China Monetary Policy Report
Quarter Two, 2007

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the first half of 2007, the Chinese economy maintained a momentum of steady and rapid growth and the overall situation was good. Consumption expanded at an accelerated pace, agricultural sector performance was sound, the efficiency of the overall economy continued to pick up, and the people's livelihood continued to improve. In the period under review, the GDP grew by 11.5 percent and the CPI rose by 3.2 percent year on year.

Given the continued excessive liquidity in the banking system and huge pressures on money and credit expansion, the PBC, according to the State Council's overall arrangements, implemented a series of financial measures to strengthen macro-economic management and to maintain balanced monetary aggregates. Sterilization instruments such as open market operations and reserve requirement policies were employed to withdraw liquidities from the release of RMB for foreign exchange purchases. Since the beginning of 2007, on six occasions the PBC increased the reserve requirement ratios of financial institutions by 3 percentage points and on three occasions it raised the benchmark interest rates on loans and deposits of financial institutions. Meanwhile, efforts were made to guide the optimization of the credit structure, steadily promote financial institutional reform, further enhance the elasticity of the RMB exchange rate, and speed up foreign exchange administration reform.

In general, as a result of various macro-economic management measures, the liquidity in the banking system was appropriately under control and the overly rapid growth of money and credit was alleviated, though it remained at high levels. At end-June, the outstanding balance of broad money M2 had increased 17.1 percent year on year, down 1.4 percentage points from the same period of last year. Outstanding RMB loans grew by 16.5 percent year on year, representing an acceleration of 1.3 percentage points from the same period of last year and 0.2 percentage points from the first quarter of 2007. New loans reached 2.5 trillion yuan in the first half of 2007, 368.1 billion yuan more than the growth recorded during the same period of last year. The elasticity of the RMB exchange rate was further strengthened. At end-June, the central parity of the RMB against the US Dollar was 7.6155 yuan per US Dollar, appreciating by 2.54 percent over the end of last year.

The economic environment will remain favorable both at home and abroad in the second half of 2007, and it is expected that China's economy will continue to grow at high levels. However, we should be fully aware of the potential risks in economic performance. At present, it has become more apparent that the economy is heading from relatively fast growth to overheating. The trade surplus is growing larger, credit growth is higher than expected, and investments are still growing too fast. In particular, energy-consuming industries are growing at a high speed and efforts to conserve energy and reduce emissions are facing challenges. Inflation pressures continue to build, especially on prices that are closely related to household welfare, such as food and housing.

The PBC will follow the overall strategy of the Central Government, giving the highest priority to macro-economic adjustment efforts to prevent the economy from growing relatively rapidly to overheating. It will continue to conduct a sound monetary policy featuring moderate tightening, and making necessary policy adjustments to maintain a stable monetary environment, control inflation expectations, and maintain overall price stability. The PBC will continue the coordinated application of open market operations and the required reserve ratio, and will create new instruments as fit for macro-adjustments to manage liquidity. It will also improve the liquidity analysis and forecasting system, and manage the pace and magnitude of open market operations to effectively influence the liquidity in the banking system and guide the smooth operations of the money market. The role of market interest rates in balancing the supply and demand of financial resources will be brought into full play. The market-based interest rate reform will be further advanced, and the establishment of a benchmark interest rate system will be promoted to strengthen the leveraging role of prices in macro-economic adjustments. The PBC will continue to follow a policy of improving the RMB exchange rate formation mechanism in a self-initiated, controllable, and gradual manner, further giving market supply and demand a fundamental role in the RMB exchange rate formation, strengthening the RMB exchange rate flexibility, and maintaining it at an adaptive and equilibrium level. Meanwhile, the exchange rate will play a more active role in adjusting the balance of payments. Reform of the foreign exchange management system should be strengthened to meet the needs of domestic institutions to retain and use foreign exchange. Measures will be taken to steadily expand the systems of qualified foreign institutional investors and qualified domestic institutional investors, research will be undertaken on new ways for individuals to invest overseas, monitoring and administration of capital inflows will be strengthened, overseas borrowing will be further regulated, especially short-term debt management, and illegal foreign exchange transactions will be punished. In compliance with the priorities set by the national tax policy, industrial policy, foreign trade and foreign investment policy, and environmental protection policy, the PBC will also guide financial institutions to improve the credit structure and to prevent credit risks in order to promote economic structural adjustments and to transform the growth paradigm. Efforts will be made to promote financial market development based on “innovation, development, standardization, and coordination” and to deepen financial reform by improving corporate governance and the financial structure.

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Part 1 Monetary and Credit Performance

In the first half of 2007, the national economy continued to grow steadily and rapidly, with the financial industry performing in a sound manner. The growth of money and credit was basically consistent with macro-economic developments.

I. Money supply remained at a high level, but the relatively rapid growth was somewhat eased

At end-June 2007, outstanding broad money M2 amounted to 37.8 trillion yuan, an increase of 17.1 percent year on year, down 1.4 percentage points from the previous year. Narrow money M1 reached 13.6 trillion yuan, an increase of 20.9 percent year on year, up 7 percentage points over the same period of 2006. The acceleration of M1 growth was caused mainly by the rapid growth in demand deposits of enterprises and government agencies. First, with good performance and a dynamic market, enterprises and government agencies had strong investment needs, therefore their needs for demand deposits increased rapidly; second, growth in the issuance of banker's acceptance bills slowed down, so enterprises had to hold more demand deposits for payment purposes. Cash in circulation M0 grew by 14.5 percent year on year to 2.7 trillion yuan, up 2 percentage points over the same period of 2006. Net cash withdrawals in the first half of 2007 totaled 19.2 billion yuan, 37.1 billion yuan less than in the previous year.

II. Deposits of financial institutions continued to tilt toward demand deposits

At end-June 2007, outstanding deposits of all financial institutions (including foreign-funded financial institutions, as throughout this Report) denominated in both RMB and foreign currencies increased by 15.3 percent year on year to 38.2 trillion yuan, a deceleration of 1.9 percentage points from the previous year. In particular, outstanding RMB deposits rose by 16 percent year on year to 36.9 trillion yuan, a deceleration of 2.4 percentage points from the previous year. In terms of the growth trends of various RMB deposits, from January through May growth declined month by month, whereas in June, as the capital market declined, some inter-bank deposits shifted to general deposits, so growth recovered. The outstanding foreign currency deposits totaled US$166.8 billion, up 3.6 percentage points from the previous year.

Companies and households had a stronger preference for demand deposits. At end-June, outstanding household RMB deposits grew by 9.4 percent year on year to 17.3 trillion yuan, representing a deceleration of 8 percentage points from a year earlier and an increase of 827.1 billion yuan from the beginning of 2007, but 593.8 billion yuan less than the increase during the same period of 2006. In particular, the growth of household demand deposits accelerated by 40.4 billion yuan, whereas household time deposits increased less than during the same period of 2006 by 634.3 billion yuan. Outstanding non-financial corporate deposits stood at 17.1 trillion yuan, representing growth of 19.7 percent year on year, up 1.2 percentage points from the previous year, and an increase of 1.7 trillion yuan from the beginning of 2007 and an acceleration of 316.8 billion yuan from a year earlier. Outstanding corporate deposits amounted to 14 trillion yuan, representing an increase of 1.4 trillion yuan from the beginning of 2007 and an acceleration of 561.4 billion yuan from the same period of 2006. In particular, corporate demand deposits accelerated by 326.4 billion yuan. Outstanding fiscal deposits amounted to 1.9 trillion yuan, representing an increase of 816.7 billion yuan from the beginning of 2007 and an acceleration of 379.2 billion yuan from a year earlier.

III. Loans of financial institutions grew relatively rapidly

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 26.5 trillion yuan at end-June 2007, representing growth of 16.3 percent year on year and an acceleration of 1.9 percentage points from the same period of 2006, an increase of 2.6 trillion yuan from the beginning of 2007 and an acceleration of 412.8 billion yuan. In particular, outstanding RMB loans grew by 16.5 percent year on year to 25.1 trillion yuan, up 1.2 percentage points from the same period of 2006, representing an increase of 2.5 trillion yuan over the beginning of the year and an acceleration of 368.1 billion yuan. Outstanding foreign currency loans rose by 17.8 percent year on year to US$185.2 billion, up 12.9 percentage points from the same period of 2006, representing an increase of US$16.5 billion over the beginning of 2007 and an acceleration of US$9.1 billion from the previous year. Broken down by institutions, RMB loans of the various financial institutions accelerated, especially those of rural financial institutions, joint stock banks, and policy banks.

Table 1: RMB Lending by Financial Institutions in the First Half of 2007

Unit: 100 million yuan

	The first half of 2007 New Loans	The first half of 2006 New Loans
Policy banks	2264	1444
State-owned commercial banks	9472	9185
Joint-stock commercial banks	5616	4918
City commercial banks	2025	1641
Rural financial institutions	4561	3472
Foreign financial institutions	655	376

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 the RMB loans, outstanding loans to households, especially consumer loans, accelerated markedly, and outstanding loans to non-financial companies and other sectors grew steadily. In the first half of 2007, outstanding loans to households increased by 25.7 percent year on year to 4.6 trillion yuan, up 10 percentage points from the same period of 2006, representing an increase of 674.1 billion from the beginning of 2007 and an acceleration of 307.4 billion yuan from the same period of 2006. Consumer loans increased by 380 billion yuan from the beginning of 2007, 369.9 billion yuan more than the increase during the same period of 2006. In particular, households' medium and long-term loans witnessed a further increase of 320.6 billion yuan compared with the increase during the same period of 2006. Households' housing loans became the main force driving the marked increase in medium and long-term consumer loans. Households' operational loans increased by 294.2 billion yuan from the beginning of 2007, 62.4 billion yuan less than the increase a year earlier. Loans to non-financial companies and other sectors increased by 14.6 percent to 20.5 trillion yuan from the beginning of 2007, 87.4 billion yuan more than the increase in the previous year, down 0.3 percentage points, representing an increase of 1.9 trillion yuan. In particular, the growth rate of paper financing continued to decelerate while short-term and medium and long-term loans grew steadily.

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. The share of new medium and long-term loans to high-energy consuming industries declined. In the first half of 2007, the shares of 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) in infrastructural sectors (including the transportation, storage and postal services, electricity, gas, and water production and supply, water conservancy, and environmental and public facility management sectors), the real estate industry, and manufacturing industries were 35.9 percent, 15.1 percent, and 9.1 percent respectively. The high-energy consuming sector accounted for 12.1 percent of the total medium and long-term loans, down 4.6 percentage points from the same period of 2006.

Box 1: Paying Attention to the Changes in the Structures of Assets and Liabilities of the Commercial Banks

In recent years, with the development of the financial markets, especially the dynamic capital market, the assets selection and investment preferences of Chinese households and enterprises changed significantly, causing duration changes in the commercial banks' assets and liabilities, such as more short-term fund sources and more long-term fund uses, bringing about mismatch problems between the maturities of deposits and credits. With the further opening up and advancement of the RMB exchange rate reform, the currencies structures of the commercial banks' assets and liabilities were changed as well, resulting in the phenomenon of a currency mismatch.

In terms of the maturity structure, there was a significant trend toward more short-term fund sources but more long-term fund uses, especially in the first half of 2007. In terms of fund sources, enterprises, governmental entities, and households' general deposits tended to be demand deposits. At end-June 2007, demand deposits accounted for 66.1 percent of the total deposits of enterprises, up 1.1 percentage points year on year. The demand deposits accounted for 37.6 percent of the total savings deposits, up 2.9 percentage points year on year. Moreover, since the savings deposits were diverted to inter-bank deposits, the stability of the fund sources declined somewhat. In April and May, the savings deposits witnessed a net decline for two consecutive months, the first consecutive decline since 2000. In the first half of 2007, the savings deposits increased by 797.2 billion yuan, 598.1 billion yuan less than the increase in the same period of the previous year. At the same time, inter-bank deposits surged by 1.15 trillion yuan, 849 billion yuan more than the increase during the same period of the previous year. In particular, the margins of the securities companies increased by many times. In terms of fund uses, lending tended to be long term. In the first half of 2007, medium and long-term loans accounted for 54.8 percent of the total new loans, up 7.9 percentage points from the previous year.

In terms of the currency structure, due to expectations of a RMB appreciation, the commercial banks preferred to hold short positions of foreign exchange. Commercial banks were supplemented with foreign exchange capital through governmental capital injections, the introduction of foreign strategic investors, and IPOs in the overseas market, but they normally sold foreign exchange capital for RMB capital to avoid exchange rate risks. At end-June 2007, the foreign exchange assets of financial institutions totaled US$498.93 billion, whereas the realized foreign exchange capital was only US$12.76 billion and the ratio of realized foreign exchange capital to foreign exchange assets was 2.56 percent. Since 2007, the net foreign exchange forward sales over the commercial banks' counters grew rapidly, especially the over 1-year foreign exchange long-term forward sales. Commercial banks covered their forward positions on the spot markets so they had to obtain foreign exchange by increasing foreign exchange liabilities and then selling foreign exchange on the spot markets. Since the foreign exchange liquidity in the domestic market was rather tight, commercial banks' foreign exchange borrowings were concentrated on short-term borrowings, resulting in a large maturity mismatch with their forward sales.

We should have a correct understanding of the current maturity and currency mismatch issues. First, we should note that the deposits were diverted away from the banking system, namely, financial disintermediation was a trend in the financial structural changes. In China, indirect financing has accounted for a large proportion over a long period of time, which induced undeveloped direct financing and weak market functions in resource allocation. Enterprises had excessively high financial leverage, and financial risks were overly concentrated in the banking system, which also produced certain difficulties for financial institutions to transfer social savings into investments and to manage their assets and liabilities. From a certain point of view, such changes are necessary and positive. However, we should pay great attention to the potential risks from the maturity mismatch between the commercial banks' assets and liabilities, especially when global inflationary pressures are rising; once market interest rates change or reverse, financial institutions will face liquidity and interest rate risks. Second, we should understand that it is rational for commercial banks to sell foreign exchange and to avoid the currency mismatch problems between assets and liabilities and equities on the balance sheets based on expectations of a RMB appreciation. However, on the one hand, commercial banks' foreign exchange assets at risk, stemming from foreign exchange liabilities, are not covered by foreign exchange capital; once these assets incur losses, commercial banks will have to purchase foreign exchange to compensate for their losses; on the other hand, dividends for overseas shareholders have to be paid with foreign exchange, so commercial banks will face exchange rate risks. Since the RMB is not a fully convertible currency, commercial banks will face policy risks when they purchase foreign exchange in the future. With the increased floating flexibility of the RMB exchange rate, the above-mentioned risks will become ever greater. The rapid growth of foreign exchange forward sales over the counter will bring about liquidity risks, interest rate risks, and market risks, all of which require our attention.

