rise in the prices of agricultural production materials. Farmers faced increasing difficulties to increase their income.

Industrial production grew rapidly, and enterprise profits continued to improve. In 2006, the industrial value added of the statistically large enterprises grew 16.6 percent, accelerating by 0.2 percentage points on a year-on-year basis; their ratio of sales to total output was 98.1 percent, unchanged from that in the previous year; profits posted 1.9 trillion yuan, a growth of 31.0 percent and an acceleration of 8.4 percentage points; the ratio of total profits to sales revenue was 6.09 percent, up 0.27 percentage points over the previous year and at a high level for recent years. The 2006 Fourth Quarter Survey on 5,000 Enterprises by the PBC indicates that 37.1 percent of the surveyed enterprises evaluated their overall business operations to be “good,” up 2.2 and 1.9 percentage points over that recorded in the previous year and in the previous quarter respectively.

3. The rise in various price indices was smaller than last year, there was, however, an upward trend in the second half of 2006

Before October 2006, the CPI was stable. Later on, due to the increase in grain prices, the rise in the CPI displayed a rapid upward trend. The rise in non-food and services prices, however, was relatively stable. In 2006, the CPI rose 1.5 percent over the previous year. Specifically, the quarterly CPI rose 1.2 percent, 1.4 percent, 1.3 percent, and 2.0 percent respectively. In December, driven by the increase in food prices, the CPI grew 1.4 percent month on month and 2.8 percent year on year. In 2006, consumer goods prices rose by 1.4 percent, services prices by 1.8 percent, food prices by 2.3 percent, and non-food prices by 1 percent.

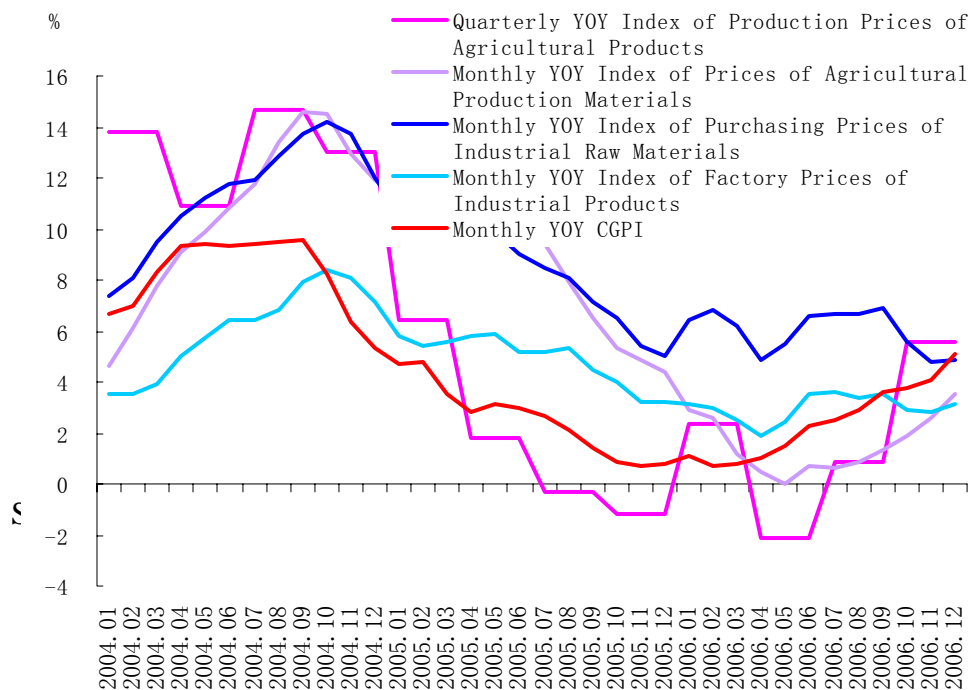
Figure 3: CPI Movements since 2004



Source: National Bureau of Statistics.

