

China Monetary Policy Report Quarter Four, 2007

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

Executive Summary

In 2007 China's economy grew steadily and rapidly. Industrial production growth accelerated. Consumer demand was strong. Household income, corporate profits, and fiscal revenue all increased substantially. GDP stood at 24.7 trillion yuan, up 11.4 percent, and CPI rose by 4.8 percent.

In 2007, given the excess liquidity in the banking system, huge pressures on money and credit expansion, and the rise in inflation, the monetary policy stance was gradually shifted from "a sound policy" to "a tight policy." The People's Bank of China (PBC), according to the State Council's overall arrangement, made efforts to take comprehensive measures to maintain a balance at an aggregate level. The PBC strengthened liquidity management in the banking system, raised the reserve requirement ratios on ten occasions, with a cumulative increase by 5.5 percentage points, and hiked the RMB benchmark deposit and lending rates on six occasions, while flexibly conducting open market operations. The PBC also endeavored to 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 administrative reform so as to promote harmonious economic and financial development.

With the implementation of various macro-adjustment policies, the rapid growth in the momentum of money and credit was slowed down, though great pressures for expansion still existed. At the end of 2007, the outstanding balance of broad money M2 increased by 16.7 percent year on year, down 0.2 percentage points from the previous year. The outstanding balance of RMB loans grew by 16.1 percent year on year, up 1 percentage point from 2006, representing an increase of 3.6 trillion yuan over the beginning of the year. At end-2007, the central parity of the RMB against the US dollar was 7.3046 yuan per US dollar, an appreciation of 6.90 percent over the end of 2006.

Pushed by the combined factors of industrialization, urbanization, internationalization, and the structural upgrade in industrial production and consumption, the economy is expected to maintain relatively rapid growth in 2008. With the external uncertainties looming larger and with the effects of the domestic macro-adjustment policy, economic growth may slow somewhat from the elevated path of last year. Inflation is likely to remain at a high level in the first half of 2008 as structural supply constraints and external price pass-through may bring about short-term price shocks.

The PBC, following the coordinated instructions of the CPC Central Committee and the State Council, will make it a top priority to prevent the rapid growth from turning into overheating and to prevent the structural price rises from turning into generalized

inflation. Efforts will be made to implement a tight monetary policy, restrain the rapid growth of money and credit, control the rhythm and degree of adjustment in a scientific manner based on the changing domestic and external environments, and create a sound monetary and financial environment for economic growth and the structural adjustment by fine-tuning policies when appropriate. Endeavors will be made to continue to use policy tools such as open market operations and the reserve requirement ratio to absorb liquidity in the banking system. Measures will be taken to continue to increase the flexibility of the RMB exchange rate so that the role of the exchange rate in adjusting the balance of payments and guiding structural adjustments and containing price rises will be put into full play, and will enhance the discretion and effectiveness of monetary policy. The PBC will adjust interest rates discreetly, take measures to steadily carry forward the market-based interest rate reform, and strengthen guidance of public inflation expectations. Meanwhile, efforts will be made to strengthen window guidance and credit policy guidance, and will remind financial institutions to strengthen credit policy management and risk prevention and to improve the credit structure. Great efforts will be made to foster and develop financial markets, deepen financial enterprise reform, and improve foreign exchange administration.

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Part 1 Monetary and Credit Performance

In 2007 the national economy continued to grow steadily and rapidly, with the financial industry performing in a sound manner. With the implementation of various macro-adjustment policies, the rapid growth in the momentum of money and credit was slowed down, though great pressures for expansion still existed.

I. Broad money grew rapidly, falling back from the high level at year-end

At the end of 2007 outstanding broad money M2 amounted to 40.3 trillion yuan, an increase of 16.7 percent year on year, down 0.2 percentage points from the previous year. Narrow money M1 reached 15.3 trillion yuan, an increase of 21 percent year on year, up 3.5 percentage points over 2006. Cash in circulation M0 grew by 12.1 percent year on year to 3 trillion yuan, down 0.6 percentage points over 2006. Net cash injections in the entire year of 2007 totaled 330.3 billion yuan, 26.2 billion yuan more than in the previous year.

In the first half of 2007, against the background of relatively abundant liquidity in the banking system, growth of M2 accelerated, reaching the highest level in 2007 at end-July. At end-2007, because of no new IPOs in the stock market and the decline of the inter-bank deposits, the growth of M2 fell significantly. Growth of M1 accelerated from 2006 due to the increase in demand deposits of enterprises and remained at a high level. At end-2007, the growth rate of M1 was 4.3 percentage points higher than that of M2, reflecting the increasing liquidity in the banking system.

II. Deposits of financial institutions grew steadily, clearly tilting toward demand deposits

At end-2007, outstanding deposits of all financial institutions (including foreign-funded financial institutions) denominated in both RMB and foreign currencies increased by 15.2 percent year on year to 40.1 trillion yuan, a deceleration of 0.7 percentage points from the previous year, but 5.3 trillion yuan more than that at the beginning of 2007, representing an acceleration of 335.6 billion yuan year on year. In particular, outstanding RMB deposits rose by 16.1 percent year on year to 38.9 trillion yuan, 5.4 trillion yuan more than at the beginning of 2007, an acceleration of 459.9 billion yuan year on year. Outstanding foreign currency deposits totaled US\$159.9 billion, down 0.9 percent from the previous year.

Broken down by sectors, household RMB deposits grew slowly whereas RMB

deposits of non-financial companies increased greatly. The reason why household deposits grew slowly was that households had more diversified choices in terms of allocating financial assets and their willingness to save weakened. Non-financial companies, due to their increased profits and funding in the market, had sufficient funds for deposit. With the dynamic capital market and rising inflation expectations, both households and enterprises preferred demand deposits. At end-2007, outstanding household RMB deposits grew by 6.8 percent year on year to 17.6 trillion yuan, representing a deceleration of 7.8 percentage points from a year earlier and an increase of 1.1 trillion yuan from the beginning of 2007, but 959.8 billion yuan less than the increase in 2006. In particular, the growth in household time deposits increased by 897.4 billion yuan less than that during 2006. Outstanding non-financial corporate RMB deposits stood at 18.9 trillion yuan, representing a growth of 22.4 percent year on year, up 5.1 percentage points from the previous year, and an increase of 3.5 trillion yuan from the beginning of 2007, 963.7 billion yuan more than the increase during 2006. In particular, corporate demand deposits accelerated by 603.5 billion yuan. At end-2007, outstanding fiscal deposits amounted to 1.8 trillion yuan, representing an increase of 663.3 billion yuan from the beginning of 2007 and an acceleration of 371.4 billion yuan from a year earlier.

III. Loans of financial institutions grew relatively rapidly, with household loans witnessing the largest increase

Outstanding loans of all financial institutions in both RMB and foreign currencies amounted to 27.8 trillion yuan at end-2007, representing a growth of 16.4 percent year on year, an acceleration of 1.9 percentage points from 2006, and an increase of 3.9 trillion yuan from the beginning of 2007. In particular, outstanding RMB loans grew by 16.1 percent year on year to 26.2 trillion yuan, up 1 percentage point from 2006, representing an increase of 3.6 trillion yuan over the beginning of the year and an acceleration of 448.2 billion yuan. In the entire year of 2007, RMB loan extensions continued the trend of decreasing quarter by quarter, that is to say, from the first quarter to the fourth quarter new loans stood at 1.4 trillion yuan, 1.1 trillion yuan, 817.8 billion yuan, and 272.1 billion yuan respectively. Outstanding foreign currency loans rose by 30.2 percent year on year to US\$219.8 billion, representing an increase of US\$51.1 billion over the beginning of 2007 and an acceleration of US\$32.7 billion from the previous year.

In terms of the sectoral distribution of loans, the growth of loans to households was remarkably faster than the growth of loans to non-financial companies and other sectors. In 2007, outstanding loans to households increased by 1.2 trillion yuan,

representing a growth of 30.4 percent year on year, up 9.3 percentage points and an acceleration of 546.6 billion yuan from 2006. Among the loans to households, consumer loans increased by 868.6 billion yuan from the beginning of 2007, of which 80 percent were housing loans; and operational loans increased by 311.1 billion yuan from the beginning of 2007. Loans to non-financial companies and other sectors increased by 2.5 trillion yuan, representing an increase of 13.1 percent year on year, down 0.8 percentage points from a year earlier and a deceleration of 98.3 billion yuan year on year. In particular, short-term loans grew by 1.3 trillion yuan and paper financing dropped by 441.4 billion yuan, whereas medium and long-term loans grew by 1.7 trillion yuan. In terms of the loan issuance institutions, 2007 witnessed accelerations of loans of various financial institutions.

Table 1: RMB Lending by Financial Institutions in 2007

Unit: 100 million yuan

	New Loans in 2007	New Loans in 2006
Policy banks	4280	3418
State-owned commercial banks	13055	12199
Joint-stock commercial banks	7716	7358
City commercial banks	2978	2773
Rural financial institutions	5085	4246
Foreign financial institutions	1704	969

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

Source: The People's Bank of China.