Commercial banks should pay great attention to the potential risks from the maturity and currency mismatch. Conducting financial deepening and opening up in China are a long process; therefore, commercial banks should accelerate their transformation to better adapt to the new situations and changes, to improve their risk management skills, and to properly deal with the relations between short-term profits and sound, sustainable development over the medium and long term. Efforts should be made to enhance innovation awareness, to strengthen business innovation, service innovation, and products innovation, to adjust the profit structure through diversifying businesses, financial products, and earning channels, to develop fee-based businesses, and to explore new profit-earning areas to strengthen profitability. At the same time, attention should be paid to coordinating between business expansion and risk identification and control capacity so as to combine self-development and risk prevention with macro-adjustment targets, and to promote sound operations and to maintain financial system stability.

IV. Base money grew at a stable pace after deducting the effect of the reserve requirement ratio hikes

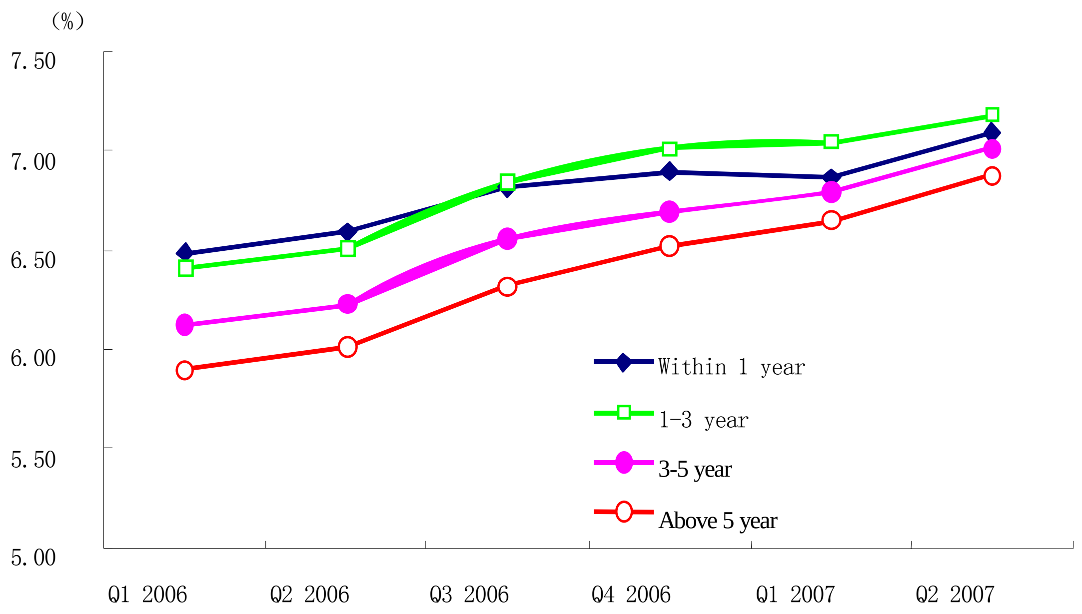
At end-June, the outstanding balance of base money increased by 31 percent year on year to 8.3 trillion yuan, representing an increase of 489.6 billion yuan from the beginning of 2007 and an acceleration of 614.3 billion yuan from a year earlier. The rapid growth of base money was caused mainly by several hikes in the reserve requirement ratios since the second half of 2006, as according to the current statistical coverage, required reserves are included in the base money but central bank bills are not. If liquidities frozen by the hike in the reserve requirement ratio since 2006 were instead sterilized by the issuance of central bank bills, the current growth of base money would be lower than 10 percent. The excess reserve ratio of financial institutions averaged 3 percent at end-June, down 0.08 percentage points from a year earlier. In particular, the excess reserve ratio of the state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 2.43 percent, 4.14

percent, and 5.51 percent respectively.

V. Lending rates of financial institutions rose steadily

In the second quarter of 2007, the weighted average interest rates of 1-year, 1-3 years, 3-5 years, and above 5-year loans of financial institutions were 7.09 percent, 7.18 percent, 7.01 percent, and 6.88 percent respectively, up 0.23 percentage points, 0.14 percentage points, 0.22 percentage points, and 0.23 percentage points respectively from the previous quarter. The weighted average interest rate of 1-year RMB loans of commercial banks was 6.75 percent, 1.03 times the benchmark rate, up 0.24 percentage points from the first quarter. Among all the loans issued by financial institutions, the share of loans with interest rates floating downward from the benchmark rate was the same as during the first quarter, whereas the share of loans with interest rates at the benchmark rate increased by 1.28 percentage points and the share of loans with interest rates floating upward from the benchmark rate declined by 1.24 percentage points.

Figure 1: Lending Rates for Different Maturities by Financial Institutions since 2006



Source: The People's Bank of China.

Table 2: Share of Loans with Floating Rates in Various Ranges in the Second Quarter of 2007

Unit：percent

	Sum	Floating downward	At benchmark	Floating upward				
		[0.9,1.0）	1	Sum	（1.0,1.3]	(1.3,1.5]	（1.5,2.]	Above 2
Sum	100	26. 85	29. 13	44. 02	27. 13	6. 46	9. 00	1. 44
State-owned commercial banks	100	29. 94	33. 58	36. 48	34. 19	1. 87	0. 40	0. 01
Joint-stock commercial banks	100	38. 91	33. 68	27. 41	26. 86	0. 49	0. 03	0. 02
Regional commercial banks	100	32. 31	17. 87	49. 82	35. 50	9. 30	4. 20	0. 83
Urban and rural credit cooperatives	100	2. 53	5. 58	91. 89	19. 27	23. 61	42. 25	6. 76
Policy banks	100	29. 88	68. 32	1. 80	1. 80	0	0	0

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

Source: The People's Bank of China.

The inter-bank deposit rate of financial institutions rose slightly. The inter-bank demand deposits accounted for 91.3 percent, with a weighted average interest rate of 1.41 percent, up 0.03 percentage points from the previous quarter; the share of inter-bank time deposits was 8.7 percent, with a weighted average interest rate of 2.58 percent, up 0.29 percentage points from the previous quarter.

Table 3: Average Interest Rates of Large-value Dollar Deposits and Loans in the first half of 2007

Unit: percent

	Jan.	Feb.	Mar.	Apr.	May	Jun.
I. Large-value Deposits:						
Within 3 months	4. 3192	4. 1626	4. 3773	4. 3949	4. 4756	4. 5441
3-6 months	5. 1244	5. 2424	5. 1802	4. 7302	4. 9277	5. 2338
6-12 months	5. 0632	5. 3322	4. 8745	5. 2713	5. 0535	5. 3547
1 year	5. 0020	4. 3134	4. 7066	5. 0930	4. 8413	5. 0009
II. Loans:						
1 year (fixed)	6. 2037	6. 0972	6. 0174	6. 1770	6. 1330	6. 1259
1 year (monthly floating)	6. 0936	6. 2679	6. 1866	6. 1435	6. 1963	6. 1656

Source: The People's Bank of China.

The interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) increased month by month. In the second quarter, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 4.5 percent, up 0.38

percentage points from the previous quarter; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 4.56 percent, up 0.23 percentage points from the previous quarter.

The interest rates of large-value foreign currency deposits and foreign currency loans in China fluctuated slightly.

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

In the first half of 2007, in general the RMB exchange rate appreciated and the fundamental role of market supply and demand was further enhanced. At end-June, the central parity of the RMB against the US Dollar was 7.6155 yuan per US Dollar, an appreciation of 1932 basis points or 2.54 percent over the end of 2006; the central parity of the RMB against the Euro and the Japanese Yen was 10.2337 yuan per Euro, and 6.1824 yuan per 100 Japanese Yen, an appreciation of 0.32 and 6.16 percent respectively. Beginning with the exchange rate regime reform in 2005 up until the end of June 2007, the RMB cumulatively appreciated by 8.68 percent and 18.17 percent against the US Dollar and the Japanese Yen respectively, but it cumulatively depreciated by 2.15 percent against the Euro.

In the first half of 2007, the elasticity of the RMB exchange rate was further strengthened, and the linkage of the RMB exchange rate with the major currencies was obvious. The peak and bottom central parities of the RMB against the US Dollar were 7.6155 yuan per US Dollar and 7.8135 yuan per US Dollar respectively. Among the 117 trading days, the inter-bank foreign exchange market saw RMB appreciations for 74 days and RMB depreciations for 43 days. The largest appreciation and depreciation of the central parity against the US Dollar in a single business day was 0.41 percent (310 basis points), above 0.3[1] percent before May 21, 2007 and 0.27 percent (209 basis points) respectively; the daily fluctuation of the central parity averaged 51 basis points, much larger than the average of 40 basis points recorded in 2006.

[1] Beginning on May 21, 2007, the daily fluctuation ceiling of the RMB against the US Dollar in the inter-bank foreign exchange market was broadened from 0.3 percent to 0.5 percent.

Part 2 Monetary Policy Conduct

In the first half of 2007, given the continued excess liquidity in the banking system, and huge pressures on money and credit expansion, the PBC, according to the State Council's overall arrangements, implemented a series of financial measures to strengthen macro-economic management, strike a balance at the aggregate level, guide the optimization of the credit structure, steadily promote financial institutional reform, further enhance the flexibility of the RMB exchange rate, and speed up foreign exchange administration reform. These actions have contributed to sound and relatively rapid economic growth.

I. Comprehensive measures were taken to strengthen liquidity management

In the first half of 2007, with close attention to the international and domestic financial market movements and changes in money and credit, the PBC carried out its monetary policy by means of open market operations and reserve requirement policies in an effort to siphon the liquidity in the banking system. As a result, the PBC withdrew liquidities from the release of RMB for foreign exchange purchases. In open market operations, first, the PBC maintained the issuance of central bank bills. To support the hike in the reserve requirement ratios, the PBC properly arranged a combination of open market operation instruments and their duration. The issuance of central bank bills totaled 2.6 trillion yuan, up 0.4 trillion yuan from a year earlier, with outstanding central bank bills amounting to 3.8 trillion yuan at end-June, an increase of 0.8 trillion yuan from the end-2006. Second, the PBC extended the maturity of central bank bills at a proper time. To ease the liquidity pressures from the maturity of a large amount of central bank bills, the PBC reissued 3-year central bank bills together with 3-month and 1-year central bank bills to absorb the excess liquidity in the banking system. In the first half of 2007, the issuance of central bank bills with 3-month, 1-year, and 3-year maturities amounted to 623 billion yuan, 1270 billion yuan, and 748 billion yuan respectively. Third, the issuance of market-based central bank bills was combined with specialized issuances. While maintaining the intensity of the issuance of market-based central bank bills, in the middle of March, the middle of May, and the middle of July, the PBC issued 3-year specialized central bank bills amounting to 303 billion yuan to those commercial banks that experienced rapid loan growth and ample liquidities. Such actions not only withdrew liquidities but also provided a warning to banks that reported rapid loan growth. Fourth, the issuance rate of central bank bills was driven up. In the first half of 2007, the issuance rate for 3-month, 1-year, and 3-year central bank bills rose by 24, 30, and 52 basis points respectively, affecting market interest rate movements so as to adjust fund supply and demand through the interest rate. Additionally, the PBC increased the reserve requirement ratios of financial institutions by 3 percentage points on six occasions, basically once per month.

II. Interest rates played a leveraging role

The PBC raised the benchmark interest rates on loans and deposits of financial institutions on three occasions, namely March 18, May 19, and July 21, 2007. The 1-year benchmark deposit rate was raised by 0.27 percentage points on each occasion to 3.33 percent from a beginning of 2.52 percent. As the deposit interest income tax was decreased from 20 percent to 5 percent beginning on August 15, 2007, the real deposit interest rate was actually raised. In particular, the interest rate after taxes for 1-year deposits was up by 0.5 percentage points. The 1-year lending rate was raised by 0.27, 0.18, and 0.27 percentage points respectively from 6.12 percent to 6.84 percent. Interest rates on deposits and loans of other maturities were adjusted accordingly. The hikes in the benchmark interest rates on deposits and loans of financial institutions helped adjust and stabilize inflation expectations, maintain general price stability, and guide an appropriate growth of money and credit.

The steady advancement of market-based interest rate reform promoted the establishment of a benchmark interest rate system in the money market. After the Shanghai Inter-bank Offered Rate (Shibor) was formally launched on January 4, 2007, it functioned well. The Shibor's rationality and stability were strengthened continuously and its relation with the inter-bank borrowing rate and repo rate in the money market was gradually normalized. With the authorization of the PBC, the National Inter-bank Funding Center offered a bill rediscount rate, bill repo rate, and interest rate swap price based on the Shibor so as to provide an effective market benchmark interest rate. Accordingly, many financial products on the basis of the Shibor emerged in the market, and the role of the Shibor in guiding pricing was enhanced.

III. Window and credit policy guidance was strengthened

In the first half of 2007, the PBC continued to strengthen the role of window guidance and credit policy guidance to alert commercial banks of the risks arising from an excessively rapid growth of loans and to guide them in controlling the size and pace of credit extension. The PBC also focused on guiding commercial banks to strengthen financial services for energy conservation and environmental protection, strongly limiting lending to weak enterprises in industries with high energy consumption, heavy pollution, or excess production capacity, strengthening credit support to the rural economy, job creation, students, small and medium-sized enterprises, consumption, and other weak sectors, expanding their fee-based businesses and strengthening financial product innovation, and transforming profit-earning modes.

IV. Financial enterprise reform was promoted

Great achievements were made in the joint-stock reform of state-owned commercial banks. Through the share-holding reform, the state-owned commercial banks, according to international practices, improved their corporate governance structure, earnestly transformed their management mechanism, strengthened internal control and risk management, and enhanced their services and efficiency. The capital adequacy ratio, asset quality, profitability, and other financial indicators of the state-owned commercial banks improved markedly. As of end-2006 the capital adequacy ratio of the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications reached 14.1 percent, 13.6 percent, 12.1 percent, and 10.8 percent respectively, with NPL ratios of 3.8 percent, 4.0 percent, 3.3 percent, and 2.0 percent and profits before taxes of 71.5 billion yuan, 67 billion yuan, 65.7 billion yuan, and 17.4 billion yuan respectively. Their financial performance was fundamentally improved and their financial viability was further strengthened. To promote the sound and sustainable development of the domestic capital market, the Bank of Communications listed on the Shanghai Stock Exchange on May 15, 2007, and the China Construction Bank announced the issuance of 9 billion A-shares on the Shanghai Stock Exchange. After in-depth investigation, relevant government departments seeking to promote relevant fundamental work in relation to the joint-stock reform conducted research on the share-holding reform scheme of the Agricultural Bank of China.