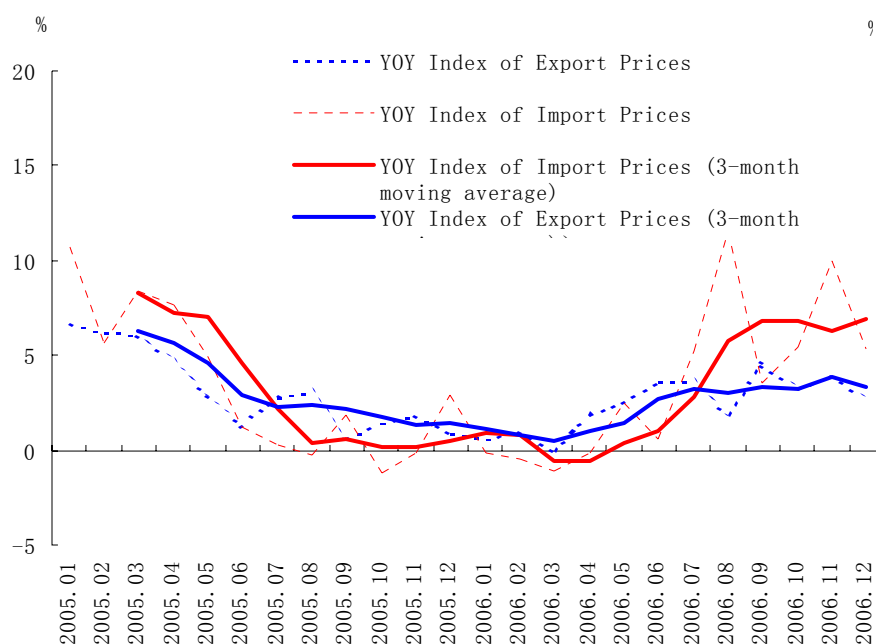
Various producer price indexes (PPI) displayed a generally upward trend after the first quarter. In 2006, the factory prices of industrial products rose by 3.0 percent, the purchasing prices of industrial raw materials, fuels, and power increased by 6.0 percent; the production prices of agricultural products rose by 1.2 percent, and the prices of agricultural production materials increased by 1.5 percent, all lower than in the previous year, yet displaying a generally upward trend after the first quarter. The Corporate Goods Price Index (CGPI) released by the PBC's Financial Survey and Statistics Department was on the rise during the course of 2006.

Figure 4: PPI Movements since 2004



In the second half of 2006, import prices increased rapidly, and the increase in the customs prices of imports was greater than that in the customs prices of exports. According to the statistics of the General Administration of Customs, the year-on-year growth in the customs prices of imports posted 1.0 percent, 2.6 percent, 9.1 percent, and 6.3 percent in the four quarters respectively, averaging 4.8 percent; the year-on-year growth of the customs prices of exports posted 0.8 percent, 2.6 percent, 4.7 percent, and 3.5 percent respectively, averaging 2.9 percent.

Figure 5: Movements of Export and Import Prices since 2004



Source: National Bureau of Statistics.

Labor compensation grew faster than the normal GDP. In the first three quarters of 2006, the average monthly salary of employees in urban China was 1,545 yuan, 14.6 percent higher than during the same period of last year. In particular, the average monthly salary of employees in state-owned units posted 1,610 yuan, up 14.8 percent; that of employees in collectively-owned units was 934 yuan, up 16.3 percent; and that of employees in other ownership units was 1,560 yuan, up 11.4 percent.

The GDP deflator was lower than that during last year. In 2006, the nominal GDP growth rate was 13.9 percent and the real GDP growth rate was 10.7 percent, resulting in a 3.2 percent GDP deflator (the difference between the nominal GDP growth rate

and the real GDP growth rate), down by 1.4 percentage points on a year-on-year basis.

In 2006, price reforms were carried out steadily on natural resource products such as fuel, natural gas, electricity, and coal. The prices of water and electricity were raised by different margins all over the country. Reforming the prices of natural resources is imperative in the efforts to build an energy-conserving society, maintain sustainable economic growth, and improve the effectiveness of monetary policy. By letting prices reflect the scarcity, as well as the demand and supply of natural resources, the cost of undesirable environmental effects, and follow-up conservation, the price reforms will provide incentives for investors and producers to improve management, technology, and energy-efficiency, and for consumers to save energy and reduce wasteful consumption. In the short run, the reforms might cause price volatility, but in the long run they will facilitate a transformation of the economic growth pattern, improve the environment for monetary policy implementation, and help bring the economy onto a path of sustainable growth.