The bulk of RMB medium and long-term loans went to infrastructure sectors. In 2007 the total RMB medium and long-term loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) rose by 2.4 trillion yuan from the beginning of 2007, increasing by 22 percent year on year. In particular, medium and long-term loans to infrastructure sectors (including transportation, storage and postal services, electricity, gas, and water production and supply, water conservancy, and environmental and public facility management sectors) amounted to 798.36 billion yuan, to the real estate industry 333.75 billion yuan, and to the manufacturing industries 179.49 billion yuan, accounting for 33.2 34, 13.9 percent, and 7.5 percent of the total new medium and long-term loans respectively.

IV. Base money grew at a stable pace after deducting the effect of the

reserve requirement ratio adjustment

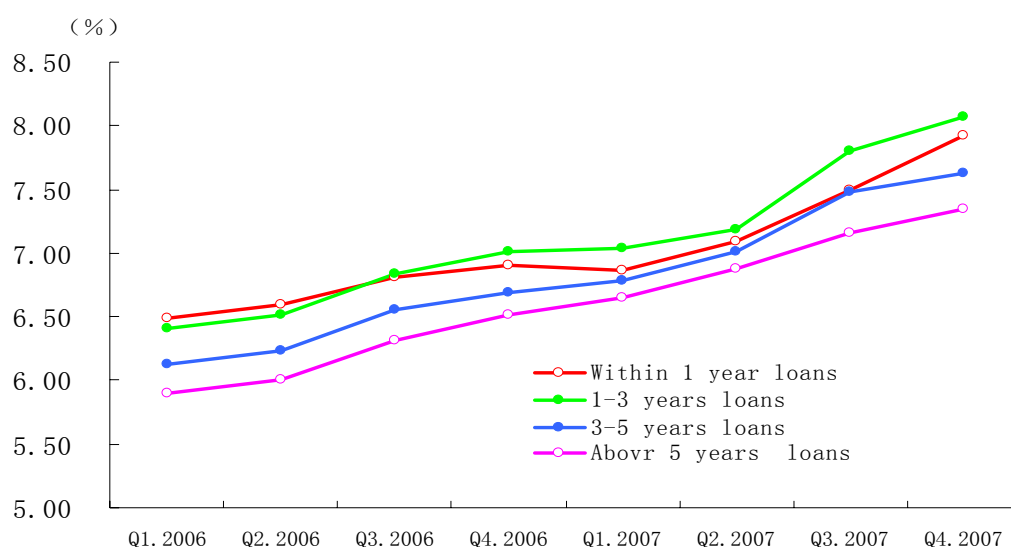
At end-2007, the outstanding balance of base money increased by 30.5 percent year on year to 10.2 trillion yuan, representing an increase of 2.37 trillion yuan from the beginning of 2007 and an acceleration of 1.03 billion yuan from 2006. The rapid growth of base money was mainly due to 10 hikes in the reserve requirement ratios in 2007, cumulatively by 5.5 percentage points. The reason being that 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 in 2007 were instead sterilized by the issuance of central bank bills, the current growth of base money would be lower than 5 percent. Meanwhile, the money multiplier (broad money/base money) was 3.97 at end-2007, the lowest since 2003. At end-2007, the excess reserve ratio of financial institutions averaged 3.5 percent, down 1.3 percentage points from end-2006. In particular, the excess reserve ratio of state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 2.0 percent, 3.7 percent, and 8.9 percent respectively.

V. Lending rates of financial institutions gradually rose

In 2007, the RMB lending rate of financial institutions continued to rise. In the fourth quarter, the weighted average interest rate of 1-year, 1-3 year, 3-5 year, and above 5-year loans of financial institutions was 7.93 percent, 8.07 percent, 7.62 percent, and 7.35 percent respectively, up 0.43 percentage points, 0.27 percentage points, 0.19 percentage points, and 0.19 percentage points from the previous quarter, and up 1.07 percentage points, 1.03 percentage points, 0.83 percentage points, and 0.7 percentage points from the first quarter. The weighted average interest rate of 1-year RMB loans of commercial banks was 7.25 percent, up 0.1 percentage points from the third quarter and 0.74 percentage points from the first quarter. Among all loans issued by financial institutions, the share of loans with interest rates floating downward from the benchmark rate was down 0.52 percentage points from the third quarter, whereas the share of loans with interest rates at the benchmark rate was up by 1.04 percentage points and the share of loans with interest rates floating upward from the benchmark rate declined by 0.52 percentage points from the third quarter.

Figure 1: Lending Rates of 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 Fourth Quarter of 2007

Unit: %

	Total	Floating downward	At bench-mark	Floating upward				
		[0.9, 1)	1	Subtotal	(1, 1.3]	(1.3, 1.5]	(1.5, 2]	Above 2
Total	100	28.07	27.69	44.24	27.17	7.31	8.47	1.29
Policy banks	100	31.63	67.12	1.25	1.24	0	0.01	0
State-owned commercial banks	100	35.64	28.82	35.54	33.04	1.97	0.46	0.07
Joint-stock commercial banks	100	35.20	35.45	29.35	28.75	0.52	0.03	0.05
Regional commercial banks	100	33.31	20.39	46.30	32.65	9.27	3.75	0.63
Urban and rural credit cooperatives	100	2.42	5.39	92.18	22.41	26.02	38.03	5.72

Source: The People's Bank of China.

The inter-bank deposit rate of financial institutions rose in 2007. The inter-bank demand deposit rate continued to climb up slightly, whereas the time deposit rate declined somewhat at the end of year after rising in the second and third quarters. In the fourth quarter, the share of inter-bank demand deposits was 91.85 percent, with a weighted average interest rate of 1.51 percent, up 0.06 percentage points from the previous quarter and 0.13 percentage points from the first quarter; the share of inter-bank time deposits was 8.15 percent, with a weighted average interest rate of 2.9 percent, down 0.24 percentage points from the previous quarter but up 0.61

percentage points from the first quarter.

The interest rates of negotiable RMB deposits (above 30 million yuan in one deposit) increased quarter by quarter. In the fourth quarter, the weighted average interest rate of negotiable deposits with a maturity of 61 months stood at 5.60 percent, up 0.32 percentage points from the previous quarter; the weighted average interest rate of negotiable deposits with a maturity of 37 months was 5.59 percent, up 0.44 percentage points from the previous quarter.

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

Table 3: Average Interest Rates of Large-value Dollar Deposits and Loans, January through December of 2007

Unit: %

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
I. Large-value Deposits:												
Within 3 months	4.3192	4.1626	4.3773	4.3949	4.4756	4.5441	4.2490	4.5101	4.4244	3.9158	3.0304	3.7664
3-6 months	5.1244	5.2424	5.1802	4.7302	4.9277	5.2338	5.2404	5.1916	4.9672	4.9755	4.6308	4.8092
6-12 months	5.0632	5.3322	4.8745	5.2713	5.0535	5.3547	5.0300	4.9929	4.7331	5.0223	4.6433	5.0812
1 year	5.0020	4.3134	4.7066	5.0930	4.8413	5.0009	4.2010	5.3843	4.9235	4.9412	5.5599	5.5539
II. Loans:												
1 year (fixed)	6.2037	6.0972	6.0174	6.1770	6.1330	6.1259	6.1226	6.0023	6.0240	6.1029	5.7820	4.9252
1 year (monthly floating)	6.0936	6.2679	6.1866	6.1435	6.1963	6.1656	6.2601	6.2388	6.2053	5.8812	5.8534	6.2507

Source: The People's Bank of China.

VI. The RMB exchange rate floated in both directions, with strengthened flexibility

The fundamental role of market supply and demand continued to function well, and in general the RMB appreciated in 2007. At end-2007, the central parity of the RMB against the US dollar was 7.3046 yuan per US dollar, an appreciation of 6.90 percent over the end of 2006; the central parity of the RMB against the euro and the Japanese yen was 10.6669 yuan per euro, and 6.4064 yuan per 100 Japanese yen, a depreciation of 3.75 percent and an appreciation of 2.44 percent over end-2006 respectively. Beginning with the exchange rate regime reform up until end-2007, the RMB cumulatively appreciated by 13.31 percent and 14.04 percent against the US dollar and the Japanese yen respectively, but it cumulatively depreciated by 6.12 percent against the euro.

The flexibility of the RMB exchange rate was further strengthened, and the linkage of

the RMB exchange rate with the major currencies was obvious. In 2007 the peak and bottom central parities of the RMB against the US dollar were 7.3046 yuan per US dollar and 7.8135 yuan per US dollar respectively. Among the 242 trading days in 2007, the inter-bank foreign exchange market saw RMB appreciations for 151 days and RMB depreciations for 91 days. The largest appreciation of the RMB central parity against the US dollar in a single business day was 0.41 percent (310 basis points) above 0.3 percent before May 21, 2007,¹ and the largest depreciation in a single business day was 0.30 percent (223 basis points). The daily fluctuation of the central parity averaged 62 basis points, much larger than the average of 40 basis points recorded in 2006.

¹ Starting from May 21, 2007, the daily floating band of the RMB exchange rate against the US dollar in the inter-bank foreign exchange market was widened from 0.3 percent to 0.5 percent.