The reform of the rural credit cooperatives (RCCs) also underwent important advances and produced results. First, the financial support policy was gradually implemented. At end-June, the PBC, together with the CBRC, issued 166.1 billion yuan in special bills and special loans to the RCCs, accounting for 99 percent of the planned volume of financial assistance. The PBC also redeemed 31.1 billion yuan in special bills from the RCCs in 505 counties (cities) of 14 provinces, including Jiangsu.

Second, the quality of assets improved markedly. With the implementation of various supporting policies, the historical burdens of the RCCs were effectively released. According to the four-category loan classification system, the outstanding balance of the non-performing loans (NPLs) of the RCCs totaled 297.2 billion yuan, down 42 percent from end-2002. The NPL ratio was 9.6 percent, down 27.3 percentage points from end-2002. Accumulated losses stood at 58.6 billion yuan, down 55 percent from end-2002. The capital adequacy ratio of the RCCs, rural commercial banks, and rural cooperative banks reached 12.0 percent, 8.6 percent, and 14.6 percent respectively. Third, their capacity to support rural economic activities was enhanced significantly. By end-June, the registered capital, the outstanding balance of deposits, and the outstanding balance of credits of the RCCs amounted to 208.9 billion yuan, 4335.4 billion yuan, and 3083.1 billion yuan respectively, up 388 percent, 118 percent, and 121 percent respectively from end-2002. Fourth, their credit support to the rural economy was strengthened continuously. At end-June, the outstanding agricultural loans of the RCCs posted 1.436 trillion yuan, their share in the total loans of the RCCs increasing from 40 percent at end-2002 to 47 percent. Their share in the total agricultural loans issued by all financial institutions surged from 81 percent at end-2002 to 93 percent. Outstanding rural households' loans reached 1.184 trillion yuan, with the number of rural household borrowers reaching above 80.64 million, accounting for 34 percent of the total rural households and 75 percent of the qualified rural household borrowers who had borrowing needs. It is worth noting that in recent years the nationwide growth of RCC credits has accelerated, especially in the first half of 2007. However, we should note that although the RCCs provided strong financial support to the agricultural economy, some RCCs had rather high deposit/lending ratios due to the excessively rapid growth of lending, and their potential credit risks with regard to poor management should not be neglected. The RCCs should extend credits rationally, strengthen management of credit assets, and strictly control incremental NPLs so as to realize sound management and healthy and sustainable development.

V. The RMB exchange rate formation mechanism was improved, the reform of the foreign exchange management system was accelerated, and a broadly balanced external sector was promoted

Efforts have been made to continue to improve the managed floating exchange rate regime based on market demand and supply and with reference to a basket of currencies, to further promote the fundamental role of market supply and demand in the RMB exchange rate formation mechanism, to strengthen the flexibility of the RMB exchange rate, and to keep the RMB exchange rate broadly stable at an adaptive and equilibrium level. At the same time, reform of the foreign exchange management system was accelerated to promote a BOP equilibrium. First, the floating band of the RMB trading prices against the US Dollar in the inter-bank foreign exchange market was enlarged. The PBC announced on May 18, 2007, effective May 21, that the floating band of the RMB trading prices against the US Dollar in the inter-bank spot foreign exchange market would be enlarged from 0.3 percent to 0.5 percent, i.e., on each business day, the trading prices of the RMB against the US Dollar on the inter-bank spot foreign exchange market would float within a band of ±0.5 percent around the central parity publicized on the same day by the China Foreign Exchange Trading System. Second, the foreign exchange purchase and surrender system through designated foreign exchange banks was improved. Management of the entry and exit of commercial banks to the foreign exchange purchase and surrender system was standardized to treat different banks by different methods, including approval-based and record filing-based management. Annual foreign exchange purchases and sales quotas for individuals were set at US$50000 to meet their needs for holding and using foreign exchange. In the first half of 2007, the total foreign exchange purchases by individuals reached US$12.9 billion, up 2.6 times year on year. Third, overseas financial investments were expanded by broadening the commercial banks' overseas investment instruments on behalf of their clients, from fixed interest rate products to stocks and structural products, and trust and investment companies were allowed to develop QDII businesses. As of end-June, the accumulated quotas for the various QDIIs reached US$20.5 billion, with accumulated foreign investment of US$7.29 billion. Fourth, foreign debt growth was strictly contained. The short-term foreign debt quotas of foreign institutions were reduced gradually and they were encouraged to use domestic funds. Fifth, approval and supervision over direct investment in the real estate industry by foreign investors were strengthened to strictly control their investments in luxury homes, acquisitions and mergers, and investments in domestic real estate companies.

Box 2: Two Years of Smooth Implementation of the Reform of the RMB Exchange Rate Formation Mechanism

On July 21, 2005, China adopted a managed floating exchange rate regime based on market demand and supply and with reference to a basket of currencies. Up until July 20, 2007, the new RMB exchange rate formation mechanism has been smoothly implemented for two years. During these two years, the PBC has endeavored to improve the managed floating exchange rate regime in line with the principles of reform in a self-initiated, controllable, and gradual manner; as a result, the flexibility of the RMB exchange rate has been greatly strengthened, with steady appreciation of the real effective exchange rate. Market participants, after many efforts, have gradually adapted to the managed floating exchange rate regime and have enhanced their ability to avoid exchange rate risks; and the profits of enterprises have increased. In terms of the macro-economy, the reform of the RMB exchange rate formation mechanism has promoted economic restructuring, industrial upgrading, and transformation of the economic growth mode, cultivating financial institutions' pricing and risk management abilities and boosting the flexibility of the macro-economy.

I. Improvements in the managed floating exchange rate regime

First, efforts have been made to promote the development of the foreign exchange market so as to provide institutional support for the new RMB exchange rate formation mechanism. After the introduction of the OTC transaction mode, market-maker system, and improvement in the formation of the RMB central parity, the inter-bank spot foreign exchange markets developed rapidly, including the inter-bank RMB forward and swap market. Second, under the managed floating exchange rate regime, the RMB exchange rate indirect adjustment system and the primary dealer system in the foreign exchange market were established. Third, the RMB exchange rate floating band was enlarged to enhance the flexibility of the RMB exchange rate. Fourth, efforts were made to improve foreign exchange management, gradually implementing balanced management of foreign exchange movements to promote a BOP equilibrium.

II. The flexibility of the RMB floating exchange rate was improved continuously, with steady appreciation of the effective exchange rate

After the reform of the RMB exchange rate formation mechanism, the RMB exchange rate was no longer pegged to US Dollar; rather it was adjusted with reference to a basket of currencies. In the two years since the reform of the exchange rate regime, in general the RMB exchange rate has appreciated, fully reflecting the fundamental role of market supply and demand in the exchange rate formation process. The RMB exchange rate against the Japanese Yen witnessed the largest appreciation, with an accumulated appreciation of 20 percent in two years; the second largest appreciation was against the US Dollar, with an accumulated appreciation of 10 percent. The effective RMB exchange rate appreciated as well, indicating that the RMB exchange rate against the currencies of China's main trading partners had appreciated. According to the BIS statistics, as of June 2007, the nominal effective exchange rate index of the RMB appreciated by 6.2 percent since the reform, and the real effective exchange rate index appreciated by 6.3 percent since the reform, representing an appreciation larger than that of the major currencies, such as the Euro, Sterling Pound, and Singapore Dollar. Over the longer term, against the background of the "twin surpluses" in the BOP, in general the effective exchange rate of the RMB has continued to appreciate on a large scale since the exchange rate reform in 1994. From the beginning of 1994 until end-June 2007, according to the BIS calculations, the nominal and real effective exchange rate index of the RMB appreciated by 27.5 percent and 37.8 percent respectively, commensurate with supply and demand in the foreign exchange market.

Table 4: Appreciation of the Effective Exchange Rate of the Major Currencies from June 2005 to June 2007

unit:（%）

Currency	NEER	REER	Currency	NEER	REER
Chinese RMB	6.15	6.34	Indian Rupee	1.30	5.09
US Dollar	-6.01	-3.96	Thailand Baht	15.61	19.36
Euro	4.41	2.89	Singapore Dollar	4.41	1.52
Japanese Yen	-16.90	-21.13	Taiwan Dollar	-8.27	-11.03
GB Sterling	2.04	1.96	Russian Rupee	2.81	15.00
Korean Won	6.15	6.10	Australian Dollar	5.75	7.13
Ringgit	6.81	7.28	Canadian Dollar	14.57	12.95

Source：BIS.

III. Market participants actively responded to the reform of the RMB exchange rate formation mechanism and gradually adapted to the managed floating exchange rate regime

After the reform of the RMB exchange rate, the price-adjustment function of the RMB exchange rate played an increasing role and formed a positive incentive mechanism for market participants. Commercial banks, foreign trade companies, and households increased their exchange rate risk awareness by adjusting their capital operational modes and product structures so that they could effectively avoid exchange rate risks. First, enterprises gradually enhanced their pricing capabilities. Through negotiations, Chinese enterprises established a risk-sharing mechanism with their foreign counterparts. Second, enterprises used financial derivatives to ward off exchange rate risks. In the first half of 2007, the contracted amount of forward foreign exchange purchases and sales by enterprises increased 2.8 times year on year, accounting for 7 percent of the total volume of foreign trade. Third, enterprises adjusted the management of assets and liabilities denominated in both RMB and foreign currencies and increased the proportion of domestic sales. Fourth, enterprises strengthened their self-innovative capacities and established their own brands. Fifth, enterprises enhanced business management efficiency and reduced production costs. Sixth, enterprises enhanced the industrial clustering effects to reduce production costs. Some private enterprises established and expanded their own production, research and development, and sales networks based on specialized markets, realizing a “block economy” with a detailed division of labor supplemented by cooperation to enhance the effects of economic scale. Generally, market participants actively responded to the reform of the RMB exchange rate with various methods, adapted to the managed floating exchange rate regime, and improved operational efficiency. Their adjustment and endurance capacities to exchange rate movements were higher than expected.

IV. The reform of the RMB exchange rate played a positive role in promoting industrial structural adjustments

The reform of the RMB exchange rate promoted the economic restructuring, industrial upgrading, and shifts in the economic growth mode. First, faced with RMB appreciation pressures, foreign trade companies adjusted their product structures, implemented a brand strategy, and promoted the transformation of the foreign trade growth mode. Second, given the pressures from the RMB exchange rate appreciation and increase in labor costs, exporters in the coastal regions accelerated their relocation to the hinterland, strengthening the industrial gradient shift effects.

In summary, the reform of the RMB exchange rate formation mechanism during the past two years has achieved the expected results. However, we should realize that although the exchange rate adjustment can play a role in reducing external imbalances, it is not a fundamental and exclusive policy tool. Moreover, the RMB exchange rate has become an important excuse for some countries to carry out protectionist trade measures against China, and China might face higher risks of trade frictions and trade wars. On June 16, 2007, the IMF adopted the Decision on Bilateral Surveillance over Members' Policies, which will put most developing countries, especially the emerging market-economies, under greater pressure. Attention should be paid to its influence. For the next step, the PBC will continue to carry out the overall arrangements of the State Council to further improve the reform of the RMB exchange rate formation mechanism, develop foreign exchange markets, and improve the foreign exchange administration in line with a self-initiated, controllable, and gradual approach. Additionally, efforts will be made to enhance the quality of foreign investments, speed up the economic restructuring, strengthen the core competitiveness of enterprises, and realize the fundamental shifts in the economic growth mode.

Part 3 Financial Market Performance

I. An overview of financial market performance

In the first half of 2007, the financial market continued to evolve in a sound and steady manner, with brisk trading activities on the money market and the capital market, good performance in the issuance of bonds, overall increases in the issue rate, an upward and steeper yield curve on the bond market, steadily expanded innovative financial products, and improved institutional building of the financial market.

The financing structure changed obviously for the domestic non-financial institution sector, including households, enterprises, and the government sector. Stock financing increased rapidly, and its role in allocating social funds was strengthened significantly. Affected by factors such as redemption at maturity (bond financing volumes equal to issued volumes minus redemption), the growth of government financing accelerated from a year earlier, whereas that of corporate bond financing decelerated. In particular, growth in the redemption of government securities at maturity decreased by 130.3 billion yuan on a year-on-year basis, and the matured redemption of short-term financing bills accelerated by 117.6 billion yuan from the increase in the previous year.

Table 5: Financing by Domestic Non-financial Sectors in the First Half of 2007

	Volume of financing (100 million yuan)		As a percentage of total financing (percent)	
	First half of 2007	First half of 2006	First half of 2007	First half of 2006
Financing by domestic non-financial sectors	29539	24669	100.0	100.0
Bank loans	26358	22251	89.2	90.2
Equities	1237	482	4.2	2.0
Government securities	1594	361	5.4	1.4
Corporate bonds	350	1575	1.2	6.4

Source:The People’s Bank of China.