4. Fiscal revenue grew substantially

In 2006, fiscal revenue amounted to 3.76 trillion yuan, up 677 billion yuan or 21.9 percent year on year. The combined turnover of the Shanghai and Shenzhen Stock Exchanges hit a record high, and the stamp tax revenue grew by a substantial 166 percent. The personal income tax registered 245.2 billion yuan, up 17.1 percent; in the first eleven months, the corporate income tax amounted to 712.23 billion yuan, up 37.7 percent.

In 2006, fiscal expenditures increased sharply in agriculture, social security, and social development. In the first eleven months, expenditures in agriculture, forestry, water conservancy, and weather services stood at 149.32 billion yuan, expenditures in social security stood at 147.06 billion yuan, and expenditures in education, science, culture, and public health stood at 561.44 billion yuan, up 17.9 percent, 17.4 percent, and 15.5 percent respectively.

5. The balance of payments maintained a surplus

The current account and capital account continue to run a surplus and the official foreign exchange reserves grew briskly to US\$1066.3 billion at the end of the year, up

US\$247.3 billion on a year-on-year basis. The reserve buildup was driven by substantial growth in the surplus of trade in goods, which is attributed to the larger excess of domestic savings over investment, domestic manufacturing capacity expansion, continued reallocation of manufacturing to China, and strong export performance supported by robust economic growth in the world.

Under the capital account, FDI remained in a large surplus albeit by a smaller amount, due to the combined effects of rapid outward investment by Chinese firms and slower FDI inflow. According to the statistics of the Ministry of Commerce, the actual utilization of FDI in 2006 reached US\$69.5 billion, down 4.1 percent; FDI in the non-financial sectors (sectors other than banking, insurance, and securities) was US\$63 billion, up by 4.5 percent. Outward investment reached US\$16.1 billion, up 32 percent. The outstanding external debt grew modestly. At the end of September 2006, the outstanding external debt reached US\$304.98 billion, up 8.5 percent, of which medium- and long-term debt was US\$136.4 billion, up 9.2 percent, and short-term debt was US\$168.6 billion, up 7.8 percent. Short-term debt accounted for 55.3 percent of total foreign debt. The underlying reasons for the short-term debt buildup were trade credits and borrowing by foreign financial institutions and foreign enterprises.

6. Industrial analysis

The major industries performed well, featuring rapid output growth, good sales performance, higher profits, and keen interest in fixed-asset investments in many sectors. Thirty-nine industries registered an average of 16.6 percent growth in industrial added value, with 22 industries outperforming the average. In particular, added value grew substantially in the heavy industries, led by the non-ferrous metal mining, construction materials, machinery, and chemical industries. Thirty-seven industries had a sales to production ratio higher than 97 percent, the best performers being the electricity, petroleum, and natural gas exploitation, cigarettes, oil refinery, and textile sectors. Unlike the previous year, profits grew in most industries rather than being concentrated mainly in the upstream industries. The coal, petrochemical, metallurgy, non-ferrous metal, and construction materials industries accounted for 51.1 percent of profit growth, 16 percentage points less than that in 2005. The profit margins in most sectors improved. The total profit to sales revenue ratio in the textile industry and light industry reached 3.63 percent and 4.81 percent respectively, levels not seen since 2002, 0.2 and 0.23 percentage points higher than in 2005. Enterprises were keen to make fixed investments. Investment in mining went up by 25.4 percent,

of which investment in non-ferrous metal mining increased by 67.8 percent; while investment in manufacturing grew by 29.4 percent, with that in waste recycling, rubber products, beverages, equipment, and metal products soaring by more than 50 percent.

The growth in supplies of coal, electricity, and transportation accelerated, further easing the shortage of these goods and services. During the year, the output of coal and power generation grew by 11.9 percent (up by 1.2 percentage points y-o-y) and 13.7 percent (up by 0.4 percentage points y-o-y) respectively. The production, import, and refining of crude oil grew by 1.7 percent, 14.5 percent, and 6.3 percent respectively. The volume of rail passenger and freight transportation, and freight volume handled by major seaports rose by 8.1 percent, 4.5 percent, and 15.9 percent compared with the previous year. The transportation of important goods was smooth.