Part 2 Monetary Policy Conduct

In 2007, given the excess liquidity in the banking system, huge pressures on money and credit expansion, and the rise of inflation, the monetary policy stance was gradually shifted from “a sound policy” to “a tight policy.” The PBC, according to the State Council’s overall arrangements, made efforts to take comprehensive measures to strengthen liquidity management in the banking system, control growth of money and credit through the leveraging role of prices, guide the optimization of the credit structure, steadily promote financial institution reform, further enhance the flexibility of the RMB exchange rate, and speed up foreign exchange administrative reform so as to promote harmonious economic and financial development.

I. Comprehensive measures were taken to strengthen liquidity management

In 2007 the PBC continued to carry out its monetary policy by means of open market operations and reserve requirement policies in an effort to siphon off the liquidity in the banking system.

The PBC flexibly conducted open market operations. First, the PBC strengthened the issuance of central bank bills. The issuance of central bank bills totaled 4.07 trillion yuan in 2007, and the outstanding balance of central bank bills stood at 3.49 trillion yuan at end of the year, an increase of 460 billion yuan over the beginning of 2007. Second, the PBC conducted repos in timely manner. At the beginning of 2007, the PBC flexibly chose the maturity and size of repos to ease payment pressures on commercial banks before the Spring Festival. With the issuance of special treasury bonds, the PBC gradually strengthened repos operations; the total amount of repos was 1.27 trillion yuan for the entire year and the outstanding balance reached 620 billion yuan at end-2007, 560 billion yuan more than that at the beginning of 2007. Third, the PBC re-initiated the issuance of 3-year central bank bills. With a view to mitigating pressures on the liquidity increase resulting from the maturing central bank bills, the PBC re-initiated the issuance of 3-year central bank bills at end-January, substantially freezing the banking liquidity. Fourth, the market-based issuance of central bank bills was combined with targeted issuances. On five occasions, the PBC issued 555 billion yuan of 3-year special central bank bills to commercial banks that

had experienced rapid credit growth and held sufficient liquidity so as to effectively absorb liquidity and to alert banks that experienced fast credit growth. Fifth, the issuance rate of central bank bills was driven up properly to guide the rise in the market interest rates and to allow market interest rates to assume the role of adjusting fund supply and demand. During 2007 the issuance rate for 3-month, 1-year, and 3-year central bank bills rose by 90, 126, and 155 basis points respectively.

Along with open market operations, the PBC continued to make use of the role of the required reserve as it could proactively and deeply freeze liquidity to raise the reserve requirement ratio so as to sterilize the liquidity increase and contain the money creation power of the banking system. In line with the dynamic changes in liquidity, the PBC raised the reserve requirement ratio successively on 10 occasions by a total of 5.5 percentage points. On January 25, 2008, the PBC again raised the reserve requirement ratio by 0.5 percentage points. As a result, the reserve requirement ratio for financial institutions climbed to 15 percent. Furthermore, the PBC continued to implement a differentiated reserve requirement ratio system, namely, financial institutions whose capital adequacy ratio is below a certain threshold and whose NPL ratio is above a certain number will be subject to a relatively high reserve requirement ratio. In September 2007, in line with the standard for the differentiated reserve requirement ratios, adjustments were made to financial institutions that apply differentiated reserve requirement ratio. A financial institution whose capital adequacy ratio and other indicators reach certain standards would be allowed to implement the normal reserve requirement ratio. Accordingly, the number of financial institutions applying the differentiated reserve requirement ratio fell markedly. In general, since the implementation of the differentiated reserve requirement ratio, good results have been achieved in containing the blind credit expansion of financial institutions whose capital adequacy ratio is relatively low and that have rather poor quality assets, and in promoting the financial institutions' sound operations. Financial institutions applying the differentiated reserve requirement ratio actively took measures to increase their capital and to adjust the structure of their assets and liabilities so that their capital adequacy ratios were significantly enhanced.

II. Interest rates played a leveraging role

In 2007, after considering aggregate and structural factors, the PBC raised the benchmark interest rates on RMB loans and deposits of financial institutions on six occasions to flexibly make use of the leveraging role of interest rates against the background of domestic inflationary pressures and the increasingly complicated

international environment. The 1-year benchmark deposit rate was raised from 2.52 percent at the beginning of 2007 to 4.14 percent at the end of 2007, a cumulative increase of 1.62 percentage points. The 1-year lending rate cumulative increase was 1.35 percentage points, from 6.12 percent at the beginning of 2007 to 7.49 percent at the end of 2007. Meanwhile, in December 2007 interest rates of time deposits (within 1-year) were also raised, largely to guide households and other economic entities to choose short-term time deposits and hence to enhance their ability to cope with inflation. The deposit rates for 3-month and 6-month time deposits were raised by 0.45 and 0.36 percentage points respectively.

In general, the effects of the interest rate policy gradually became apparent: first, the increase in funding costs will help financial institutions and other economic entities to properly measure risks and guide reasonable money and credit expansion; second, consecutive interest rate hikes will help guide the direction of capital movements and stabilize market inflation expectations. Household acceptance of deposit rates increased quarter by quarter. According to the Survey of Households' Savings Questionnaire conducted by the PBC, since the second quarter of 2007, the proportion of households that considered the deposit rate as "proper" climbed quarter by quarter from 39.6 percent in the first quarter to 46.3 percent in the fourth quarter, a cumulative increase of 6.7 percentage points, the highest level in the history of the survey. The savings willingness index also went up. In the fourth quarter, the proportion of households considering "more savings" as the most rational choice increased by 4.9 percentage points from the previous quarter to 30.2 percent, reversing the falling trend of four successive quarters.

The establishment of a benchmark interest rate system in the money market was advanced steadily. After the Shanghai Inter-bank Offered Rate (Shibor) was formally launched on January 4, 2007, it preliminarily became the benchmark rate in the money market. The Shibor's accuracy, sensitivity, and representativeness were strengthened steadily and its consistency with the spread of the inter-bank borrowing rate and the repo rate was gradually enhanced. Trading volume based on the Shibor gradually expanded. Furthermore, the role of the Shibor in guiding market product pricing was enhanced.

III. Window and credit policy guidance was strengthened

In 2007, against the backdrop of strong credit expansion, the PBC continued to strengthen the role of window and credit policy guidance to convey the purpose of the

macro-adjustment measures, alert the commercial banks of the risks arising from an excessively rapid growth of loans and of the problems stemming from the maturity mismatch between assets and liabilities, and guide them to control the size and pace of credit extensions. In line with the principle of different treatments for different borrowers, the PBC also guided commercial banks to optimize the credit structure, control medium and long-term loans for infrastructure, strongly limit lending to weak enterprises in industries with high energy consumption, heavy pollution, or excess production capacity, strengthen credit support to the rural economy, job creation, students, small and medium-sized enterprises, energy conservation and environmental protection, and self-initiated innovation, expand their fee-based businesses, strengthen financial product innovation, and improve financial services. The credit policy for commercial real estate was revised by the PBC and the China Banking Regulatory Commission (CBRC) to strictly manage housing loans and to increase the down payment ratio and interest rate for second housing mortgage loans.

IV. Reform of financial institutions was promoted steadily

The joint-stock reform of state-owned commercial banks was deepened. After completing the reform, the Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and the Bank of Communications continued to deepen internal reform to strengthen risk management and the internal control mechanism, to enhance self-discipline, to speed up the transformation of the growth mode, and to increase asset quality. They also continued to promote the reform of branch networks, and to strengthen examination and evaluation management of the risks and internal controls of branches to ensure the effective functioning of the new institutions and new regimes. Meanwhile, China Construction Bank and the Bank of Communications were listed on the Shanghai Stock Exchange on May 15 and September 25, 2007 respectively. As a result, the four reforming banks realized public listings in both the Hong Kong and Shanghai markets, which not only offered good investment opportunities for investors, but also further supported the healthy development of the domestic capital market. The fundamental reform of the Agricultural Bank of China achieved great progress, and relevant government departments are making efforts to discuss the feasibility of introducing a shareholder reform of the bank.

The reform of the policy banks advanced steadily. The reform of China Development Bank achieved great progress. With the approval of the State Council, the Central Huijin Investment Limited Corporation (Huijin Investment Co. Ltd.) injected US\$20 billion into China Development Bank on December 31, 2007. With the capital

injection, China Development Bank will increase its capital adequacy ratio markedly and enhance its risk prevention ability. This will help to promote comprehensive commercial-based operations and will be a fundamental measure in the reform of China Development Bank, representing an important step in its reform. The Export & Import Bank of China and China Agricultural Development Bank also continued to deepen their internal reform to create conditions for overall reform.

The reform of the Everbright Bank of China achieved tangible results. On November 30, 2007, the Huijin Investment Co. Ltd.'s US dollar investment in the Everbright Bank of China was equivalent to 20 billion yuan and it held 20 billion shares of the Everbright Bank of China at 1 yuan per share, accounting for 70.88 percent of its total equity.