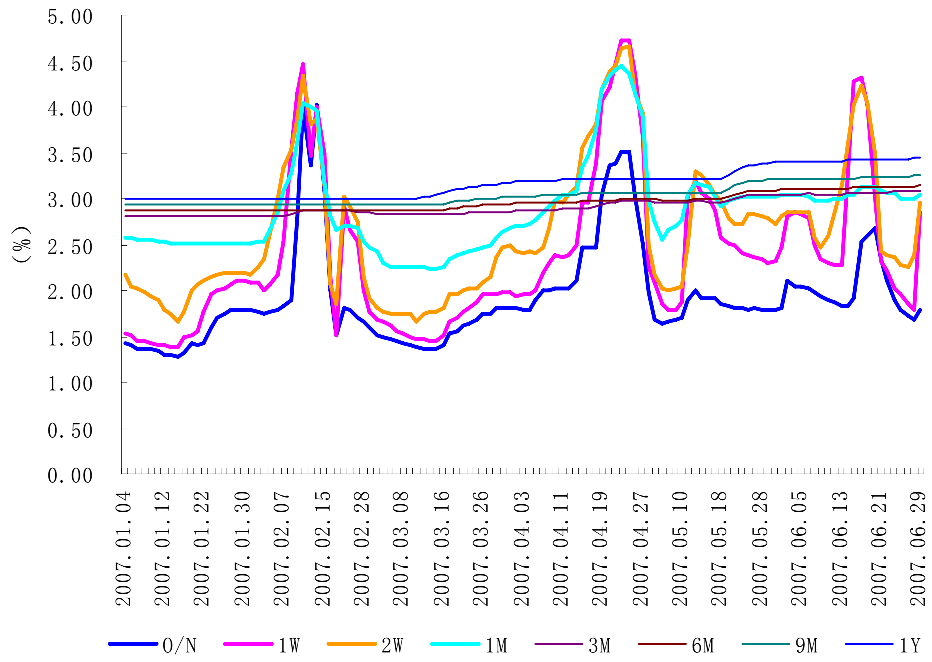
1. Trading in the money market expanded rapidly and market interest rates increased with fluctuations

Transactions on the inter-bank repo and borrowing markets were active, and fund demand, affected by the stock market, displayed an evident trend of shortening maturities. In the first half of 2007, the turnover of bond repo on the inter-bank market registered 18.2 trillion yuan, with the daily turnover averaging 150.2 billion yuan and a year-on-year growth of 69.4 percent. Inter-bank borrowing reached 2.9

trillion yuan, which was equivalent to the total trading volume of 2006, with the daily turnover averaging 24.1 billion yuan and growth of 3.2 times year on year, reaching a historical high. In particular, most of the transactions were overnight products featuring borrowing and repo products, accounting for 60.8 percent and 53.9 percent of the total respectively on the inter-bank market, increasing respectively by 35.4 and 7.7 percentage points year on year, a record high level.

Interest rate derivatives developed at a fast pace. In the first half of 2007, there were 912 RMB interest rate swap transactions, and the nominal principal registered 103.27 billion yuan, up 8.9 times and 2.9 times respectively compared with the totals in 2006. The interest rate swap business based on the Shibor was conducted steadily. Since the Shibor was launched, 15 interest rate swaps of differing maturities, including overnight, 7 days, and 3 months, were transacted based on the Shibor, with the amount reaching approximately 1.2 billion yuan. The surge in transactions of interest rate derivatives indicated that, with the market-based interest rate reform steadily advancing and the risks of interest rate movements increasing, investors have started to actively use interest rate derivatives to manage and hedge risks from interest rate movements.

Figure 2: Movements of the Shibor in the First Half of 2007



Source: National Inter-bank Funding Center.

Money market interest rates were on a rising trend but with large fluctuations. The monthly weighted average rate of bond pledged repo transactions and inter-bank borrowing registered 2.47 percent and 2.39 percent respectively in June, up 0.81 and 0.53 percentage points respectively from January. At end-June, the Shibor with maturities of 7 days, three months, and 1 year stood at 2.8411 percent, 3.0868 percent, and 3.4447 percent respectively, growth of 132, 28, and 44 basis points respectively year on year. Due to several factors, such as the issuance of new stocks, money market rates, short-term rates in particular, saw large movements. In those months when a lot of funds were raised through IPOs, the market rates increased rapidly, and vice versa.

Affected by capital market development and the subsequent inter-bank deposit transfers, the funds distribution of financial institutions underwent large changes. In the first half of 2007, state-owned commercial banks moved from a net lending position a year earlier on the inter-bank borrowing market to a net borrowing position, and net borrowing mainly occurred in April and May, amounting to 69.6 billion yuan and 219.3 billion yuan respectively; whereas on the repo market (including bond pledged repo and outright bond repo), the growth in net lending of state-owned commercial banks decelerated by 30.7 percentage points on a year-on-year basis.

Table 6: Fund Flows among Financial Institutions in the First Half of 2007

Unit: 100 million yuan

	Repo		Inter-bank Borrowing	
	First half of 2007	First half of 2006	First half of 2007	First half of 2006
State-owned Commercial Banks	-55144	-52917	2333	-1307
Other Commercial Banks	1700	15436	-8040	-2161
Other Financial Institutions	38207	32764	4261	2544
Of which: Securities and Fund Management Companies	5773	10811	3210	1540
Insurance Companies	9897	7706	—	—
Foreign Financial Institutions	15237	4717	1446	924

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

Source: The People's Bank of China.

2. Brisk bond transactions were accompanied by a steady rise in bond issue rates

Due to the continued rapid growth of the national economy and the booming capital market, the spot market traded briskly. In the first half of 2007, the turnover of spot transactions on the inter-bank bond market totaled 5.83 trillion yuan, with the daily turnover increasing by 19.4 percent to 48.2 billion yuan, hitting a historical high. The turnover of government bond spot transactions on the organized exchanges registered 65.9 billion yuan.

On the inter-bank spot transaction market, the state-owned commercial banks were the largest net purchasers, with a net purchase of 337.6 billion yuan, a year-on-year increase of 18.5 percent. Other commercial banks, securities companies, and fund companies were net sellers, and the net sales by other commercial banks saw a large increase compared with that recorded in the same period of last year, a year-on-year growth of 67.5 percent.

Bond derivative transactions became buoyant. In the first half of 2007, bond forward transactions reached 544, with a turnover of 100.61 billion yuan, up 36.7 percent and 51.4 percent respectively compared with the totals of 2006. The increasingly vibrant bond forward transactions played an active role in helping market participants effectively hedge risks, improving the price discovery of the bond market and developing the spot market, and promoting the comprehensive and coordinated development of the inter-bank bond market.

Box 3: The Interest Rate and Exchange Rate Derivative Market Expanded Rapidly

A financial derivative is a two-party or multiple-party financial contract, the worth of which is derived from the future value of some underlying assets, to hedge risks or discover prices. The underlying assets of financial derivatives include stocks, bonds, foreign exchange, loans, and commodities, and the transactions are conducted through forwards, futures, options, and swaps.

Although the financial derivative market began late in China, the interest rate and exchange rate derivatives have developed at a fast pace since 2007. Currently, the interest rate derivatives mainly include bond forwards and RMB interest rate swaps. Bond forward transactions were launched in June 2005. As the first real derivative financial tools in the inter-bank bond market, they could effectively help investors to hedge interest rate risks, enhance market liquidity, and improve price discovery of the market. The RMB swap was introduced in the inter-bank bond market in February 2006 on a pilot basis. After these steps were taken, the market performed smoothly and transactions became increasingly active. The trading volumes of the market have increased rapidly, especially since 2007.

Table 7: Transactions of Interest Rate Derivatives

	Bond Forwards		RMB Interest Rate Swaps	
	Number of Transactions	Turnover (billion yuan)	Number of Transactions	Nominal Principal(billion yuan)
2005 [1]	108	177.99	-	-
2006 [2]	398	664.46	103	355.70
2007,Quarter 1	253	357.19	276	393.64
2007,Quarter 2	291	648.95	636	639.02
Total	1050	1848.59	1015	1388.36

Note: 1. Bond forward transactions began in June 2005.

2. The RMB interest rate swap began in February 2006.

Source: China Foreign Exchange Trading Center.

China's exchange rate derivatives mainly include forward foreign exchange purchase and surrender, inter-bank foreign exchange forward transactions, and RMB foreign exchange swaps. Early in 1997, the State Administration of Foreign Exchange approved the Bank of China to provide forward foreign exchange purchase and surrender business to individuals and enterprises. Since 2004, the PBC has approved more commercial banks to conduct such business. After the RMB exchange rate regime was reformed in July 2005, the PBC stipulated that all qualified commercial banks could engage in forward foreign exchange purchase and surrender and RMB foreign exchange swap transactions, and introduced inter-bank foreign exchange forward and RMB foreign exchange swaps in the inter-bank foreign exchange market in August 2005 and April 2006 respectively. Since then, transactions became increasingly brisk, and the trading volumes of the market increased rapidly, especially in 2007. In the first half of 2007, the nominal principal of inter-bank foreign exchange forward transactions amounted to US$10.7 billion, with the daily turnover averaging US$90 million, 1.6 times that recorded in 2006. The RMB foreign exchange swap registered US$133.4 billion, with the daily turnover averaging around US$1.14 billion, 3.8 times that recorded in 2006.

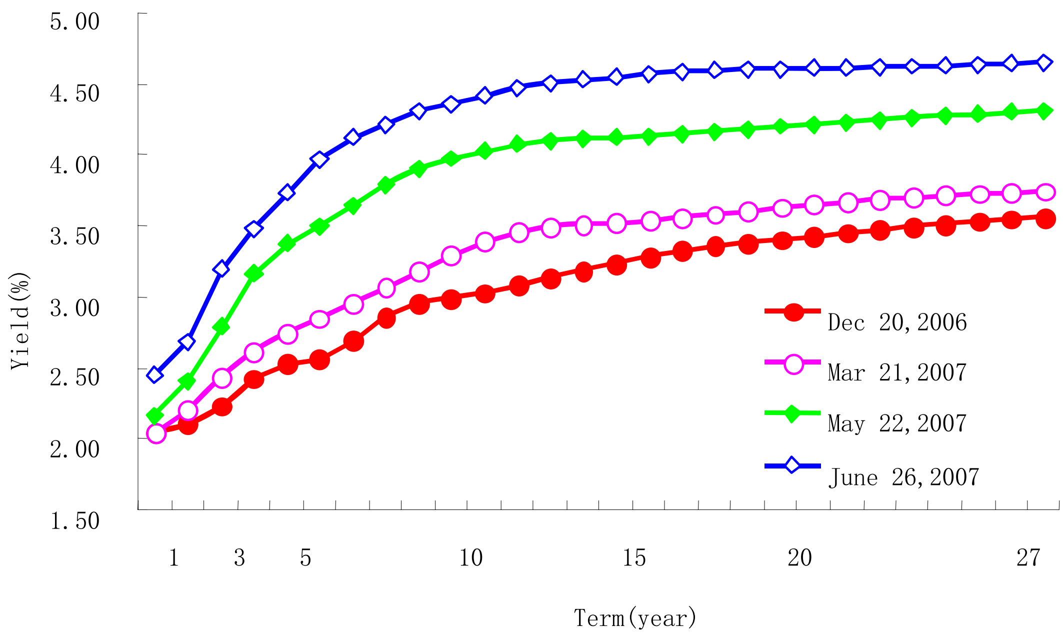
In general, the financial derivative market came to China only recently. Although certain progress has been achieved, it still has several weaknesses. First, financial derivatives have not been diversified. At present, only basic business has been introduced, including bond forwards, RMB interest rate swaps, inter-bank foreign exchange forwards, RMB foreign exchange swaps, etc., and OTC derivatives such as interest rate forward agreements, interest rate options, foreign exchange options, credit default swaps, and exchange derivatives such as futures and options have not yet been launched in the market. Second, the range of investors in financial derivatives has not been wide. The bond forward and RMB interest rate swap that were introduced recently on a pilot basis were provided only to inter-bank bond market investors, and other investors could not hedge risks through these instruments. Third, there is no standard master agreement. International experience indicates that, since derivative transactions are relatively complex and involve large risks, investors normally need to sign a unified standard master agreement when trading derivatives to clarify issues, including default verification and resolution and credit guarantees, etc., so as to lower the credit risks and reduce the transaction costs. At present, there is no standard master agreement in China's financial derivative market, thus hindering the development of the market.

China is now in a transitional period of economic development as reflected in the continuing reform of the RMB exchange rate regime and the deepening market-based interest rate reform. Developing a financial derivative market is conducive for market participants to manage interest rate and exchange rate risks and plays a significant role in preventing and resolving financial risks, safeguarding financial stability, promoting the development of the financial spot market, and improving the transmission mechanism of monetary policy. In the future, the PBC will actively take measures to support the reform of the interest rate and exchange rate system and will promote the development of the derivative market in a vigorous and sound manner.

First, the RMB interest swap will be comprehensively conducted, and research will be carried out to introduce an interest rate forward agreement and other derivatives in the market and to take opportunities to launch a RMB foreign exchange currency swap and credit derivatives. Second, a standard master agreement for OTC derivatives will be formulated to create a favorable legal environment for the development of the derivatives market. Third, efforts will be made to educate investors to enhance their investment awareness and improve their operations. The development of financial derivatives in China has vast prospects and will definitely play an increasingly important role in improving China's financial system.

The inter-bank market bond index and the stock exchanges bond index remained stable in the first half of 2007, accompanied by a rising bond yield across the spectrum. Since April, the bond indices in both the inter-bank market and the stock exchanges moved downward. The bond index in the inter-bank market dropped from 116.8 points at the beginning of 2007 to 113.7 points at end-June. The government securities index on the organized exchanges fell from 111.4 points at the beginning of the year to 109.6 points at end-June. Since the beginning of the year, bond prices on the inter-bank market declined steadily, with the bond yield rising across the spectrum. Affected by multiple factors, such as the interest rate hike and the issuance of long-term government securities, the yield curve of government securities on the inter-bank bond market displayed an overall upward trend. The yield of medium and long-term bonds climbed obviously, with a steeper yield curve.

Figure 3: Yield Curve of Government Securities on the Inter-bank Bond Market in the First Half of 2007



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

Financing activities were brisk in the primary bond market, accompanied by a large issuance of policy financial bonds. In the first half of 2007, a total of 1107.8 billion yuan in bonds (excluding central bank bills) was issued, an increase of 105 billion yuan, or 10.5 percent, from the previous year. In particular, a total of 437.9 billion yuan of policy financial bonds was issued, with a year-on-year increase of 81.7 billion yuan, or 22.9 percent, and continuing to grow at a rapid pace. On June 27, the China Development Bank issued a total of 5 billion RMB bonds in Hong Kong for the first time. The successful issuance of RMB bonds in Hong Kong further expanded the RMB bond market and advanced RMB convertibility under the capital account.

Innovative financial products on the bond market were further diversified. Direct financing by commercial banks expanded, with the stock of commercial bank common financial bonds reaching 89 billion yuan at end-June. A total of 29 billion yuan of subordinate bonds and hybrid capital bonds was issued by commercial banks in the first half of 2007, with the stock reaching 202 billion yuan, which is conducive to supplementing the capital of commercial banks and enhancing their capital adequacy ratio. The short-term financing bill market maintained rapid growth. From January through June, a total of 127 enterprises successfully issued short-term financing bills, worth 153.48 billion yuan, a year-on-year increase of 6.06 percent. At end-June, the outstanding short-term financing bills registered 267.67 billion yuan.