(1) The real estate industry

In response to the rapidly growing housing prices in some regions, the State Council adopted macro-economic measures aimed at adjusting the housing supply structure and stabilizing housing prices in 2006. At a regular meeting on May 17, 2006, the State Council decided on six measures that aimed to give further play to the readjustment of taxation, credit, and land policies, adjusting the housing supply structure, controlling the scale and pace of resettlement for real estate development, regulating the order in the housing market, improving access to affordable housing for low-income citizens, and improving housing statistics and information disclosure with a view to promoting the healthy development of the real estate sector. On May 29, 2006, the General Office of State Council issued the *Opinions on Adjusting the Housing Supply Structure and Stabilizing Housing Prices*, setting out the details about the above six measures, including the ratio of different sized housing and the down payment ratio for new housing purchases, etc., and clarifying the regulatory responsibilities. Subsequently, the relevant ministries and local governments issued corresponding requirements and measures.

On July 11 2006, the Ministry of Construction, the PBC, and 4 other ministries and commissions jointly released the *Opinions on Regulating the Access to Foreign Capital in 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 foreign institutions and individuals, enforcement responsibilities, etc. On December 28, 2006, the State Administration of Taxation issued the *Notice on Collection of a Land Value-added Tax from Housing Developers*, requiring, as of February 1, 2007, that local governments calculate and collect a land value-added tax varying from 30 to 60 percent from real estate developers all over the country. With these various measures taking effect, the real estate market showed signs of improvement, such as stable growth of investment and an improved supply structure. However, housing prices in certain cities still moved up by a large margin. Additional measures may be needed to improve market order.

The investment in real estate development posted stable growth and that in affordable housing recovered noticeably. In 2006, cumulative investment in real estate development amounted to 1.9 trillion yuan, up 21.8 percent and an acceleration of 2 percentage points over the previous year, but below the growth of fixed-asset investment in 2006. Specifically, investment in commercial residential housing grew 25.3 percent, 3.5 percentage points higher than investment in real estate; investment in affordable housing grew 32.7 percent, recovering some of the earlier slump.

Growth in the space of commercial housing sales and in vacancies remained basically stable. In the first eleven months of 2006, the space of commercial housing sold grew 12 percent year on year to 460 million square meters. Specifically, residential housing sales reached 416 million square meters, an increase of 12.6 percent year on year. At the end of November, commercial housing vacancies grew 7.9 percent year on year to 124 million square meters. Specifically, residential housing vacancies increased 6.4 percent year on year to 67.23 million square meters.

The rise in housing prices stabilized, yet some cities still saw steep rises. In 2006, housing prices in 70 large- and medium-sized cities rose 5.5 percent year on year, a slight deceleration of 2.1 percentage points over 2005. In terms of geographic locations, in the fourth quarter, a number of cities registered a large rise in housing prices, especially in Shenzhen, Beijing, Dalian, Fuzhou, and Xiamen. Housing prices in Shanghai declined year on year.

The growth of real estate loans accelerated, especially development loans. At the end of 2006, the amount of outstanding commercial real estate loans increased by 665.3

billion yuan over that at the beginning of the year to 3.68 trillion yuan, up 22.1 percent on a year-on-year basis and accelerating by 5.9 percentage points. The amount of outstanding real estate development loans grew by 299.6 billion yuan over that at the beginning of 2006 to 1.41 trillion yuan, representing a year-on-year growth of 27 percent or an acceleration of 10 percentage points. The amount of outstanding mortgage loans grew by 363 billion yuan over that at the beginning of 2006 to 2.27 trillion yuan, representing a year-on-year growth of 19 percent and an acceleration of 3.3 percentage points.

(2) Agriculture

Agriculture is an essential part of the national economy. Among the population of 1.3 billion, 57 percent live in the rural areas. The development of agriculture is important for the country's food security and for the lives of the majority of the population. It is the basis of social stability and development.