The reform of the rural credit cooperatives (RCCs) also underwent important advances and produced good results, with an improved asset quality and financial condition. At end-2007, the issuance of special bills was basically completed, and half of the work of the redemption of special bills had also been completed, with the cumulative redemption amounting to 80.7 billion yuan and the issuance of special loans amounting to 1.2 billion yuan, effectively reducing the historical burdens of the RCCs. According to the four-category loan classification system, the NPL ratio and capital adequacy ratio of the RCCs were 9.3 percent and 11.2 percent respectively, down 28 percentage points and up 20 percentage points from end-2002. Total profits in 2007 reached 44 billion yuan, an increase by 57 percent from 2006. With the remarkable capital improvements, their credit support to the rural economy and rural households further increased. At end-2007, the credit of the RCCs amounted to 3.1 trillion yuan, accounting for 12 percent of the total credit of financial institutions, up 1.4 percentage points from the beginning of the reform. Their agricultural loans reached 1.43 trillion yuan, accounting for 46 percent of their total loans, up 6 percentage points from the beginning of the reform. The reform of the property rights regime advanced steadily. At end-2007, 17 rural commercial banks, 113 rural cooperative banks, and 1,775 rural credit cooperatives with a unified legal entity at the county (city) level had been established nationwide.

However, it is noteworthy that in some regions the RCCs were established with a unified legal entity at the provincial level or provincial managerial institutions controlled the RCCs at the county (city) level in their jurisdiction. At present, the demand for financial services in rural areas is characterized by small amounts and scattered distribution, so small-sized retail banks will have advantages over national or regional banks in improving financial services at the county and village levels. International and historical experiences also show that after a bank grows, it will

likely focus on large projects in cities and deviate from its initial orientation of serving the agricultural economy. Furthermore, bank mergers & acquisitions (M&A) are usually led by administrative authorities, so they may bring about negative side-effects such as a disrespect for property rights. Currently, the long-term and stable upholding of the legal entity status of the RCCs is beneficial to the healthy and sustained development of the RCCs, to the appropriate competition of the rural financial market, and to the improvement of financial services at the county (city) level. It is important to follow market-led principles, fully respect the options of shareholders and legal persons, prevent the promotion of M&As of RCCS in an administrative manner, and avoid increasing the rank of the legal entity status of the RCCs in the process of reforming the property rights system or choosing corporate governance structures.

Box 1: Promote Rural Financial Reform and Improve Rural Financial Services

The resolution of the economic problems in the rural areas is related to the overall strategy of establishing a well-off society. In recent years, under the overall arrangements of the State Council, rural financial reform was promoted by all relevant parties through the implementation of various policy measures to improve rural financial services and to support the establishment of the socialist new countryside.

I. Accelerating the rural financial reform and promoting the establishment of a multi-layered rural financial service system

Efforts were made to accelerate the joint-stock reform of the Agricultural Bank of China. External auditing of the Agricultural Bank of China has achieved preliminary results with the asset appraisals, legal due diligence, and checking of non-performing assets that are underway. The reform of the rural credit cooperatives (RCCs) also underwent important advances and produced good results. The financial support policy was gradually carried out to exert a positive influence; the historical burdens of the RCCs were effectively relieved so that their asset quality improved markedly and financial services in the rural areas were strengthened. The functions of the Agricultural Development Bank of China were reformed and its credit support was expanded to wider rural economic fields, such as production and processing in farming, forestry, animal husbandry, sideline production, and fishery and agricultural technology. The Agricultural Development Bank of China was encouraged to persist in market-based funding and to enlarge financial sources to support agriculture. As of end-2007, the Agricultural Development Bank of China had accumulatively issued 691.1 billion yuan of policy financial bonds. The policy for postal savings deposits in the central bank was adjusted to speed up the postal savings reform. In January 2007 postal savings institutions were reorganized as the Postal Savings Bank, whose basic function is to focus on offering financial services to the agricultural economy. At

end-2007, funds under the management of the postal savings institutions reached 1.18 trillion yuan. Pilot micro-credit organizations were steadily advanced with the establishment of 7 micro-credit companies. By establishing a new operational philosophy, operational mechanism, and risk-prevention mechanism, micro-credit organizations have basically adapted to the rural self-employed entities and the scattered rural operations and demand for small amounts of capital by small-sized rural entities. Township banks, loan subsidiaries, rural cooperative credit shops, and other pilot new rural financial institutions were promoted steadily and orderly. Currently, 30 new rural financial institutions have been established and have helped to activate the local rural financial market and to improve the rural financial system and rural financial services.

II. Strengthening financial services support to the agricultural sector and effectively increasing capital inputs to the agricultural economy

Efforts were made to effectively give central bank lending a guidance role to support the agricultural sector. As of end-2007, the PBC allotted a quota of 128.8 billion yuan of central bank lending to the RCCs to support the agricultural sector, with the cumulative central bank lending amounting to 1.1 trillion yuan. The PBC also strengthened the geographical adjustment of the central bank lending quota to support the agricultural sector, with over 92 percent of the central bank lending quota going to the western area as well as to the grain- and other large agricultural -producing regions. The RCCs can enjoy a preferential reserve requirement ratio policy. At present, most RCCs are subject to 12 percent of the reserve requirement ratio, 3 percentage points lower than that of other financial institutions. Calculated with the outstanding balance at end-2007, the RCCs can increase their disposable capital by 120 billion yuan. The functioning mode of concessional loans for poverty relief was further improved. The PBC and relevant departments have successively established “reward and subsidy funds” in 8 provinces, including Jiangxi and Hebei, since 2005 to promote the pilot micro-credit for rural households, and some of the central fiscal poverty relief funds were also used as “reward and subsidy funds” to offer interest subsidies for poor households’ loans, loss subsidies, or rewards so as to increase the size of poverty relief loans for rural households and to further demonstrate the policy effect. In the past five years, agricultural loans of financial institutions grew by 124 percent, 25 percentage points higher than other loans during the same period. The outstanding balance of loans to farmers amounted to 1.16 trillion yuan, and more than 78.19 million rural households obtained such loans, accounting for 73 percent of the total qualified rural households that have loan requirements. Compared with other developing countries, the loan coverage for rural households is at a relatively high level.

III. Strengthening infrastructure construction in rural financial services and improving the rural financial eco-environment

Efforts were made to improve rural financial payment and settlement services. A large number of RCCs have connected with the Large-value Payment and Settlement

System in a timely manner so as to greatly improve their payments in other locations. RCCs are also covered by the Local Clearing House System, and the National Rural Credit Cooperatives Clearing Center was established to increase fund clearing efficiency. Endeavors were made to promote the use of bankcards in rural areas with the development of tailored services on a pilot basis. In 2005, tailored bankcard services for rural migrant workers were launched on a pilot basis in Guizhou province; since then, 14 provinces have already offered such services. Efforts were also made to accelerate the establishment of the credit registration system in the rural areas to set up a network between most RCCs and the individual credit information database. As of end-2007, deposit, remittance, exchange, and settlement services covered 90 percent of all administrative villages so that the rural areas could broadly enjoy basic financial services from rural financial institutions.

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 basically stable at an adaptive and equilibrium level. At the same time, reform of the foreign exchange management system was accelerated to promote BOP equilibrium. First, efforts were made to further enhance the flexibility of the RMB exchange rate. The PBC announced on May 18, 2007, that effective May 21, the band of the RMB trading price 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 in the inter-bank spot foreign exchange market would move within a band of ± 0.5 percent around the central parity publicized on the same day by the China Foreign Exchange Trading System. Second, efforts were made to better meet the demands of market participants to hold and use foreign exchange. The annual foreign exchange purchasing quota for individuals was raised from US\$20,000 to US\$50,000, the ceiling on the foreign exchange account of domestic institutions under the current account was removed, and the foreign exchange administrative policy on the customs special regulatory zone was consolidated. Third, capital movement channels were expanded in an orderly manner. At end-2007, the investment quota of the Qualified Foreign Institutional Investors (QFIIs) was raised to US\$30 billion and the investment quota and investment area of the Qualified Domestic Institutional Investors (QDII) were further enlarged. Fourth,

foreign exchange inflows and sales management was strengthened and improved. Efforts were made to improve foreign exchange surrender management for foreign trade earnings, to cut short-term foreign debt indicators gradually, to strictly contain disguised overseas Chinese companies from establishing or merging & acquiring real estate enterprises, to strengthen the foreign debt management of foreign-funded real estate enterprises, and to intensify the crackdown on criminal activities such as underground banking and illegal foreign exchange trading activities. Fifth, efforts were made to diversify the pool of overseas investors. On September 29, China Investment Co. Ltd. was established. It accepted foreign exchange investment through bond issuances by the Ministry of Finance and focused on overseas investment so as to broaden the multi-layered and diversified foreign exchange investment system.