The issue rates of bonds edged up and financing costs continued to rise. The Shibor has become an important indicator in pricing medium and long-term corporate bonds. Affected by expectations of inflation and a series of macro-economic management measures, especially the hike in the deposit and lending rates, the interest rate on 7-year book-entry treasury bonds issued in May 2007 was 3.74 percent, up 0.81 percentage points from February; the interest rate on 5-year fixed rate bonds issued by the China Development Bank rose from 3.5 percent in January to 3.56 percent in April and 4 percent in June, increasing cumulatively by 0.5 percentage points. In the first half of 2007, a total of 30.8 billion yuan of corporate bonds was issued with prices based on the 1-year Shibor, accounting for more than 85 percent of all medium and long-term bonds issued. The issue rates of corporate bonds rose gradually. In June, the issue rate of 10-year corporate bonds increased by 110-115 basis points based on the 1-year Shibor, with the coupon rate ranging from 4.5 percent to 4.98 percent; whereas the issue rate of 15-year corporate bonds grew by 142-160 basis points, with the coupon rate ranging from 4.83 percent to 5.03 percent, accelerating by 55 basis points and 57 basis points respectively from the beginning of the year. The issue rates of short-term financing bills were basically stable, with the issue rates of 1-year financing bills ranging from 3.4 percent to 4.5 percent.

3. Growth of commercial paper financing slowed down

At end-June, a total of 2.9 trillion yuan of commercial bills was issued by the corporate sector, up 8.6 percent year on year; discount bills totaled 5.2 trillion yuan, up 16.6 percent from 2006; and rediscount bills reached 6.18 billion yuan, a year-on-year increase of 5.61 billion yuan. The outstanding balance of commercial paper registered 2.5 trillion yuan, up 7.4 percent from the previous year; outstanding discount bills amounted to 1.8 trillion yuan, down 11.1 percent; and outstanding rediscount bills amounted to 4.91 billion yuan, 4.35 billion yuan more than that in 2006.

In the first half of 2007, the growth of commercial bills slowed down. The monthly average outstanding acceptance of commercial drafts increased by 6 percent year on year, representing a large decrease from the growth of 40 percent a year earlier; the monthly average outstanding discount declined by 5 percent, the first year-on-year decrease since 2001. From January through June, new discount loans amounted to 23.7 billion yuan, 318.4 billion yuan less than in 2006, and accounted for 0.9 percent of all new loans, down 15 percentage points from the previous year.

4. The stock market traded briskly and the index fluctuated at high levels

Due to the unfolding positive effects of the non-tradable shares reform, transactions were active in the stock market and investers had a remarkably strong willingness to invest in the stock and fund markets. In the first half of 2007, 28.61 million new investment accounts were opened, 5.4 times the total in 2006, and market transactions climbed to new highs. The total turnover of the Shanghai and Shenzhen Stock Exchanges hit a record high of 23.7 trillion yuan, 19.9 trillion yuan more than in 2006 and 2.6 times the total in 2006; the average daily turnover increased 5.2-fold to 202.7 billion yuan.

The stock market index fluctuated at high levels. Before the stamp duty was adjusted on May 30, stock indices rose continuously at a rapid pace. The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index soared from 2675 points and 551 points at end-2006 to 4335 points and 1292 points on May 29 respectively, increasing by 62 percent and 135 percent, both reaching their highest levels. As the stock market further surged, market risks accumulated gradually. On May 29, the average P/E ratio of A-shares on the Shanghai Stock Exchange remained over 46, up by 12 and 29 from end-2006 and end-2005 respectively, which was far beyond the P/E ratios of the mature stock markets in the developed countries. Since May 30, due to factors such as the increased risk education provided by the regulatory authorities, enhanced risk awareness of investors, and higher stamp duty, the stock index witnessed large fluctuations at high levels. At end-June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index closed at 3821 points and 1078 points respectively, down 7 percent and 9.2 percent from end-May.

The financing functions of the stock market improved remarkably. In the first half of 2007, a total of 249.7 billion yuan was raised by Chinese enterprises through IPOs, additional offerings, and rights issues on equity markets at home and abroad, reaching a record high and increasing year on year by 73.2 percent. In particular, funds raised on the A-share markets increased by a large margin, reaching 191.3 billion and a growth of 4.2 times year on year; while a total of US$6 billion was raised on the H-share markets.

Fueled by the soaring index and wider recognition of fund products, investors have a rising demand for wealth management products in funds, as reflected in the rapid development of fund markets. From January through June, a total of 29 securities investment funds was launched, and new fund units amounted to 638 billion yuan, 683.1 billion yuan more than the increase recorded a year earlier. At end-June, the net value of the funds reached 1.8 trillion yuan, an increase of 252 percent from the previous year, up 221 percentage points.

5. Assets in the insurance industry expanded rapidly and investment assets accounted for more than 60 percent of the total

The premium income and total assets in the insurance industry grew at a fast pace. In the first half of 2007, the total premium income in the insurance industry amounted to 371.83 billion yuan, up 20.7 percent year on year, an acceleration of 7 percentage points and the fastest growth since 2004, with a large increase in income in life insurance and property insurance. With a large number of life insurance policies coming due, claim payments and benefits increased by 80.2 percent to 115.72 billion yuan. In particular, life insurance payments grew 2.1-fold to 62.72 billion yuan. At end-June, the total assets in the insurance industry reached 2.53 trillion yuan.

With strengthened management of insurance funds, the investment structure changed obviously. Investment assets grew rapidly in the first half of 2007, a year-on-year growth of 53.2 percent. The proportion of investment assets increased remarkably, remaining above 60 percent of the total.

Table 8: Use of Insurance Funds at end-June 2007

	Outstanding balance (RMB100 million yuan)		As a share of total assets (percent)	
	End-June, 2007	End-June, 2006	End-June, 2007	End-June, 2006
Total assets	25347	17341	100	100
Of which, Bank deposits	7537	5667	31.1	33.7
Investment	15539	10141	64.0	60.3

Source: China Insurance Regulatory Commission.

The reform of the insurance market continued to advance steadily and the IPOs of insurance companies made new progress. At present, five Chinese insurance companies are listed both at home and abroad, including the PICC group, Chinalife Insurance Company, Ping An Insurance Company of China, China Insurance International Holdings Company, and Min An Holdings Company. On January 9, 2007, the market capitalization of Chinalife Insurance Company exceeded 1 trillion yuan after its first day of trading on the A-shares market, and it now has the largest market capitalization in the world of any listed insurance company.

6. The inter-bank foreign exchange market performed in a sound manner and RMB swap transactions continued to be active

The inter-bank spot foreign exchange market operated smoothly and the dominant role of the OTC market was strengthened. In the first half of 2007, the turnover in the inter-bank forward market increased by 70 percent year on year to US$10.67 billion, with most transactions in the USD/RMB currency pair. The turnover in the RMB swap market totaled US$133.37 billion, 2.6 times the total over the last nine months of 2006 (launched in April 2006). Most of the transactions were swaps with a maturity of 1 month, accounting for 71.4 percent of the total turnover of RMB and foreign exchange swap transactions. The number of participants in the foreign exchange market further increased. At end-June, the number of members on the inter-bank foreign exchange spot market, forward market, and swap market came to 264, 79, and 73 respectively.

The inter-bank foreign exchange market continued to grow at a fast pace. In the first half of 2007, the combined volume of 8 currency pairs trading on the inter-bank foreign exchange market amounted to US$46.4 billion, up 24.5 percent, with transactions in the major currency pairs of the USD/HKD, USD/JPY, and EUR/USD accounting for 81 percent of the total trading volume, down 7 percentage points from the previous year, mainly due to a large year-on-year decrease in the currency pairs of the USD/HKD.

II. Financial market institutional building

1. The inter-bank borrowing market was regulated in a comprehensive manner

In order to further promote the development of the inter-bank borrowing market, to meet the needs of the market participants, and to support the reform of the Shibor quotation system, on July 3 the PBC issued the Administrative Rules on Inter-bank Borrowing, which entered into force on August 6, 2007. The Administrative Rules on Inter-bank Borrowing regulated the inter-bank borrowing market in a comprehensive manner in terms of market access and exit, transactions and settlement, risk control, information disclosure, and supervision and management, and clearly stipulated the legal liabilities for violations of the rules. The Administrative Rules also adjusted policies in a number of respects. First, restrictions on market access, maturity, and quotas were relaxed. Steps were taken to allow all banking institutions and the majority of non-banking financial institutions to access the inter-bank borrowing market, to simplify the tranches of maturity management, to appropriately extend the longest lending maturity of some financial institutions, and, at the same time, to relax the quota verification standards of most financial institutions. Second, transparency management was strengthened to improve management measures such as ex post monitoring and examination so as to gradually realize market-based management.

2. Price discovery of the inter-bank market was improved and institutional investors were diversified

First, the market-maker system was improved. The Regulations on the Market-Maker System on the Inter-bank Bond Market were issued in January 2007 to improve the present market-maker system framework through various channels, such as lowering market access, easing business requirements, and intensifying policy support and strengthening performance assessment. Hence, the liquidity and price discovery of the market were enhanced and this was conducive to the rapid development of China's bond market. Second, the principle for calculating yields-to-maturity was adjusted. In June 2007, the PBC issued the Notice of the PBC on Improving the Calculation Principle for Yields-to-Maturity in the National Inter-bank Bond Market, and adjusted the principle from "the actual number of days/365" to "the actual number of days/the actual number of days" to calculate the yields-to-maturity more precisely, which is of great significance for improving the yield curve of China's bond market and promoting the price discovery of the financial market. Third, an enterprise annuity fund was introduced in the inter-bank bond market, which was conducive to cultivating and developing institutional investors in the inter-bank bond market.

3. The legal basis of the futures market was consolidated

The newly revised Regulation on Futures Transactions entered into force on April 15, and its supporting rules were revised and improved in a sequenced manner by the CBRC and other departments. At present, a legal framework for the futures market has initially taken shape centering around the Regulation on Futures Transactions, based on the rules and regulations of the CBRC and supplemented by the self-regulatory rules for futures exchanges, the China Futures Margin Monitoring Center, and the China Futures Association.

4. The information disclosure system of listed companies was improved to protect the legitimate rights of investors

First, the Regulations on Information Disclosure of Listed Companies were released by the CBRC to improve the rules and supervisory procedures for information disclosure, to specify and regulate information disclosure, and to further enhance the quality of information disclosure, the effectiveness of supervision, and the transparency of the information disclosure of listed companies. Second, an investor protection fund system was implemented, and the Implementing Rules on the Payment of the Investor Protection Fund by Securities Firms were released to protect the legitimate rights of investors. Third, the regulations on the senior management of listed companies were strengthened and the Rules on the Management of Shares Held by Directors, Supervisors, and Senior Executives of Listed Companies and the Share-Holding Changes were issued to concretely safeguard order in the securities market.

5. Corporate governance of insurance companies was regulated and risk management of insurance institutions was strengthened

The CIRC issued four supporting rules, including the Guidelines on Regulating the Corporate Governance of Insurance Companies, to urge and guide insurance companies to gradually establish an independent director system, improve the organizational structure of internal auditing and risk management, submit reports on internal control assessment, risk management, and compliance, and set up an internal management system on related trading. In addition, the Guidelines on the Emergency Management of Major or Unexpected Events in Insurance Asset Management were released to regulate the monitoring, early warning, emergency resolution, and reporting system of major and unexpected events regarding insurance assets management, so as to further enhance the risk awareness of insurance institutions and to build and improve risk monitoring and an early warning mechanism in asset management.

Part 4 Macro-economic Analysis

I. Global Economic and Financial Development

Since the beginning of 2007, the world economy has maintained a momentum of steady growth, but inflationary risks have intensified. The U.S. economy picked up in Q2 after a modest slowdown in Q1. The Euro area and Japan both witnessed sound growth, while the major emerging market economies and developing countries maintained fairly rapid growth. The international debt market and foreign exchange market were basically free of any large turbulences, and the stock markets gradually recovered after the slump on February 27. The prices of crude oil moved up continuously. At the moment, the world economy faces the following risks: growing trade imbalances and intensified trade frictions, stronger trade protectionism, fluctuating and high crude oil prices, more risks of stock market and real estate bubbles, and stronger inflationary pressures. In July, the IMF revised its April projection of world economic growth from 4.9 percent to 5.2 percent, 0.3 percentage points lower than the real growth rate registered in 2006. Among the revisions, the U.S. growth rate was reduced from 2.2 percent to 2.0 percent, 0.9 percentage points lower than the real growth in 2006; the growth of the Euro area was increased from 2.3 percent to 2.6 percent, 0.2 percentage points lower than the real growth in 2006; growth in Japan was revised upward from 2.3 percent to 2.6 percent, 0.4 percentage points more than the real growth in 2006.

1. Development of the Major Economies

The U.S. economy picked up in Q2 after a slight moderation in Q1. The annualized growth after seasonal adjustments was a mere 0.6 percent in Q1, but it rebounded to 3.4 percent in Q2 (a year-on-year growth of 1.5 percent and 1.8 percent respectively). Due to obviously higher energy and food prices, inflationary pressures intensified, as reflected in the month-on-month rates of 2.6 percent, 2.7 percent, and 2.7 percent (an average of 2.7 percent), an acceleration of 0.3 percentage points over Q1. The employment situation was stable, with the Q2 unemployment rate roughly unchanged from Q1 at 4.5 percent, a reduction of 0.1 percentage points year on year. In the first five months, trade in goods and services registered a deficit of US$295.5 billion, a reduction of US$22.3 billion yuan year on year. The fiscal deficit declined significantly, with the deficit in the first nine months of FY2007 (starting from October 1, 2006) totaling US$121 billion, a decrease of 41.4 percent from the same period of the previous fiscal year (which was US$206.5 billion).

Growth in the Euro area was stable. In Q1, real GDP grew 3.1 percent year on year. Inflationary pressures remained evident, with the monthly HICP rising 1.9 percent year on year in Q2, roughly on par with that in Q1. Employment improved, and the unemployment rate declined month after month from 7.3 percent in January to 6.9 percent in June. Export growth accelerated. In the first five months, the Euro area registered a trade surplus of 3.8 billion Euro, as compared with a deficit of 19.6 billion Euro in the corresponding period of the last year.