Starting from the late 1990s, farmers were reluctant to invest in grain farming due to the heavy tax burden and comparatively low profitability. Agricultural output and the area for grain production contracted. As a result, the farmers' income remained low for quite a number of years, widening the gap with urban income. In 2003, the grain-producing area amounted to less than 1.5 billion *mu* (one *mu* is 667 square meters), the lowest since 1949, and grain output totaled 430 billion kilograms. In order to change this situation, starting from 2004, the central government issued guidance on agricultural work for four consecutive years in its first document of each year, and adopted many agriculture-friendly measures to increase the farmers' income, boost production capacity, and promote the building of a socialist new countryside. These measures included abolishing the agriculture tax, increasing subsidies, improving financing conditions, and speeding up the building of infrastructure and the application of modern technology. They contributed to favorable agricultural development and an improvement in the livelihood of the rural population. Agricultural and rural development made rapid progress all over the country. By 2006, agriculture and the rural economy were growing steadily. The structure of the rural economy improved further; total and per unit grain output rose for three consecutive years, the first time in 20 years; output of major cash crops, livestock, and aquatic products reached record highs; and the farmers' income also grew for three consecutive years.

Despite encouraging development in the rural economy, there are serious problems and imbalances. With rapid industrialization and urbanization, the returns from agriculture have remained low. Bottlenecks in rural natural resources have become more acute, and it is more difficult for farmers to further increase their income. Agriculture and rural development are climbing an upward slope. On the one hand, with globalization, international competition has increased. After China's accession to the WTO, agricultural trade expanded rapidly and China became the fifth largest exporter and the fourth largest importer of agricultural products in the world. On the other, due to agricultural subsidies and trade barriers in the developed countries and a less-advanced farming approach in China, Chinese farmers are in disadvantageous position in terms of global competition. China has had trade deficits for agricultural products for three consecutive years.

At present, the urgent tasks in agricultural development are to increase investment in agriculture, promote modern agriculture, enhance the competitiveness of Chinese agricultural products, and protect national food security. On January 29, 2007, the State Council issued the *Opinions on Actively Developing Modern Agriculture and Building a Socialist New Countryside*, sending a clear message that developing modern agriculture is the top priority for building a socialist new countryside. The document requires all levels of government to speed up restructuring of the agricultural growth pattern, to promote modernization of agricultural production methods, approach, and philosophy, to encourage technological innovation, to improve irrigation, automation, and use of IT, and to increase the skills, profitability, and competitiveness of farmers, in order to maintain sustainable agricultural development.

Box 3: Active Financial Support to Agriculture, Rural Areas, and Farmers

In recent years, the PBC and other ministries and agencies have attached great importance to building and reforming the rural financial system, have made earnest efforts to implement the State Council's overall plan for rural economic development, have actively promoted rural financial development and systemic improvements through experiments in organization, mechanisms, and product innovation, and have taken effective measures to improve financial services for farmers and the rural economy. Significant results have been achieved.

Credit support to farmers and the rural economy have increased markedly. According to the current statistical coverage, agricultural loans (including agricultural produce purchase loans) accounted for 10.3 percent of outstanding loans in all financial institutions, roughly the same as the share of primary industry (agriculture, forestry, animal husbandry, fishery, etc.) in GDP. It is also worth noting that given the trend of agricultural industrialization and industry diversification in townships and villages, in order to measure loans to agriculture and the rural economy, more statistics should be included in addition to the agricultural loans, such as loans for agricultural power grids, township and village enterprises, poverty reduction projects, and other loans that are closely linked to agriculture and the rural economy. According to statistics from the China Securities Regulatory Commission, outstanding loans to agriculture and the rural economy posted about 4.5 trillion yuan, making up more than 20 percent of the outstanding loans of all financial institutions. The financial industry has provided rather vigorous support to the development of agriculture and the rural economy.