Box 2: Survey and Analysis of the “Ability of Micro-economic Entities to Adapt to Exchange Rate Movements”

Since the reform of the RMB exchange rate formation mechanism that was implemented on July 21, 2005, foreign trade enterprises have accelerated, shifting the trade growth mode by adjusting the product structure and improving technology and management skills. After two years of effort, most foreign trade companies basically adapted to the RMB exchange rate movement and maintained stable production, operations, and employees, steadily enhanced their comprehensive competitiveness, and their ability to cope with RMB exchange rate movements outperformed expectations. From January through November 2007, the sales margins of 39 main industries reached 6.47 percent, up 0.48 percentage points year on year, and 0.7 percentage points higher than that in 2005 (when the RMB exchange rate reform was initiated). RMB costs in return for foreign exchange continued to decline, losses shrank, and employees increased. However, the influence of the RMB exchange rate appreciation on different industries and different kinds of foreign trade companies varied. Import companies and companies that held foreign debts gained from the RMB appreciation as it helped to lower import costs in agricultural and agricultural product processing industries and to enhance their profitability. Export companies, for example companies in the electronic information industry, suffered exchange losses. The PBC conducted quarterly surveys of the ability of companies in the main industries to adapt to exchange rate movements so as to monitor the influence of exchange rate movements on the companies.

I. Companies coped with the RMB appreciation pressures in many ways

The survey indicated that after the RMB exchange rate reform, Chinese companies mitigated the RMB appreciation pressures to some extent by enhancing productivity, reducing production costs, and promoting product upgrades. For example, the textile industry is one of the traditional export industries in China. Since it is a

labor-intensive industry that is characterized by low export value-added and margins, it is thus weak to adapt to the exchange rate reform. However, though facing multiple pressures since the RMB exchange rate reform, companies in the textile industry managed to take various measures to reduce the exchange rate appreciation pressures and they achieved good results.

Speeding up industrial restructuring and focusing on brand cultivation.

According to the PBC's survey of textile companies in the fourth quarter of 2007, 64.2 percent of the sample companies adopted a strategy to upgrade product quality, technological ingredients, and value-added. With the acceleration of the export product upgrading in recent years, there was an upgrading of foreign sellers of Chinese textile and garments from popular supermarket retailers to middle and high-grade retailers and brand-name shops. Some textile companies strengthened their brand development ability by self-initiated development or by introducing of advanced technologies so as to transfer from production and processing for foreign brands to designing their own brands and cooperating in research & development. According to the survey, around one-third of the textile companies continue a strategy of enhancing their brand influence or creating their own brands.

Boosting export negotiating capacity and raising prices of export goods. Since the RMB exchange rate reform, most textile exporters reduced RMB appreciation pressures by increasing export prices. According to the survey, in the first half of 2007, about 55 percent of textile exporters experienced export price hikes. Some leading companies in the textile industry held a strong price negotiation capacity in the international market on the basis of their competitive advantages, such as complete production chains, product quality, and strong adaptability. By increasing export prices, textile companies were effectively relieved of the negative impacts of the high production costs, the RMB appreciation, and the cut in the export rebate rate.

Adopting a diversified operational mode and exploring new markets. In recent years, textile companies proactively adjusted their strategies by adopting a diversified operational philosophy. On the one hand, they largely increased the import of equipment and textile materials and expanded the share of domestic sales; on the other hand, they diversified investments by investing more in high-tech products, shipbuilding, real estate, and financial areas. Meanwhile, textile companies made great efforts to open new export markets. Under the precondition of maintaining their traditional European and American markets, they focused on developing markets in the ASEAN countries, Australia, New Zealand, Latin America, and Africa and creating new strategic partnerships with foreign counterparts.

Further consolidating industrial advantages and promoting geographical relocation in an orderly fashion. Confronted with various pressures, the textile industry made efforts to close down backward production facilities so that the leading companies could speed up industrial restructuring with their strong technical capacity. The concentration of industrial advantages effectively promoted the optimization of resource allocations and the enhancement of overall technical levels. At the same time,

the textile industry realized regional relocations, with textile investments relocating from the coastal areas to the hinterland.

Proactively taking financial measures to avoid exchange rate risks and strengthening risk management capabilities. Textile companies adjusted the currency structure in assets & liabilities, changed the trade settlement mode, and adopted non-US dollar currency for payment, as well as making use of many financial tools to avoid exchange rate risks. According to the PBC's survey of textile companies in the fourth quarter of 2007, 29.7 percent of the sample companies used forward foreign exchange purchase and sale instruments to avoid exchange rate risks, whereas 15.8 percent of the companies adopted trade financing tools, up 2.5 and 0.2 percentage points from the previous year respectively.

II. Micro-economic entities will face more severe challenges in 2008

In 2008 there will be generally increased uncertainties in global economic developments, and the tightening of liquidity in Europe and America caused by the U.S. sub-prime mortgage crisis may impact the real economy and weaken the affected countries' demands for Chinese products. In the fourth quarter of 2007, as export growth in China slowed down, most companies estimated that export profits and orders would decline, and micro-economic entities would face more severe challenges. Take the textile industry as an example: The survey of textile companies in the fourth quarter indicated that demand changes in the international market, the RMB appreciation, adjustments in the export rebate policy, and the increase in material prices and labor costs ranked top among the "main factors affecting exports." First, affected by the sub-prime mortgage crisis in the U.S., foreign demand growth moderated, affecting consumption demand as well. Second, labor costs, material prices, and energy prices and transportation fees surged. Currently, the hourly wages of textile workers in the eastern and coastal areas of China already exceed those in India. From January through November 2007, the export container transportation index increased by 14.8 percent. Third, though the export rebate policy and tariff policy adjustment helped to optimize the export goods structure and to reasonably protect and make use of domestic environmental resources, they exerted pressures on the capital turnover of companies and export market adjustments. Fourth, with the intensified trade protectionism in the developed countries, international trade frictions will continue to increase.

Against the above-mentioned background, micro-economic entities should attach great importance to the impact of external economic environmental changes on their operational decision-making, and more proactively cope with the challenges brought about by external environmental changes and boost their abilities to resist external shocks. Micro-economic entities should take the opportunity to transform the trade development mode, promote improvements in overall competitiveness, and further strengthen their negotiating power with foreign counterparts. Moreover, commercial banks should develop tailored financial products for different companies so as to

create a more favorable financial environment for the healthy and sound development of foreign trade companies.

Part 3 Financial Market Performance

In 2007 the financial market continued to evolve in a sound and steady manner, with relatively abundant market liquidity, brisk trading activities on the money market and capital market, good performance of bond issuances, a steady increase in issue rates, an evidently upward yield curve on the bond market, sound performance of the foreign exchange market, steadily expanded innovative financial products, and improved institutional building of the financial market. In the domestic non-financial institution sector, including households, enterprises, and the government sector, funds raised through major financing instruments totaled 4.97 trillion yuan. In terms of the financing structure, loan financing continued to play a dominant role; the share of equity financing increased obviously, with its role significantly strengthened in allocating social funds, whereas the share of government securities financing (excluding special government bonds) and corporate bond financing decreased by a large margin.

Table 4: Financing by Domestic Non-financial Sectors in 2007

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	2007	2006	2007	2006
Financing by the domestic non-financial sector	49705	39874	100.0	100.0
Bank loans	39205	32687	78.9	82.0
Equities	6532	2246	13.1	5.6
Government securities	1790	2675	3.6	6.7
Corporate bonds	2178	2266	4.4	6.7

Notes: 1. Equity financing does not include financing by financial institutions in the stock market.

2. Government securities financing does not include 1.55 trillion yuan of special government bonds.

Source: The People's Bank of China.

I. An overview of financial market operations

1. Trading on the money market was active, market interest rates increased with

fluctuations, and fund lenders in the market diversified

In 2007 transactions on the inter-bank repo market and borrowing market were active, with daily transactions climbing to new highs and the market size expanding rapidly. The turnover of bond repos registered 44.8 trillion yuan in the inter-bank market, with the daily turnover averaging 179.9 billion yuan and a year-on-year growth of 69.8 percent. Inter-bank borrowing registered 10.7 trillion yuan, with the daily turnover averaging 42.8 billion yuan (a record high level) and a growth of 4 times year on year. Most of the transactions were overnight products, and fund demand displayed a trend of shortening maturities. Borrowing and repo overnight products accounted for 75.4 percent and 52.2 percent on the borrowing and repo markets respectively. Fund lenders and borrowers showed two distinct features: first, fund lenders diversified, and included other commercial banks rather than only state-owned commercial banks as in the past. Second, foreign financial institutions showed a strong demand for capital due to their rapid loan expansion, with net purchases representing year-on-year growth of 169 percent. At end-2007, outstanding RMB loans of foreign financial institutions amounted to 376.2 billion yuan, a year-on-year growth of 82.8 percent. In 2007 the total turnover of government bond repos in the exchange market increased by 101.8 percent year on year to 1.83 trillion yuan.

Table 5: Fund Flows among Financial Institutions in 2007

Unit: 100 million yuan				
	Repo		Inter-bank borrowing	
	2007	2006	2007	2006
State-owned commercial banks	-132639	-124757	11031	-3168
Other commercial banks	9899	52114	-28619	-5218
Other financial institutions	88364	59825	10868	5952
Of which: Securities and fund management companies	15175	17797	7670	5236
Insurance companies	31055	18664	—	—
Foreign financial institutions	34376	12819	6720	2434

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

Source: The People's Bank of China.