The Japanese economy continued to expand. In Q1, real GDP grew by 2.6 percent year on year. Prices were generally stable, as the monthly CPI in Q2 was up 0 percent, 0 percent, and minus 0.2 percent in April, May, June respectively year on year, averaging minus 0.1 percent, roughly the level in Q1. Employment improved, with the monthly unemployment rate registering 3.8 percent, 3.8 percent, and 3.7 percent respectively, averaging 3.8 percent, a decrease of 0.2 percentage points and 0.3 percentage points respectively from that in Q1 2007 and Q1 2006. In the first six months, the trade surplus expanded by a significant amount of 1.9 trillion Yen year on year to 5.1 trillion Yen.

The major emerging market economies and developing countries were on a stable course for growth, yet under stronger inflationary pressures. Driven by both domestic demand and external trade, the emerging market countries in Asia registered robust growth, while steady growth continued in Latin America.

2. Financial market developments

Since the beginning of this year, the exchange rates of the major currencies moved modestly. The US Dollar weakened against the Euro but gained against the Yen. On June 29, the Euro to Dollar and Dollar to Yen exchange rates closed respectively at 1.35 Dollar per Euro and 123.14 Yen per Dollar, indicating a depreciation of the Dollar against the Euro by 2.59 percent and an appreciation of the Dollar against the Yen by 3.44 percent since the beginning of 2007.

The returns of major international bonds rebounded steadily since the beginning of the year. On June 29, the returns of ten-year government securities in the U.S., Euro area, and Japan closed at 5.03 percent, 4.56 percent, and 1.87 percent respectively, up 0.34, 0.61, and 0.15 percentage points from the beginning of 2007.

The major stock indices fluctuated. In the period up to February 26, the major indices rallied rapidly, but they experienced large slumps on February 27, followed by a gradual recovery. On June 29, the Dow Jones Industrial Average closed at 13409 points, up 7.49 percent from the beginning of the year; the NASDAQ closed at 2603, up 7.43 percent; the STOXX50 closed at 3974, up 5.34 percent; and the Nikkei 225 closed at 18138, up 4.52 percent.

In the first half of 2007, due to growth expectations in the U.S. and other factors, the dollar Libor moved up amid fluctuations and reached a semi-annual high of 5.51 percent on June 15 before falling back to 5.43 percent on June 29, up 0.1 percentage points from the beginning of 2007. Against the background of the ECB rate hikes, the Euro Libor continued the 2006 momentum and edged up slowly, reaching 4.53 percent on June 29, up 0.4 percentage points.

3. Monetary policy in the major economies

Since the beginning of 2007, the Federal Open Market Operations Committee kept the

Fed funds target rate unchanged at 5.25 percent. The ECB raised the interest rate for the main refinancing operations by 25 basis points on March 8 and June 6 respectively to 4.0 percent. The Bank of Japan raised the unsecured overnight call rate by 25 basis points to 0.5 percent. The Bank of England raised the official interest rate by 25 basis points on January 11, May 10, and July 5 respectively to 5.75 percent.

Box 4: Views of Foreign Central Bank Officials on Monetary Policy and Asset Prices

Most central banks take price stability as the main objective of their monetary policy. Since the 1990s, economies throughout the world have displayed a new feature, i.e., increased asset price volatility even though consumer prices have been somewhat under control. The asset market channel transmits monetary policy and monetary policy instruments have an impact on financial markets, including the asset market, causing the prices and yields of financial assets to change and ultimately to affect the behavior of enterprises and households in the economy. An unstable asset market is unable to perform the various functions of resource allocation and price discovery, and might become a source of macro-economic instability and price swings. Therefore, there has been a heated debate within various circles, especially among central bankers, as to whether the asset price should become a monetary policy target, and whether there should be a monetary policy response to asset price fluctuations.

1. Asset prices are not a monetary policy target

Federal Reserve Chairman Ben Bernanke said in 1999 that asset prices should not become a monetary policy target. The reason is that a central bank does not usually know what has caused an asset price movement, fundamentals, non-fundamentals, or both. On the non-fundamental side, there are at least two sources. First, due to the absence or lack of financial regulation, a government may provide too many financial guarantees, thus spurring excessive lending growth and excessive financial asset inflation and ultimately causing a crash; second, irrational behavior on the part of investors, such as over optimism, short-sightedness, or herding behavior, may give rise to frequent and large fluctuations in financial asset prices.

In 2004, the ECB’s vice president Otmar Issing listed four reasons for not having asset prices as a target of monetary policy. First of all, there is no a plausible empirical model to assess the “reasonable value” of an asset price, and it is difficult to determine if there is “deflation or inflation” in asset prices; second, as a central bank does not have any advantage in obtaining asset price information and assessing asset prices, the inclusion of asset prices in monetary policy targets will make it difficult to implement monetary policy; third, the impact that a central bank can have on asset prices, if any, is, at most, indirect and limited. Fourth, if a central bank attempts to affect asset prices, for example by administering a stimulus policy to a sluggish stock market, it may trigger moral hazards in the stock market. ECB President Claude

Trichet expressed similar views in a speech in 2005. He pointed out that decision makers should not fall into the trap of trying to remove all risks in the financial system, for this would either prove to be futile because of moral hazards, or would hamper the proper functioning of the market, as the essence of the market is to take risks.

2. Monetary policy should look at asset prices

According to Bernanke, whether or not a central bank should respond to asset price movements depends on whether such movements bring about inflationary or deflationary pressures to the overall economy. When asset price fluctuations have not brought such pressures, it is neither necessary nor appropriate for monetary policy to respond; when asset price fluctuations show a sign of bringing inflationary or deflationary pressures, a monetary policy response is necessary to ease such pressures. A central bank should look at price stability and financial stability as highly complementary targets, but financial stability does not necessarily mean stability in financial asset prices.

On June 16, 2007, President Toshihiko Fukui of the Bank of Japan said in a press interview that the Bank of Japan closely follows the development of the capital markets, especially the asset prices, in formulating and implementing monetary policy; though at the moment there were no substantive risks due to elevated asset prices, it was necessary to learn from past lessons and to prevent potential risks. On June 16, 2006, President Lee Seongtae of the Bank of Korea said that if monetary policy makers looked only at price stability, other factors that might undermine overall economic stability might be neglected. As revealed by the asset price bubbles in Japan in the 1980s, low inflation is not always a guarantee of financial and macro-economic stability.

Trichet pointed out that money and credit expansion are related to asset price inflation and a comprehensive monetary analysis helps to discover risks to medium- and long-term price stability. The practice at the ECB is to closely follow the movements of asset prices and their impact on the real economy through monetary analysis. According to reports released by the Bank of England, asset price information is among the important factors that its Monetary Policy Committee considers in judging inflation prospects; but the relationship between asset prices and inflation should be analyzed based on the actual situation.

4. Major risks in the global economy

As global imbalances developed and widened, countries became worried about competition from the emerging market economies and trade protectionism gained further ground. On June 13, the U.S. Treasury Department released its latest Exchange Rate Policy Report and explicitly stated, for the first time ever, that the RMB was undervalued. On July 26 and August 1, the U.S. Senate Finance Committee and the

Senate Committee on Banking, Housing, and Urban Affairs adopted the Currency Exchange Rate Oversight Reform Act of 2007 and the Currency Reform and Financial Markets Access Act of 2007 respectively. These acts will serve to strengthen the trends toward trade protectionism originating in the U.S. and will cause these trends to spread quickly. With the further development of economic globalization, trade frictions among trading partners are a normal phenomenon. But, the rapid spread of trade protectionism is not good for the sustained and sound growth of the world economy, or for the orderly unwinding of the global imbalances.

The global geopolitical situation may witness more volatility. If the geopolitical situation continues to worsen in the Middle East, international oil prices will rebound drastically. Since the beginning of 2007, international crude oil prices have climbed steadily. On August 1, NYMEX crude oil future prices reached a new high of US$78.77 per barrel.

The worsening of problems in the U.S. sub-prime mortgage market triggered worries about the outlook for the U.S. economy. The sub-prime mortgage loans are mortgage products offering low interest rates in the short term but high rates in the medium term that are provided to borrowers with low credit scores or low income levels. Due to the high risks of such loans, their interest rates are high. For a variety of reasons, the default rate of the sub-prime market hit record highs and housing sales continued to decline. At end-June, the interest rate on 30-year mortgage loans was 6.74 percent, the highest in almost a year. In Q1, housing prices in the U.S. moved up by 0.5 percent year on year, the smallest growth in almost ten years. By the beginning of August, more than 30 sub-prime mortgage companies had ceased operations. In addition, the problems in the sub-prime mortgage institutions also affected institutions holding such loans and their derivatives, such as mutual funds, hedge funds, large banks, and insurance companies. In the middle of July, Chairman Bernanke said in the Second Monetary Policy Report to the Congress before the Senate Committee on Banking, Housing, and Urban Affairs that the losses caused by the sub-prime mortgage market were estimated to be between US$50 billion and US$100 billion. If the sub-prime mortgage problems continue to spread, they may have a fairly large impact on economic growth and financial stability in the U.S.

In addition, the impact of the Yen carry trade and its unwinding on international financial markets merits our attention. Yen carry trade refers to the activities of borrowing Yen (whose interest rate is low), converting it into currencies with high interest rates, and making investments in such currencies. Recently, due to the rate hikes by the major central banks and the persistent low rate in Japan, and the subsequent large spread between the Yen and other developed nations and the emerging Asian countries, the Yen carry trade has been brisk and growing in size. Due to exchange rate and interest rate expectations and the risk premium change, there may be a large volume of position squaring in the Yen carry trade, bringing risks to the international financial market. At the same time, the Yen has weakened against the major currencies and Japan’s trade surplus has widened by a large margin.

II. Analysis of China's macro-economic performance

In the first half of 2007, the Chinese economy maintained a momentum of steady and rapid growth and the overall situation was good. Consumption expanded at an accelerated pace, agricultural sector performance was sound, the 1efficiency of the overall economy continued to pick up, and the people's livelihood continued to improve. In the period under review, the GDP reached 10.7 trillion yuan, up 11.5 percent year on year, an acceleration of 0.5 percent compared with the same period of last year; the CPI was up 3.2 percent year on year, 1.9 percentage points higher than the same period of last year; the trade surplus registered US$112.5 billion, up US$51.1 billion from the same period of last year.

1. Consumption growth accelerated, investment growth remained high, and the trade surplus expanded further

Household disposable income made fresh gains, and domestic demand remained strong. In the first half of 2007, the per capita disposable income of urban residents was up 14.2 percent in real terms to 7052 yuan, an acceleration of 4 percentage points over the same period of last year; the per capita cash earnings of rural residents were up 13.3 percent in real terms to 2111 yuan, an acceleration of 1.4 percentage points and 1.2 percentage points over the same period of last year and the first quarter of this year respectively. Strong income growth, faster consumption upgrading, and other factors supported the expansion of consumer demand. In the first half of 2007, the total volume of retail sales reached 4.2 trillion yuan, up 15.4 percent year on year, an acceleration of 2.1 percentage points over the same period of last year, a new high since Q1 1997. Although urban consumption was still the pillar of the rapid consumption growth, rural consumption accelerated, leading to a smaller differential between the two growth rates. In the total volume of retail sales, the share of urban residents was up 15.9 percent to 68 percent; the share of residents living in counties and administrative areas below the county level was up 14.3 percent to 32 percent, an acceleration of 2.3 percentage points. The differential between the two growth rates was 1.6 percentage points, 0.8 percentage points lower than that during the same period of last year.

The fixed asset investment structure improved modestly, yet its growth rate remained high and under pressures of rebounding. In the period under review, fixed asset investment grew by 25.9 percent to 5.4 trillion yuan, a deceleration of 3.9 percentage points from the same period of last year but an acceleration of 2.2 percentage points from Q1. Regarding the improvement in the investment structure, rural investment growth made a larger gain than urban investment, with urban investment up 26.7 percent year on year and accelerating by 1.4 percentage points, and rural investment up 21.5 percent and accelerating by 4.8 percentage points; investment in the central and western regions grew faster (by 35.6 percent and 22.3 percent respectively) than that in the eastern region (by 22.3 percent); moreover, some high energy-consuming industries witnessed slower growth in fixed asset investment, whereas the equipment manufacturing sector saw rapid growth.

Foreign trade performance was stable, but the growth of exports remained higher than the growth of imports and the trade surplus continued to widen. In the first half of 2007, the total import and export volume went up by 23.3 percent, roughly the same as during the same period of last year, to US$980.9 billion. Within this total, exports grew by 27.6 percent, an acceleration of 2.4 percentage points from the same period of last year, and imports grew by 18.2 percent, a deceleration of 3.1 percent. As a result of persistently higher export growth than import growth, the trade surplus became larger, reaching US$112.5 billion, representing a year-on-year growth of 83.1 percent and an acceleration of 27.9 percent. In addition to low resource prices and low labor costs, another factor behind this ballooning surplus was enterprises rushing to export before the tax rebate policy adjustment took effect.

2. All three industries registered fast growth, with tertiary industry taking the lead

In the first half of 2007, the added value of primary industry grew by 4 percent year on year to 0.9 trillion yuan, a deceleration of 1.1 percentage points over the same period of last year; the added value of secondary industry was up by 13.6 percent to 5.5 trillion yuan, an acceleration of 0.4 percentage points; the added value of tertiary industry reached 4.2 trillion yuan, up 10.6 percent, an acceleration of 1.2 percentage points.

Agricultural production had another bumper harvest, as the output of summer grain reached an all-time high. According to preliminary statistics, the total summer grain output grew by 1.3 percent to 1.2 trillion tons, the fourth consecutive year of a bumper harvest. Another good year of early rice output is also expected. The sown area of cotton expanded further, and the quality of agricultural produce improved season after season. The producer price of agricultural goods (the price at which a producer sells his/her produce) was up 8.8 percent, a margin larger than the factors of agricultural production and good for encouraging farmers to increase their output.