Agricultural produce futures, insurance, and payment services made remarkable progress. In the past five years, the trading volume of agricultural produce futures increased steadily, and futures market prices have become an important reference for spot trade pricing, playing a positive role in promoting agricultural production. The pilot agricultural insurance developed soundly in various forms and through various channels in about 28 provinces (autonomous regions and municipalities). The pilot bank card services tailored for migrant farmers have effectively solved the fund security problems of migrant farmers who have to transfer home a large amount of cash and these services have been warmly welcomed by migrant farmers and people from other walks of life, generating good economic and social results.

A series of agriculture-friendly financial policies have produced results. According to the overall requirements of the State Council to deepen the pilot rural credit cooperative reform, the PBC arranged financial support of 165.6 billion yuan in the form of special central bank bills and earmarked lending, leading to an obvious improvement in the performance of the rural credit cooperatives; the upward floating ranges of the lending rates have been gradually enlarged for commercial banks and rural credit cooperatives, providing more incentives for financial institutions to support farmers, agriculture, and the rural economy; the required reserve ratio of rural credit cooperatives is lower than that of other financial institutions, making 80 billion yuan available to the rural credit cooperatives and contributing to their ability to support farmers; micro-credit organization experiments have proceeded steadily and

made good progress; the Agricultural Development Bank is able to raise funds from more sources and operate in more fields, not only lending to its traditional destinations of grain, cotton, and edible oil purchases, sales, and storage businesses, but also to agricultural production, forestry, animal husbandry and fishery, processing of agricultural produce, and agricultural science and technology; the interest rates on deposits with postal savings institutions of the central bank have been cut by a large margin to facilitate postal savings flowing back to the rural areas. The China Banking Regulatory Commission has recently released *Several Opinions on Adjusting and Relaxing Access Policy for Rural Banking Institutions to Provide Stronger Support to the Building of a Socialist New Countryside*, allowing the creation and reorganization of various kinds of banking institutions and contributing to a competitive financial system in the rural areas.

Although financial support to the agricultural economy has achieved remarkable results in recent years, a lot more needs to be done in line with the long-term requirements of building a socialist new countryside. In order to realize the ultimate objective of sustainable development, the development strategy for rural finance needs to shift from providing preferential policies to fostering a rural financial system that is fairly competitive and able to sustain itself in the long run. An important basis underpinning this transformation is to allow interest rates to serve as leverage more effectively to cover the risks and costs in rural financial businesses and to encourage more fund flows into the rural areas, and to reduce the moral hazards in low-interest lending. Meanwhile, the role of public finance should be further clarified to support farmers and the rural economy. Given the large rural population, low agricultural productivity, and poor infrastructure and public services in the countryside, the government should invest more in public services, infrastructure, and social undertakings. Fiscal expenditures for building a socialist new countryside can guide the direction of financial flows and create a basis for such flows into the rural areas. Determining the rate of fiscal compensation for farmers and the rural economy, especially rural household lending in tender, will help reduce the borrowing costs of rural households and bring the financial support to the rural economy onto a track of sustainable development.

The National Financial Work Conference has decided to “provide strong financial support to building a socialist new countryside and to strengthen rural financial services through effective measures in many areas.” In general, when promoting rural financial reform, the principle of rural finance serving farmers and the rural economy should be followed; the commercial viability of the rural credit cooperatives and other

financial institutions should be achieved by allowing interest rates to cover credit risks and other measures; at the same time, policy finance and fiscal subsidies to rural financial service institutions should also be included. An effective fiscal and financial support policy should be adopted to give preferential treatment to rural financial service institutions; a fair degree of competition should also be encouraged to attract financial institutions with a variety of ownerships into rural financial services; the role of commercial finance, policy finance, cooperative finance, and other financial organizations should be given full play to build a multi-layered, wide-coverage, and sustainable rural financial system befitting the rural areas and the rural economy.

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

I. Macro-economic outlook

The growth of the Chinese economy is expected to experience a slight slowdown in 2007 against the backdrop of the domestic and global economic environment and under the effect of various policy measures for macro-economic management. However, as breakthroughs are made in succession in the reform of key areas, the institutional environment for growth has improved and some weaknesses in social and economic development have been addressed. Meanwhile, because China is at a stage of upgrading the consumption and industrial structures, industrialization, urbanization, market-based reform, and internationalization are making even more rapid progress, consequently the inherent dynamism of economic growth has been strengthened. With the forces driving economic growth remaining strong, the economy is expected to maintain stable and rapid growth momentum.