Interest rate derivatives developed at a steady pace, and the Shibor played a significant role in the pricing of interest derivatives. The trading volumes of bond forwards and RMB swaps displayed an overall upward trend. The forward interest rate agreement was formally launched on November 11, 2007. At end-2007, 14 transactions were made on forward interest rate agreements, with the turnover reaching 1.05 billion yuan, and 24 institutions had fulfilled the requirement of filing

with the China Foreign Exchange Trading System. In 2007 the Shibor-based interest rate swap accounted for 13 percent of the total RMB interest rate swap transactions, with the share increasing to 24 percent in the second half of the year. Most of these transactions were based on 3-month and overnight Shibor, which respectively accounted for 79 percent and 20 percent of the Shibor-based transactions. After the introduction of the forward interest rate agreement, the 3-month Shibor was adopted as the basis for the pricing of all relevant transactions.

Table 6: Transactions of Interest Rate Derivatives

	Bond forwards		RMB interest rate swaps	
	Transactions	Turnover (RMB 100 million)	Transactions	Nominal principal (RMB 100 million)
2005	108	177.99	-	-
2006	398	664.46	103	355.70
Q1 2007	253	357.19	276	393.64
Q2 2007	291	648.95	636	639.02
Q3 2007	364	576.46	565	622.53
Q4 2007	330	935.49	501	531.71
Total	1744	3360.54	2081	2542.60

Note: Bond forward transactions were launched in June 2005; the RMB interest rate swaps began in February 2006.

Source: China Foreign Exchange Trading System.

Box 3: The Shibor was preliminarily established as the money market benchmark interest rate

The Shanghai Inter-bank Offered Rate (Shibor) was formally launched on January 4, 2007, indicating that China had begun to build a money market benchmark interest rate system. The establishment of the Shibor is conducive to further strengthening the pricing capacity of financial institutions, guiding the pricing of money market products, improving the monetary policy transmission mechanism, and advancing the market-based interest rate reform.

With the concerted efforts of the central bank and market members over the past year, the Shibor has been established as the money market benchmark interest rate. The short-end Shibor within 3 months fully reflected the changes in market supply of and demand for funds, and it had three features: first, it was representative of the market interest rate. The short-end Shibor was highly correlated with the borrowing and pledged repos. Second, the spread between the Shibor and the money market rate increasingly stabilized. Third, market transactions based on the Shibor steadily increased. More than 82 percent of borrowing and pledged repos was transacted based on the Shibor. The medium- and long-end Shibor with a maturity of 3 months (or above) reflected market expectations of future interest rate movements, and the

transactions were mainly concentrated in the bond market, commercial bill market, and derivatives market.

The Shibor promoted the rapid development of the money market. In 2007 the trading volume on the inter-bank market totaled 71.3 trillion yuan, increasing by 32.2 trillion yuan or 82 percent on a year-on-year basis. In particular, the trading volume of borrowing rose by 395 percent to 10.6 trillion yuan, and that of repo increased by 68 percent to 44.1 trillion yuan, both hitting record highs. The borrowing transactions and repo transactions of banks eligible for price quotation accounted for 94 percent and 80 percent respectively of the total. The turnover of medium- and long-end borrowing and repos reached 190.4 billion yuan, up 101 percent from a year earlier. The turnover was seen in all key products, including medium- and long-end products in the money market. At present, the development of the Shibor and money market are mutually reinforcing.

The Shibor was widely used in the market-based pricing of products. First, the Shibor provided an increasingly important guidance for the pricing of bond products. In 2007 floating-rate bonds, short-term financing bills, and corporate bonds issued based on the Shibor totaled 99 billion yuan, 137.6 billion yuan, and 165.7 billion yuan respectively, accounting for 18 percent, 41 percent, and 97 percent of total issuances in the market. Second, financial innovative products based on the Shibor traded briskly. In particular, the turnover of interest rate swaps reached 28.5 billion yuan, the forward interest rate agreement registered 1.05 billion yuan, and inter-bank borrowing and deposit and wealth management products amounted to 130 billion yuan. Third, the market-based pricing mechanism based on the Shibor was initially set up for bill rediscount businesses and repo businesses. Fourth, the quoted price of internal fund transfers was more or less combined with the Shibor. The pricing mechanism based on the Shibor in the building of the financial market and the relationship among interest rates was clear and appropriate.

The Shibor is vital to further advancing the market-based interest rate reform. First, as an important financial infrastructure, the Shibor is directly related to the market-based interest rate reform and the building of the treasury bond yield curves. The establishment of the Shibor promoted the development of the market-based interest rate reform and provided a market reference for the reform of deposit and lending rates. Therefore, promoting the development of the Shibor is key to the current market-based reform of the interest rate. Second, the Shibor is conducive to the transformation of the mechanism of commercial bank operations. The introduction of the Shibor provided a better basis for the internal and external pricing of commercial banks, greatly enhanced pricing transparency, and vigorously advanced the reform of the interest rate pricing mechanism as well as the operation and management mechanism of commercial banks, and promoted the transformation of Chinese commercial banks from traditional banks to modern banks. Third, the Shibor fostered the adoption of price instruments in monetary policy. The development of the Shibor will further deepen the money market and the capital market, help to improve the Shibor-based RMB market interest rate system, establish an interest rate formation

and transmission mechanism that allows the central bank to adjust the Shibor with price instruments and affects the behavior of financial institutions, enterprises, and residents through the Shibor, and promote the transfer of monetary policy instruments from quantity instruments to price instruments in macroeconomic management.

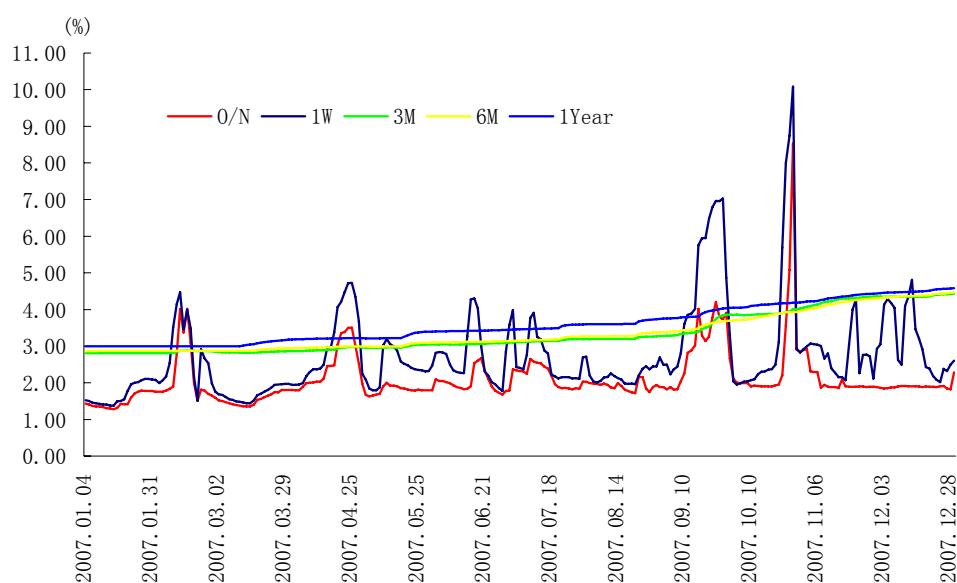
Table 7: Use of the Shibor in 2007

	Issuance / transactions	Turnover (100 million yuan)	As a percentage of total transactions
Floating-rate bonds	10	990	18
Short-term financing bills	107	1376	41
Corporate bonds	78	1657	97
Interest rate swaps	424	285	13
Forward interest rate agreements	14	11	100

Source: The People's Bank of China.

Affected by such factors as the concentration of pre-IPO (especially the big caps) capital verifications, the interest rate on the money market fluctuated greatly in 2007. Under the guidance of central bank monetary policy, the money market rate was on a rising trend and accelerated particularly in the second half of 2007, hitting a record high in October. At end-2007, the Shibor with maturities of 3 months and 1 year stood at 4.4348 percent and 4.5825 percent respectively, increasing by 1.63 and 1.58 percentage points respectively from the end of January and exceeding the extent of the one-year deposit rate adjustment by 0.28 and 0.23 percentage points respectively. The weighted average interest rates of inter-bank borrowing and pledged repo were 2.09 percent and 2.79 percent respectively, up 0.23 and 1.13 percentage points respectively from January.

Figure 2: Movements of the Shibor in 2007



Source: National Inter-bank Funding Center.

2. Brisk issuances and transactions in the bond market were accompanied by a steady rise in bond issue rates

In 2007 spot transactions were active on the inter-bank bond market, with the turnover totaling 15.6 trillion yuan and the daily turnover increasing by 53.4 percent to 62.7 billion yuan, reaching a historical high. The turnover of government bond spot transactions on the exchange market registered 120.1 billion yuan. On the inter-bank spot transaction market, the state-owned commercial banks, other financial institutions, and foreign financial institutions were the largest net purchasers, with net purchases of 474.1 billion yuan, 209.4 billion yuan, and 165.3 billion yuan respectively. Other commercial banks were the largest net sellers, with net sales of 828.2 billion yuan, a year-on-year increase of 27 percent.