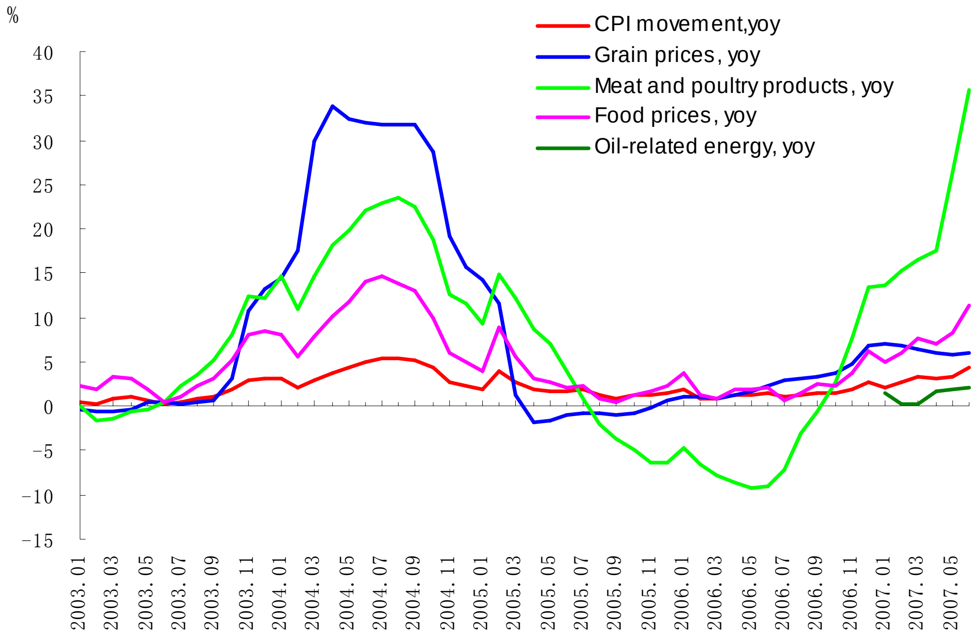
The growth of industrial production accelerated, and enterprise returns went up higher. In the first half of 2007, the added value of the statistically large enterprises climbed 18.5 percent, an acceleration of 0.8 percentage points. Enterprise profits surged. In the first five months, profits of the statistically large enterprises totaled 902.6 billion yuan, up 42.1 percent and an acceleration of 16.6 percentage points; the ratio of sales income to profits was 6.34 percent, up 0.66 percentage points over the same period of last year. The Quarterly Survey of 5000 Enterprises by the PBC indicates that 32.4 percent of the surveyed enterprises evaluated their overall business operations as good, up 2.1 percentage points and 5.2 percentage points respectively over the previous quarter and the same period of last year.

3. Inflationary pressures continued to build up

Consumer prices moved up by a larger margin. Due to the surge in the prices of grain, meat, and poultry products, the CPI was up 3.2 percent year on year in the first half of 2007, an acceleration of 1.9 percentage points. To be more specific, the CPI was up

2.7 percent and 3.6 percent respectively in Q1 and Q2. Food price hikes drove the CPI up, while non-food prices remained relatively stable. In the first half of 2007, food prices were up 7.6 percent, pushing the CPI up by 2.5 percentage points; non-food prices were up 1 percent, pushing the CPI up by 0.7 percentage points. Among non-food items, oil and energy items increased 1.4 percent, contributing fairly little to the increase in the CPI. The prices of consumer goods increased more than the prices of services, but the latter have tended to move up since the beginning of this year, a trend worthy of our attention. In the period under review, the prices of consumer goods grew 3.6 percent, driving the CPI up by 2.8 percentage points, while the prices of services grew 0.4 percent, moving the CPI up by 0.4 percentage points. As for the contribution of base period factors and new hike factors, base period factors made a larger contribution, but new price hike factors had a larger year-on-year growth in the period under review. In the first half of 2007, base period factors were 1.7 percent, up 1.5 percentage points from the same period of last year; new price hike factors were 1.5 percent, up 0.4 percentage points.

Figure 4: The CPI: Year-on-year Movements since 2003



Source: National Bureau of Statistics.

Many factors worked together in this round of price hikes, including cost, demand, and structural factors. Based on a statistical analysis, the food price hike was the driving force behind the CPI growth, with grain prices up 6.4 percent, meat, poultry and their products up 20.7 percent, and fresh eggs up 27.9 percent. In fact, the rapid increase in food, meat, and poultry product prices started to rise quickly in November 2006; later on, grain prices gradually stabilized after the adoption of a series of policy measures, whereas the prices of meat, poultry, and their products reached new highs after April 2007. At the moment, the higher prices of grain, meat, poultry, and their products have gradually passed to lower-stream industries such as food processing and catering. Therefore, it is necessary to pay attention to the price contagion and prevent across-the-board price hikes.

Box 5: Core Inflation

Core inflation refers to the underlying inflation after the temporary factors in price movements are excluded; it is an indicator reflecting general price trends. For many central banks, core inflation is an important indicator, usually measured by some general inflation indicators after excluding items whose prices are volatile, such as food, energy, indirect taxes, and costs of mortgage loans (usually the interest rates of such loans). Food and energy are usually excluded from core inflation as well. In some countries, these items are not excluded, but are assigned weights based on their price volatility. Items with a larger volatility receive a smaller weight. Core inflation indicators include the core CPI, core PPI, core PCE (prices of consumer expenditures), etc. The Federal Reserve uses the PCE (excluding food and energy) and CPI (excluding food and energy); the Bank of Japan uses the CPI (excluding fresh food); and the European Central Bank uses the CPI (excluding unprocessed food and energy).

Table 9: An International Comparison of Weights in the CPI Basket

	U.S.	Euro Area	Japan
Per Capita National Income in 2006(US$)	44970	34149	38410
Consumer Goods	40. 3	59. 2	49. 4
Services	59. 7	40. 8	50. 6
Food	13. 9	19. 6	24. 5
Fresh food			4. 1
Unprocessed food		7. 6	
Housing	42. 7	10. 2	20. 4
Energy	8. 7	9. 6	7. 4
Excluding food and energy	77. 4		68. 1
Excluding unprocessed food and energy		82. 8	
Excluding fresh food			95. 9

Notes: 1. Food: food in the U.S. and Japan includes beverages (but not liquors); food in the Euro area includes cigarettes and liquors. In China, if cigarettes and liquor are included in food, the weight of food will be about 37 percent.

2. Energy usually includes power, natural gas, petroleum products, etc.

Sources: Home pages of the statistical institutions and the central banks.

Monetary policy makers look at core inflation because food and energy price changes are often caused by supply shocks, such as a reduction in the OPEC oil supply and agricultural produce output losses due to climate reasons. The impact of such shocks is either quickly reversed or temporary, and will not alter the long-term trends in prices. In addition, food and energy hikes caused by supply shocks might reduce output and employment. If an upward adjustment of the interest rate is applied to address inflation, it may trigger further contraction of output and employment. Therefore, many believe that core inflation is a better measure than general inflation of the underlying inflation.

In recent years, with global food and energy prices going up, the core inflation rate and the general inflation rate have displayed different trends. The central banks of the major economies have been increasingly questioned about their attention to core inflation, and some economists and central bank officials have expressed the view that if you look only at core inflation, you might end up underestimating the inflationary risks. First, food and energy prices might not be reversed within a short period, and their movement might have a second-round effect on other prices, especially in the developing countries. Second, if monetary policy does not pay attention to elevated food and energy prices, this might give rise to household inflationary expectations, affecting the credibility of monetary policy and working against the central bank's efforts to control inflation. Third, useful information on future price trends can be drawn from energy and food price movements. Excluding them from the price index all together does not help to properly understand and judge the trends in inflation. It is worth mentioning that in recent years some inflation-targeting central banks have switched their targets from the core CPI to the general CPI. Even the Federal Reserve that has stressed core inflation has started to attach importance to overall inflation.

At the moment, core inflation statistics are not released in China. While looking at the overall CPI, the PBC also follows the changes in every item. Given the actual situation in China, any analysis of the price situation should, in addition to looking at the core CPI, also pay attention to the impact of food prices. Unlike a developed country, China's Engel's coefficient remains fairly high, and food prices have a weight of about 30 percent in the CPI basket. Looking at past statistics, grain price fluctuations have been the driving force behind the CPI changes. Between 2003 and 2006, the year-on-year change in grain prices ranged between 2.3 and 10.0 percent, whereas non-food prices remained fairly stable, up between 0.02 percent and 1.23 percent year on year. Excluding food, the CPI was up between 0.0 and 0.8 percent year on year. Climbing or persistently high food prices will shove up the cost of living, feed inflationary expectations, and may cause cost-pushing inflation. Moreover, higher food prices in China are closely related to grain prices. The latter are not only affected by the climate and natural disasters, but also by the shrinking farming areas and the shrinking agricultural labor force, as well as by the rising demand for grain in the industrial sectors. Such information is of significance to monetary policy.

The producer prices of industrial goods increased at a stable pace whereas the purchasing prices of raw materials, fuel, and power moderated, leading to a smaller differential between the two. In the first half of 2007, the producer prices of industrial goods moved up 2.8 percent year on year, an acceleration of 0.1 percentage points compared with the same period of last year. The purchasing prices of raw materials, fuel, and power were up 3.8 percent year on year, a deceleration of 2.3 percentage points. The producer price of agricultural products surged by 8.8 percent year on year, an acceleration of 8.6 percentage points. The prices of the factors of agricultural production rose by 5.2 percent year on year, an acceleration of 3.9 percentage points.

The prices of imports and exports increased rapidly. In June, import and export prices were up 6.6 percent and 8.1 percent year on year respectively, an acceleration of 6.0 and 4.4 percentage points compared with the same period of last year. Due to the removal and reduction of the export tax rebate, the export tariff on high energy-consuming, highly polluting, and natural resource goods, and other policies, the terms of trade improved. In June, the index of the terms of trade was 101.4. Analysis based on both economic theory and empirical evidence in various countries supports the view that a stronger currency helps arrest domestic inflation, in terms of adjusting the domestic price of imports and improving the terms of trade. Although there is a time- lag in the adjustment, changes in the nominal effective exchange rate will have a visible impact on the retail price index and the producer price index in the long run.

Labor compensation rose quickly. In the first half of 2007, the average salary of employees in urban units was up 18.5 percent to 10,990 yuan. In particular, the average salary of employees in state-owned units posted 11,790 yuan, up 20.4 percent; that of employees in collectively-owned units was 6,552 yuan, up 17.7 percent; and that of employees in other units was 10,581 yuan, up 15.5 percent.

The GDP deflator edged up. In the first half of 2007, with the nominal GDP growth at 15.6 percent and real growth at 11.5 percent, the GDP deflator (the nominal GDP growth minus the real growth) was 4.1 percent, up 1.6 percentage points.[2]

Since the beginning of the year, the price reform for refined oil, electricity, water, and other natural resource goods has gradually deepened, and has played a large role in promoting the transformation of the growth pattern, energy conservation, and emission reductions. In July, the Ministry of Finance and the General Administration of Taxation decided to adjust the criteria for the amount of the natural resource tax to be paid on lead and zinc ore, copper core, and tungsten ore and raised the natural resource tax rate on products of these ores by between 3- and 16-fold, the largest adjustment since the adoption of the natural resource tax in 1994. Despite the recent food price increase and the large spike in the consumer price index, speeding up the natural resource and environment-related price reform helps reverse the excessive reliance of growth on natural resource and energy consumption, promotes the smooth

[2] According to recently revised GDP figures released by the National Bureau of Statistics, the GDP deflator in the first half of 2006 was 2.6 percent, a downward revision of 0.8 percentage points.

process of energy conservation and emission reductions, and brings down the trade surplus. Therefore, in general this is in the interest of sustainable economic growth and should be carried out in a firm and steady manner.

4. Fiscal revenues and expenditures

In the first half of 2007, total fiscal revenues (excluding debt income) totaled 2.6 trillion yuan, up 30.6 percent year on year and an acceleration of 8.6 percentage points compared with the same period of last year; fiscal expenditures amounted to 1.8 trillion yuan, up 22.7 percent and an acceleration of 5.2 percentage points. Netting revenue and expenditures, fiscal revenues exceeded expenditures by 819.8 billion yuan, 279.3 billion yuan more than during the same period of last year. The rapid growth of fiscal revenues was supported by substantially higher profit gains of enterprises, stamp duty revenue from brisk trading in the stock market, and significant increases in local tax revenue due to the strengthening of local taxation efforts and policy adjustments.

5. The BOP remained in surplus

In the first half of 2007, the balance of payments still registered a large surplus. At end-June 2007, the official foreign exchange reserves were up 41.6 percent year on year to US$1332.6 billion, an increase of US$266.3 billion from the end of 2006 and US$144 billion more than the increase during the same period of last year.

In the period under review, a total of US$31.9 billion was utilized as FDI (foreign direct investment), up 12.2 percent year on year. The structure of foreign investment continued to improve, as reflected in the sharp increase in investment in the services trade, the decline of investment in the manufacturing sector, and the higher growth of investment in the central and western regions.

The size of China’s net external assets expanded further. At the end of 2006, with external financial assets totaling US$1626.6 billion (up 33 percent compared with the end of 2005), and external financial liabilities of US$964.5 billion (up 21 percent), net external assets registered US$662.1 billion, up 57 percent compared with the end of 2005, accounting for 25 percent of GDP.

6. Industrial analysis

The first half of 2007 saw positive developments in the industrial structural adjustment as a result of various macro-economic management measures. First, the growth of output, investment, and exports of some high energy-consuming, highly polluting, and natural resource goods moderated; second, the rapid increase in the supply of coal and power eased the shortages in the supply of energy and provided better support for economic growth. In the first half of 2007, the output of raw coal, electricity, and crude oil was up 11.4 percent, 16 percent, and 1.7 percent respectively year on year. Third, with the policy environment for independent innovation improving and greater incentives for enterprise innovation, the increase in output of new industrial products accelerated by 3.5 percentage points year on year; the independent development of major equipment proceeded smoothly and the added value of the machinery industry went up 23.9 percent year on year.

(1) The real estate sector

Since the beginning of 2007, the demand for housing remained strong. Despite faster growth of investment in real estate development, the supply and demand relationship was still tight and housing prices displayed a momentum of accelerated growth. Housing prices in some cities rose quickly.

The growth of investment in real estate development picked up and the structure of investment improved. In the first half of 2007, investment in real estate development totaled 988.7 billion yuan, up 28.5 percent and an acceleration of 4.3 percentage points over the same period of last year, 2.6 percentage points higher than the growth of fixed asset investment. In particular, investment in commercial residential housing increased 30.8 percent and amounted to 70.3 percent of the total development investment, up 1.2 percentage points compared with the same period of last year. Within investment in commercial residential housing, investment in economic housing grew 34.4 percent year on year and accounted for 4.2 percent of residential housing investment, 0.1 percentage points higher than during the same period of last year.