With respect to domestic demand, since the corporate profit margin is on the rise and companies have more funds available, there is pressure of an investment rebound given the strong potential investment demand. As for consumption demand, the government will focus on boosting consumer demand, especially consumer demand in the rural areas, speeding up income distribution adjustments, improving the social security system, improving the income level and consumption ability of farmers and low-income urban dwellers, and optimizing the consumption environment. Consumption demand is expected to become stronger. As indicated by the PBC Quarterly Urban Depositors Survey in the fourth quarter of 2006, the satisfaction of urban households with current income apparently improved, with the current income sentiment index rising by 4.2 percentage points and 8.3 percentage points respectively over the previous quarter and the previous year; households were optimistic about income in the next quarter, and the future income confidence index hit a new record high. With the slowdown in the world economy and adoption of structural adjustment measures in China, exports are expected to decelerate in the first half of the year. Given the domestic and international economic and financial developments as well as the improved ability for import substitution, it will be fairly difficult to expand imports. Therefore, though China's trade surplus is expected to grow at a slower pace, the surplus will remain relatively large.

Upward risks are expected to grow in domestic price movements, leading to potential pressure in maintaining price stability. Although the growth capacity in some sectors and the decline in prices of international staple commodities are expected to check price hikes in certain sectors, upward risks have built up. In terms of demand, booming investment and credit demand have intensified the pressure of an investment rebound; as policies for economic structure adjustment have gradually produced results, household income is expected to increase at a faster pace. Combined with better social security, this will help boost consumer demand. In terms of costs, the price reform of water, power, natural gas, land, and other resources will be advanced; corporate costs and labor costs will be pushed up by stringent regulations on environmental protection, workplace safety, labor security, etc. According to the PBC Urban Depositors Survey in the last quarter of 2006, households were not optimistic in terms of their future price expectations, with the future prices expectation index rising to an all-time high since the Survey first began in 1999.

In general, with the effective implementation of the macro-economic management and structural adjustment policy measures, prominent imbalances in economic performance have been alleviated and the national economy will continue to maintain steady and rapid growth momentum. However, the moderation of credit and investment growth is not yet solidly based, there is still a serious BOP imbalance, the overall inflationary pressures have slightly intensified, and the deep-rooted structural problems of the excessively low consumption rate and the overly high savings rate remain prominent issues inhibiting sustainable economic development. In 2007, a scientific development approach should be followed in all areas of economic and social development to build a harmonious socialist society; efforts should be made to strengthen and improve macro-economic development, promote economic structure adjustments and transformation of economic growth patterns, conserve resources, protect the environment, and press ahead with reform, opening-up, and independent innovation, in order to bring economic development on to a track of scientific development. Based on the initial projection of a GDP growth rate of 8 percent and a CPI growth rate of less than 3 percent, the expected growth of money and credit aggregates as measured by broad money M2 is 16 percent.

II. Monetary policy stance to be adopted in 2007

According to the State Council's overall arrangements, the PBC will continue to

implement a sound monetary policy, further improve financial macro-management, strengthen liquidity management, and maintain money and credit growth at an appropriate level. While maintaining a balance at the aggregate level, efforts will be made to optimize the credit structure and provide stronger support to key areas and to the weak points. The RMB exchange rate regime will be further improved; the coordination of quantity adjustments and price instruments will be strengthened; financial reform will be deepened; the financial market will be develop more quickly; the transmission mechanism for the monetary policy will be improved; and the forward-looking and scientific nature of the monetary policy and its effectiveness in macro-economic management will be improved to contribute to high-quality and rapid economic growth.

1. Improve and strengthen liquidity management and create a stable monetary and financial environment for economic growth

The PBC will improve its liquidity analysis and projection system, apply a mix of measures including open market operations, and a reserve requirement ratio hike to effectively adjust liquidity in the banking system and to guide money and credit to grow at an appropriate pace and money market interest rates to move in a stable manner.