Financing activities were brisk on the primary bond market. In 2007 a total of 2.48 trillion yuan in bonds (excluding central bank bills and special government bonds) was issued, an increase of 222 billion yuan, or 9.8 percent, from the previous year. In terms of maturity, 62.3 percent of the issued bonds had a maturity of less than five years, down 4.8 percentage points from a year earlier. Market products further diversified. In 2007, 7 financial companies issued a total of 15 billion yuan in financial bonds on the inter-bank bond market, 3 listed companies issued 12.2 billion yuan in corporate bonds, and domestic financial institutions issued a total of 10 billion yuan in RMB bonds in Hong Kong.

Table 8: Issuance of major bonds and innovative bonds in 2007

Bond	Issuance (100 million yuan)	Year-on-year growth (%)
Government securities	7637	-14.0
Policy financial bonds	11090	23.5
Bank subordinated bonds and hybrid capital bonds	377	75.1
Bank common bonds	446	43.9
Corporate bonds	5059	28.4
Of which: short-term corporate financing bills	3349	14.7
Asset-backed securities	178	—

Note: Special government bonds were excluded from government securities.

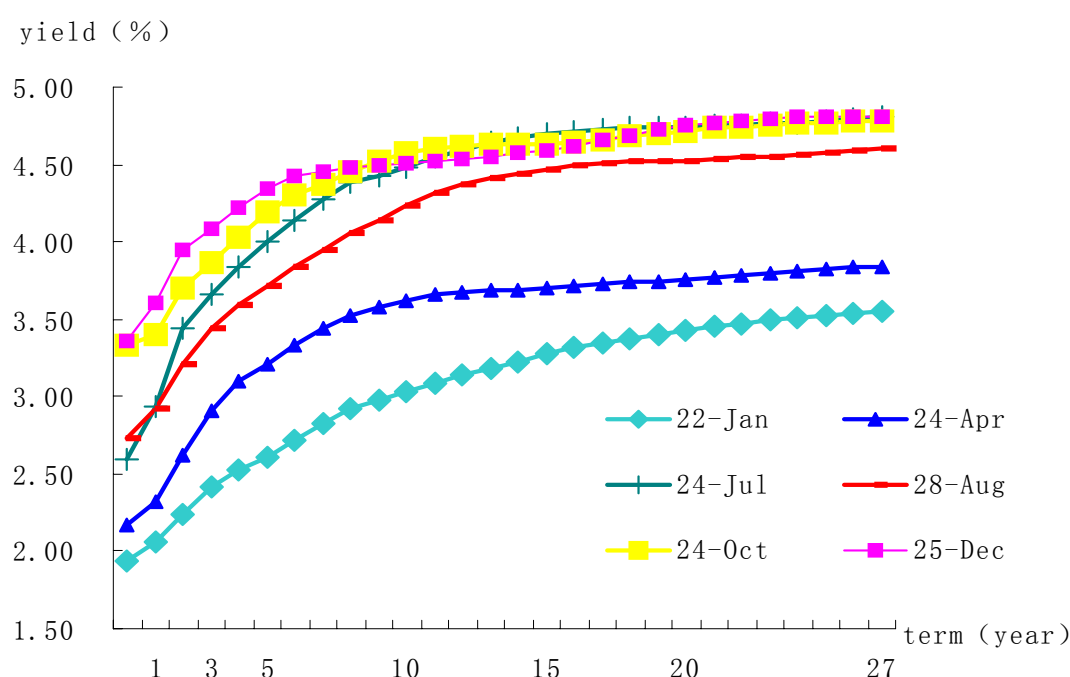
Source: The People's Bank of China.

Both the inter-bank market bond index and the stock exchange bond index declined. In 2007 the inter-bank market bond index was down from 116.79 points at beginning-2007 to 114.76 points at end-2007. The government securities index on the exchange market decreased to 110.87 points at end-2007 from 111.39 points at beginning-2007.

The yield curve of government securities on the inter-bank bond market displayed an overall upward trend. Specifically, from January to July, the bond price on the

inter-bank market gradually declined, and the yield curves went upward across the spectrum and suddenly became steeper. From late July to end-August, the trend of the yield curve of government securities changed due to the changes in market expectations. The short-term yield curve edged up, whereas the medium and long-term yield fell with flattening yield curves. Thereafter, the yield curve on the inter-bank bond market climbed, rebounding at end-2007 to the level recorded in late July. However, since the yields of short- and medium-term bonds rose by a larger margin, the yield curve flattened further.

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



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

The issue rates of bonds edged up. Affected by strengthened market expectations of inflation and a series of macroeconomic management measures, including the six required reserve ratio hikes, bond market financing costs rose obviously in 2007. The interest rate on 1-year book-entry treasury bonds issued in December 2007 was 3.66 percent, up 1.56 and 1.05 percentage points respectively from March and June; the interest rate on 7-year fixed rate bonds issued by the China Development Bank in December rose to 5.14 percent, up 1.32 and 0.79 percentage points respectively from April and August; the issue rate on 10-year corporate bonds issued in December increased by 155-200 basis points on the basis of the 1-year Shibor, with the coupon rate ranging from 6.02 percent to 6.68 percent; the issue rate on 15-year corporate bonds grew by 141 basis points, with the coupon rate reaching 5.9 percent,

accelerations of 186 basis points and 142 basis points respectively from the beginning of the year.

3. Growth of commercial paper financing slowed down

In 2007 a total of 5.87 trillion yuan of commercial bills was issued by the corporate sector, up 8.13 percent year on year; discount bills totaled 10.11 trillion yuan, up 19.07 percent from 2006; and rediscount bills reached 13.822 billion yuan, a year-on-year increase of 9.835 billion yuan. Outstanding commercial bills amounted to 2.44 trillion yuan, up 10.36 percent from the previous year; outstanding discounts stood at 1.28 trillion yuan, representing a year-on-year decrease of 25.61 percent; and outstanding rediscount bills amounted to 5.743 billion yuan, 3.92 billion yuan more than that in 2006.

The commercial bill business in 2007 saw large fluctuations and the growth of the discount business decelerated on a year-on-year basis for the first time since 2001. The growth of acceptance of commercial bills slowed down, with the outstanding acceptance of commercial bills increasing by 228.8 billion yuan, 21.3 billion yuan less than the growth recorded a year earlier. The outstanding discount witnessed a large decrease, down 441.4 billion yuan at end-2007 from the beginning of the year. Due to its short maturity, rapid circulation, controllable risks, and stable costs and returns, commercial paper financing has become an important means for commercial banks to adjust the asset and liability structure and to manage liquidity. In addition, the market-based interest rate of commercial bills was able to transmit monetary policy signals in a timely and effective manner and to respond immediately to macro management policies. Therefore, with the macroeconomic management further strengthened, commercial banks reduced commercial bill business for the purpose of adjusting credit aggregates and structure and maximizing profits.

4. The stock index soared, with transactions and financing in the stock market hitting record highs, and the fund market developed at a fast pace

Trading was active in the stock market, and investors had a remarkably strong willingness to invest in the stock and fund markets. In 2007 the total turnover of the Shanghai and Shenzhen Stock Exchanges reached 46.1 trillion yuan, reaching a new record high. Daily trading averaged 190.3 billion yuan, representing a year-on-year increase of 4.1 times, and 60.5 million new investment accounts were opened, 10.5 times the total in 2006.

Except for the large adjustments of the stock index from end-May to late July and at year-end, the stock index rose rapidly in 2007, and it reached its highest level on October 16 (the Shanghai Stock Exchange Composite Index recorded 6124 points, increasing by 3449 points from the beginning of the year). At end-2007, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index soared to 5262 points and 1447 points respectively, increasing by 97 percent and 163 percent from the beginning of the year. The average P/E ratio of A-shares on

the Shanghai Stock Exchange was 59, a historical high level.

The financing functions of the stock market recorded a new high. Driven by the return of H-shares in the domestic A-share market and the steady acceleration of IPOs, in 2007 a total of 852.2 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 52.4 percent. In particular, funds raised on the A-share market (including additional offerings and rights issues) reached 752.1 billion, a growth of 2.1 times year on year and accounting for 88.3 percent of the total financing.

Fueled by the soaring index and wider recognition of fund products, investors had a rising demand for wealth management products in funds. The fund market developed very rapidly. At end-2007, securities investment funds increased by 45 year on year to 346, and fund units amounted to 2.2 trillion yuan, a growth of 1.6 trillion yuan or 2.7 times from a year earlier. The net value of the funds reached 3.3 trillion yuan, an increase of 3 times year on year.