The increase of completed areas was smaller than that of sold areas, leading to a reduction in vacancies. In the first half of 2007, the area of sold commercial housing grew 21.5 percent to 280 million square meters; the area of completed housing was up 11.1 percent to 150 million square meters; the latter was lower than the former by 10.4 percentage points, but was higher by 3.9 percentage points than during the same period of last year. The area of completed residential housing was smaller than that of sold residential housing for 30 consecutive months. At end-June, the area of commercial housing vacancies was up 2.3 percent year on year to 120 million square meters; in particular, the area of commercial residential housing declined by 2.3 percent to 65.62 million square meters.

The growth of housing prices picked up, and housing prices in some cities went up by a fairly large margin. In June, housing prices in 70 cities were up 7.1 percent year on year, an acceleration of 0.7 percentage points from the previous month. In particular, Shenzhen, Beijing, and several other cities saw even larger increases. In Shenzhen, the year-on-year growth was over 10 percent for 17 consecutive months, reaching 15.9 percent in June 2007; in Beijing, the year-on-year growth was over 8 percent for 14 consecutive months, reaching 9.5 percent in June 2007.

There were sufficient funds for real estate development, and the use of foreign investment grew rapidly. In the first half of 2007, a total of 1561.8 billion yuan was placed in real estate investment, up 27.8 percent, but decelerating by 1.3 percentage points from the same period of last year. In particular, with a combined share of 76.1 percent, up 28.4 percent and 26.9 percent respectively, self-raised funds and other funds were the major sources of real estate development investments; with a share of

22.1 percent, domestic lending increased by 25.9 percent, down 30.5 percentage points from the same period of last year; with a share of 1.8 percent, the use of foreign investment surged by 68.7 percent, an acceleration of 36.2 percentage points from the same period of last year.

Lending to commercial housing projects increased with some acceleration, while trust lending by housing provident funds grew rapidly. At end-June, outstanding loans to commercial housing projects totaled 4.3 trillion yuan, up 24.5 percent year on year and an acceleration of 3.9 percentage points. In particular, outstanding real estate development loans reached 1.7 trillion yuan, up 25.6 percent year on year and a deceleration of 3.3 percentage points; outstanding commercial housing purchase loans posted 2.6 trillion yuan, up 23.9 percent and an acceleration of 8.0 percentage points. Since the beginning of 2007, individual housing purchase loans grew faster month after month and growth in June represented an acceleration of 4.8 and 4.6 percentage points from that at end-January and that at the end of Q1 respectively. In addition, housing provident fund trust lending grew fairly rapidly, with the outstanding volume reaching 400.26 billion yuan at end-June, up 31.9 percent year on year and 7.1 percentage points higher than that of individual housing purchase loans.

At the current stage of development, the rapid growth in housing demand is a somewhat normal phenomenon. First, as a result of economic growth, the sharp increase in the disposable income of urban residents has directly boosted the housing demand; second, sweeping urbanization and the influx of the rural population into cities and towns have expanded the housing demand; third, due to expectations of rising housing prices and an irrational housing purchasing mentality, demand to purchase housing by households has been released within a fairly short time, adding to the upward pressures; further still, due to the lack of investment channels, the household demand for housing as an investment tool has ballooned; fourth, given the shortage of housing supply and the slow pace of structural adjustments, the gap in supply and demand remains large. Therefore, it is necessary to fully understand the housing market in China, strengthen coordination among various policies, beef up supply, guide demand, stabilize housing prices, improve the housing security system, and promote social equity and harmony.

(2) High energy-consuming industries

High energy-consuming industries usually refer to the six sectors of iron and steel, non-ferrous metals, building materials, power, oil processing and coking, and chemical industries. These six industries account for more than 70 percent of the total industrial energy consumption in China. Since 2003, due to the elevated growth rate and the accelerated expansion of high energy-consuming industries, their energy consumption has increased sharply. In response, the government adopted a series of policy measures to exercise macro-economic management over some of these industries and to speed up their structural adjustment. As a result, the excessive expansion of high energy-consuming industries was somewhat contained. Yet, since the beginning of 2007, due to the easing of the domestic energy supply and demand, the practice of offering favorable local policies to attract investment, and stronger profits in the high energy-consuming industries, the blind expansion of these industries has regained momentum in some regions. Production of high energy-consuming industries increased sharply, investment remained high, and exports of some high energy-consuming products accelerated. In the first half of 2007, the added value of the six industries rose 20.1 percent, an acceleration of 3.6 percentage points compared with the same period of last year; their export value moved up by 38.6 percent, an acceleration of 23.9 percentage points. As the profits of high energy-consuming industries have increased by many times, market forces driving their expansion are still strong and investment has gone up quarter after quarter. In Q2, total investment in the six industries was up 24.1 percent, an acceleration of 4.3 percentage points over Q1.

Blind expansion of high energy-consuming industries has exacerbated shortages of energy supplies, environmental pollution, and trade imbalances. Therefore, economic and legal measures, in combination with necessary administrative measures, should be taken to intensify the structural adjustment of the high energy-consuming industries, to adopt more stringent market-access standards, to continue to control the exports of high energy-consuming and highly polluting products as well as natural resource products, to steadily promote natural resource and environmental pricing reforms, and to achieve sustainable economic development. The financial sector should always place special importance on financial services for energy conservation and emission reductions, strengthen the awareness of financial institutions of their social responsibility in terms of environmental protection, energy conservation, and emission reductions and risk prevention, and remain on the alert against the credit risks of backward enterprises (high energy-consuming, highly polluting, and high-emission enterprises); it is necessary to set up an effective information mechanism to gradually include emission- and environment-related violations of enterprises in the enterprise credit information system, to provide services for credit extensions of financial institutions, to improve the asset quality of financial institutions, to offer enquiry services to government agencies, individuals, and enterprises, and to strengthen law enforcement in environmental protection and energy conservation; it is necessary to provide market and policy support for capacity allocations in line with environmental affordability; it is necessary to enable the market to play a fundamental role in financial asset allocations, to use financial markets to encourage and guide the industrial structure upgrading and the transformation of the economic growth pattern.

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

I. Macro-economic outlook

At present, against a background of a robust world economy, China's growth momentum is strong and the economy is expected to grow at a relatively rapid pace in the later half of 2007.

Investment will remain strong. The underlying factors include rapid industrialization and urbanization, construction of the socialist new countryside, revitalization of the northeast industrial bases, steady development of the central and western regions, industrial upgrading and migration of industries to new regions, and a buoyant enterprise investment upsurge. The results of the second quarter PBC entrepreneur survey showed that the second quarter fixed investment and equipment investment stood at 7.6 percent and 6.4 percent respectively, up by 1.9 and 2.1 percentage points year on year, showing an upward trend. In addition, the enterprises' performance improved, leading to improved capital strength. As a result, the enterprises not only had investment enthusiasm, but also the needed funds: 28.9 percent of the enterprises expected increased profits in the second quarter, the best performance in the last ten years; 40 percent of the enterprises were optimistic about their performance in the next quarter. In terms of the funding structure, the share of domestic loans decreased and that of self-raised funds increased. Given the stronger investment willingness and financial strength, there still remains the possibility of a rebound in investment. In the past two months, newly started projects and the funding involved exceeded the level at the same time of last year.

Demand remains strong and steady. With the rapid progress in the structural change, featuring stimulating domestic demand and with various policy measures taking effect, urban and rural residents have witnessed rising incomes. Taxes and fees accounted for a much lower 0.22 percent of household cash expenditures in the first quarter of 2007, down from 4.2 percent in 2000. The PBC household savings survey shows that the income of urban households witnessed a broad-based increase and the households expectations for future income growth are encouraging. The second quarter income confidence index went up by 1.0 and 5.8 percentage points compared to the last quarter and the same period of last year respectively. The consumption structure has been transformed from mainly clothing and food to durable goods and further toward housing, transportation, telecommunications, education, and recreation, resulting in a higher consumption contribution to GDP growth. For the past several years, the Engel indexes of both urban and rural households have come down, from 54.2 percent and 58.8 percent in 1990 to 35.8 percent and 43 percent respectively in 2006. In the next stage, the promotion of rural consumption and improvements in the income of medium- and low-income households will be an important policy measure for stimulating consumption. In 2006, the rural population was 1.3 times that of the urban population. But rural consumption accounted for only 48.2 percent of total consumption. More efforts are needed to explore consumption markets in a comprehensive and multi-layered manner based on the purchasing power structure in order to attain a better match between consumption and income.

The trade surplus will remain at a relatively high level. The growth of the world economy is likely to grow at above 4 percent for the fifth consecutive year, making this expansionary cycle the longest in the past 30 years. On the one hand, this will result in continued strong external demands. On the other hand, restrictions on exports of high-tech equipment to China by trading partners will continue to limit China's efforts to expand imports. On the domestic side, the strong production capacity built up by the rapid investment in recent years has given rise to a strong export capacity, in many areas replacing imports. In addition, the prices of the factors of production, i.e., labor, energy, and resources are still at a low level, leaving Chinese products very competitive in international markets. Meanwhile, it will take some time for the policy measures to become effective. Furthermore, issues such as the international structural change in the division of labor and the high domestic savings rate cannot be addressed within a short time. Overall, in the near future the growth of China's trade surplus is expected to slow down, but it will still remain at a relatively high level.

As the upward price pressures are mounting, inflation risks require attention. At present, domestic supply and industrial production capacity are growing rapidly. The supply bottlenecks have been reduced. In combination with measures to restrain inflation pressures, the upward trend in prices has been checked to some extent. Given that the accumulation of the balance of payment surplus has had an impact on price development, an analysis of the domestic and external factors shows that the current price hikes have not been influenced by accidental and temporary factors; rather, the risk of inflation is on the rise. One reason is that the price hikes in grain and meat cannot recede in the near term. This year's drought also complicates the harvest prospects for the autumn. Rapid urbanization and nearly 12 percent economic growth have increased greater demand for grain. The bio-energy application of grain will also push the demand higher and place tensions on the international demand and supply of grain. The cyclical feature of meat supply and the already high cost of pork production make it likely that the price of meat will stay high for some time, with possible repercussions for other food prices. A second reason is that there is upward pressure on energy prices. International oil prices have moved up again lately. On the domestic side, energy price reform and environmental protection measures will also push energy prices up. In addition, as production capacity is released, bottlenecks in coal, electricity, and transportation cannot be ruled out. A third reason is that the rising labor costs, which will be reflected in the prices of goods and services, may push consumer prices up. A fourth reason is that inflation expectations have gone up, adding further inflationary pressures. The second quarter PBC survey on urban households shows that household expectations for inflation reached 40.2 percent, the second highest since 1999. In addition, households may have felt a higher inflation than there actually is because their major daily consumption consists of meat, poultry, and eggs, the prices of which have gone up the most. When the "perceived-inflation" is higher than the "actual inflation," prices may be further pushed upward. Overall, within the context of higher global inflationary pressures, attention should be paid to the risks of price hikes in food spreading to the prices of other goods.

In general, the economy is growing at a steady, fast, and sustainable pace, which reflects the combined effects of taking advantage of the favorable external environment, making breakthroughs in the systemic reform, and the growing economic strength. It should be noted, however, that it has become more apparent that the economy is heading from relatively fast growth to overheating. The trade surplus is growing larger, credit growth is higher than expected, and investments are still growing too rapidly. In particular, energy-consuming industries are growing at a higher speed and efforts to conserve energy and reduce emissions are facing challenges. Inflationary pressures continue to build, especially on the prices of items closely related to household welfare, such as food and housing.

II. Monetary policy stance in the second half of the year

The PBC will follow the overall strategy of the Central Government, giving the highest priority to macro-economic adjustment efforts to constrain the economy from growing relatively fast to overheating. It will continue to conduct a sound monetary policy featuring moderate tightening, making the necessary policy adjustments to maintain a stable monetary environment, to control inflation expectations, and to maintain overall price stability.

The PBC will continue the coordinated application of open market operations and the required reserve ratio, and will create new instruments to fit the macro-adjustment to manage liquidity. It will also improve the liquidity analysis and forecasting system, orchestrate the pace and magnitude of open market operations to effectively influence the liquidity in the banking system, and guide the smooth operations of the money market. The role of the market interest rate in balancing the supply and demand of financial resources will be put into full play. The market-based interest rate reform will be further advanced, and the establishment of a benchmark interest rate system will be promoted to strengthen the leveraging role of prices in macro-economic adjustments. The PBC will continue to follow the policy of improving the RMB exchange rate formation mechanism in a self-initiated, controllable, and gradual manner, further giving market supply and demand a fundamental role in the RMB exchange rate formation, strengthening the RMB exchange rate flexibility, and maintaining it at an adaptive and equilibrium level. Meanwhile, the exchange rate shall be given a more active role in adjusting the balance of payments. Reform of the foreign exchange management system should be strengthened to meet the needs of domestic institutions for retaining and using foreign exchange. Measures will be taken to steadily expand the systems of qualified foreign institutional investors and qualified domestic institutional investors, research will be conducted on new ways for individuals to invest overseas, to strengthen monitoring and administration of capital inflows, to further regulate overseas borrowing, especially short-term debt management, and to punish illegal foreign exchange transactions. In compliance with the priorities set by the national tax policy, industrial policy, foreign trade and foreign investment policy, and environmental protection policy, the PBC will also guide financial institutions to improve the credit structure and to prevent credit risks in order to promote economic structural adjustment and transformation of the growth paradigm. Efforts will be made to promote financial market development based on "innovation, development, standardization, and coordination" and to deepen financial reform by improving corporate governance and the financial structure.

Sterilizing excess liquidity in the financial system itself cannot solve the accumulation of liquidity in the banking system and the structural problems in the economy, but serves to create a stable monetary and financial environment for economic adjustment. At present, while strengthening liquidity management of the banking system, a more important task for the country is to implement an adjustment policy mix which includes promoting consumption to stimulate domestic demand, lowering the savings rate, changing the preferential treatment for foreign-funded enterprises, opening the market, and expanding imports. The implementation of the above measures will help quicken the structural adjustments and contain the rapid growth in the balance of payments surplus. In order to maintain a favorable external and domestic environment, changes and standardization of foreign trade, foreign investment, and industrial policies should be further pursued. Measures should also be taken to speed up the transformation of public finance, increasing spending on education, health care, environmental protection and housing, improving the social security system, stabilizing the consumption expectations of households. and lowering the savings rate. Measures are being taken to improve and implement income policy, raising the share of household income and expanding consumption markets to promote consumption. In addition, efforts need to be made to improve the price formation mechanism for resources and the factors of production and to improve and strengthen environmental protection and labor protection standards to promote the structural transformation of the economic growth pattern.