2. Further promote market-based interest rate reform and strengthen the role of interest rates and other leverages in macro-economic management

A market-based interest rate reform will be promoted prudently to improve the mechanism whereby interest rates are determined market supply and demand and can be adjusted by the central bank's use of monetary policy instruments. We will gear up the building of market base rates, facilitate the SHIBOR to gradually play a role, and improve a market-based pricing mechanism. The interest rate instruments will be used to flexibly enhance the effects of price instruments in macro-economic management and to let the price leverage gradually play an important role in macro-management through monetary policy measures.

3. Further improve the RMB exchange rate regime and promote a BOP equilibrium in combination with other policy measures

The role of the exchange rate shall be furthered to achieve a balance at the aggregate level, structural adjustments, and transformation of the economic development strategy in combination with other economic structure adjustment policies. More will be done to enable market supply and demand to play a fundamental role in the formation of the RMB exchange rate, improve the managed floating exchange rate regime, increase the elasticity of the RMB exchange rate, and keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

4. Optimize the credit structure, and beef up financial support to key areas and weak points

The commercial banks will be guided to lend in a balanced and appropriate manner, to optimize the credit structure, to properly control the infrastructure and other medium- and long-term loans, to strictly control lending to high energy-consuming, highly-polluting enterprises, and to provide more lending to the agricultural sector, SMEs, and to the creation of independent innovation, energy conservation, environmental protection, and employment. Financial resources will be guided to promote economic structure adjustments and balanced regional development. Financial institutions will be guided to provide more support to farmers and the rural economy against the background of building a socialist new countryside.

5. Energetically foster development of the financial market

The institutional building of the financial market will be strengthened to hasten the pace of direct financing, improve the financial asset structure, enrich the layers in the financial market and products, and promote balanced development of the financial market. In addition to expanding the trade volume of financial products already launched, efforts will be made to encourage financial products and instruments innovation, and to intensify research and development in financial derivatives to satisfy the diversified demand in the market. Meanwhile, there will be more channels for financial participation and the supply of financial products to provide more income-generating sources for households so that the financial sector will play a positive role in boosting domestic consumption. The market infrastructure will be built to strengthen market functions, industry self-regulation, and market transparency, and to build a market-based discipline and incentive mechanism. Regulation and supervision over the financial market will be intensified to maintain market order.

6. Further deepen financial reform by focusing on better corporate governance and optimization of the financial structure

Efforts will be made to improve corporate governance and transform the operational mechanism in the Industrial and Commercial Bank of China, Bank of China, and China Construction Bank. The joint-stock reform of the Agricultural Bank of China will be advanced steadily. Policy bank reforms will be conducted at a faster pace. The rural financial reform will be promoted across-the-board and the reform of the rural credit cooperatives will be further deepened. Rural financial institutions of various ownerships will be explored and developed suitable to the specificities of the countryside. Innovation in the modes of micro-credit will be encouraged to promote rural financial products and service innovation. Reforms of other financial institutions will be also conducted at a steady pace.

7. Further strengthen and reform foreign exchange management

Centering on the promotion of an equilibrium in the BOP, foreign exchange management will be improved and strengthened. The following are priorities. First, limits on holdings by individuals and enterprises and use of foreign exchange will be relaxed orderly to speed up foreign exchange market development and to diversify products. The RMB exchange rate regime will be further improved. The operation and risk management of the official foreign exchange reserves will be intensified, and ways of expanding the channels and means of reserve investments will be explored. Second, restrictions on the scale and products of outward financial investments by individuals and institutions will be relaxed. Enterprises with financial strength, good credit standing, and competitiveness will be supported in their endeavors to “go out,” regardless of their ownership. Third, the mode of external debt management will be improved to rein in the exceedingly rapid growth of external debt; meanwhile, implementation of supervisory policies on trade-related foreign exchange receipts and sales, and foreign exchange investment and foreign capital investment in the real estate sector by individuals will be enhanced. Management of capital inflows including trade credits will be intensified. Fourth, abnormal cross-border capital flows and illegal foreign exchange trading will be closely monitored; the use of electronic networks will be expanded for foreign exchange management; and the efficiency of on-site examination and off-site monitoring will be enhanced.