5. Assets in the insurance industry expanded rapidly and the asset structure changed noticeably

The insurance industry continued to develop at a steady pace, with total assets increasing rapidly. According to initial statistics, at end-2007 total assets in the insurance industry reached a historical high of 2.9 trillion yuan, up 47 percent over the previous year. The fast growth of assets was mainly driven by the rapid growth of premium income and equity-type and securities-type investment assets. In 2007 the total premium income in the insurance industry amounted to 703.6 billion yuan, up 24.7 percent year on year, with an increase of 32.4 percent in property insurance. With a large number of life insurance policies coming due, claim payments and benefits increased by 57.5 percent to 226.5 billion yuan. In particular, life insurance payments grew 2.2-fold to 106.4 billion yuan.

With strengthened management of insurance funds, the investment channel further expanded and the asset structure obviously changed. Investment assets, especially equity-type and securities-type fund investments, grew rapidly. At end-2007, investment assets increased year on year by 71.3 percent, accounting for nearly 70 percent of the total.

Table 9: Use of Insurance Funds at End-2007

	Outstanding balance (100 million yuan)		As a share of total assets (percent)	
	End-2007	End-2006	End-2007	End-2006
Total assets	29004	19731	100	100
Of which, Bank deposits	6516	5989	22.5	30.4
Investment	20206	11796	69.7	59.8

Source: China Insurance Regulatory Commission.

6. The foreign exchange market developed in a sound manner and RMB swap transactions were active

The inter-bank spot foreign exchange market operated smoothly and the dominant role of OTC transactions was strengthened, with market supply and demand continuing to play a fundamental role. The number of participants in the foreign exchange market further increased. The RMB swap transactions were brisk and the trading volume far exceeded that of forwards. In 2007 the turnover on the RMB swap market increased by 5.2 times and the turnover on the inter-bank forward market increased by 59.2 percent year on year, with most transactions in the USD/RMB currency pair. The trading volume of currency pairs increased steadily. In 2007 the turnover of eight “currency pairs” totaled US\$89.8 billion, up 18.7 percent from the previous year, with transactions in the major currency pairs of the USD/HKD, USD/JPY, and EUR/USD accounting for 86 percent of the total trading volume.

II. Financial market institutional building

1. Infrastructure building in the inter-bank market was actively advanced

First, the *Regulation on the Market-Maker System on the Inter-bank Bond Market* was issued to improve the present market-maker system framework through various channels, such as lowering market access, intensifying policy support, easing business requirements, and strengthening performance assessments. Second, the newly revised *Administrative Rules on Inter-bank Borrowing* entered into force, which allowed more participants to access the inter-bank borrowing market, simplified the tranches of maturity management, appropriately extended the longest lending maturity of some financial institutions, and at the same time relaxed the quota verification standards of most financial institutions. The *Rules* also stipulated the information disclosure obligations, basic principles, platform, and responsibility of market participants, which provided institutional guarantees for the transparency of market operations. Third, the National Association of Financial Market Institutional Investors was established to mobilize market participants to exercise self-disciplined management, shift government functions, and cater to market demands. In October 2007, with the authorization of the PBC, the National Association of Financial Market Institutional Investors issued the *Master Agreement for Financial Derivatives in the National Inter-bank Market* to put in place the basic rules of financial derivative transactions for market participants. Moreover, steps have been taken to actively support the issuance, trading, circulation, and registration and custody of corporate bonds on the inter-bank bond market, to introduce the enterprise annuity fund on the inter-bank bond market, to actively cultivate and develop institutional investors, and to specify

“the actual number of days/ 365” as the benchmark to calculate the yields-to-maturity of the inter-bank bond market.

2. The pilot program for asset-backed securities was steadily expanded

The *People's Bank of China Announcement* specified rules and regulations on information disclosure concerning underlying asset pools as well as pledged repo transactions of asset-backed securities to provide vigorous support for preventing risks and enhancing the liquidity of asset-backed securities. By the end of 2007, China had issued a total of 36.3 billion yuan in asset-backed securities on the inter-bank market.

3. Financial derivative products were diversified

The forward interest rate agreement business and RMB foreign currency swaps were launched on the inter-bank securities market. The forward interest rate agreement introduced in September 2007 was conducive to strengthening the capability of investors to manage interest rate risks, enhancing market stability, improving price discovery, and the coordinated development of the financial derivatives market. RMB foreign currency swaps were introduced on the inter-bank foreign exchange market in August 2007 to manage medium- and long-term exchange rate risks, and they began trading on December 10, which further diversified the products available on the inter-bank foreign exchange market so as to satisfy the needs of domestic market participants to hedge risks.

4. Institutional building for stock and futures market supervision was strengthened

First, the newly revised *Regulation on Futures Transactions* was released, which expanded the application and improved the risk control and regulation system of the futures market. Second, the *Regulation on Information Disclosure of Listed Companies* was released to improve the rules and supervisory procedures for information disclosure of listed companies. Third, the 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 legal rights of investors. Fourth, the *Methods on Determining Insider Trading* and *Methods on Determining Market Manipulation* came into force on a tentative basis, which clarified the standards on how to determine insider trading and market manipulation in order to speed up the investigation and punishment of such behavior. In addition, a system to coordinate cross-market supervision of stocks and stock index futures took initial form and the securities law enforcement system was reformed. The chief enforcement office and investigation team of the China Banking Regulatory Commission were established to set up a centralized investigation system and to

improve investigation work.

5. Corporate governance of insurance companies was regulated and the building of a risk prevention and resolution mechanism was promoted

A series of documents were released to improve corporate governance of insurance companies, foster insurance companies to establish a standard management and risk control system, and strengthen the regulatory basis of insurance companies. The *Provisional Guidance on Credit Ratings of Bond Investments by Insurance Companies* and *Guidelines on Emergency Management of Major or Unexpected Events in Insurance Asset Management* were put in place to enhance the risk awareness of insurance institutions and to build and improve the risk management system for insurance assets so as to safeguard the safety of insurance funds. The development of key businesses was advanced, and efforts were made to regulate the pension insurance business, promote the specialization of pension insurance, and protect the interests of policyholders and beneficiaries. The opening up of the insurance sector was steadily promoted and insurance institutions were allowed to invest overseas with their own or purchased foreign exchange.

Part 4 Macroeconomic Analysis

I. Global Economic and Financial Development

In 2007 the world economy maintained a momentum of stable growth. Affected by the sub-prime mortgage turbulence in the U.S., U.S. economic growth clearly slowed down, the euro zone faced downward risks; Japanese economic growth decelerated moderately, but the major emerging economies and developing countries (regions) registered robust economic growth. On January 29, 2008, the IMF projected growth of the global economy in 2007 to be 4.9 percent, 0.2 percentage points higher than the projection made in October, 2007, but 0.1 percentage points lower than the actual growth in 2006.

1. Developments in the major economies

The U.S. economy clearly slowed down. In 2007 the U.S. GDP grew by 2.2 percent, 0.7 percentage points lower than that in the previous year, hitting a new low since 2002. Broken down by quarters, in Q1 annualized quarter-on-quarter growth after seasonal adjustments was merely 0.6 percent. But in Q2 and Q3 GDP growth resumed its momentum, posting 3.8 and 4.9 percent respectively. In Q4 economic growth decelerated to 0.6 percent influenced by the deepening recession in the real estate market, weak business and household consumption, the deteriorating crunch in the financial market, and other factors. Inflationary pressures picked up, with the quarterly CPI up 2.4 percent, 2.7 percent, 2.4 percent, and 4.0 percent year on year respectively. The employment situation worsened, with the quarterly unemployment rate registering 4.5 percent, 4.5 percent, 4.7 percent, and 4.8 percent respectively. The trade deficit dropped somewhat. The deficit of trade in goods and services in 2007 posted US\$711.6 billion, a reduction of US\$46.9 billion year on year. The trade deficit to GDP ratio decreased from 5.7 percent in 2006 to 5.1 percent in 2007. The fiscal deficit shrank significantly. In FY2007 that ended on September 30, 2007, the fiscal deficit plummeted by 34.4 percent from a year earlier to US\$162.8 billion. The percentage of the fiscal deficit to GDP declined to 1.2 percent, its lowest point in five years.

Growth in the euro zone confronted downside risks. In 2007 the GDP of the euro zone rose by 2.7 percent, 0.1 percentage points lower than that in the last year, with quarterly growth standing at 3.2 percent, 2.5 percent, 2.7 percent, and 2.3 percent respectively year on year. Inflationary pressures continued to build, driven by the oil

and food price hikes. The Harmonized Index of Consumer Prices (HICP) grew 1.9 percent year on year in the first three quarters respectively, and edged up from September 2007, surpassing the European Central Bank target of 2 percent four months in a row and posting 2.9 percent in the fourth quarter. Employment further improved. The quarterly unemployment rate in 2007 registered 7.6 percent, 7.5 percent, 7.3 percent, and 7.2 percent respectively, whereas the trade surplus reached 28.3 billion euro, as compared with a deficit of 9.3 billion euro in the corresponding period of 2006.

The Japanese economy slowed down moderately. GDP grew by 2.1 percent in 2007, a decrease of 0.3 percentage points over 2006, with the quarterly GDP posting 3 percent, 1.7 percent, 1.7 percent, and 2 percent year on year respectively. Prices were generally stable, with the CPI declining by 0.1 percent year on year in the first three quarters and posting positive growth of 0.5 percent in the fourth quarter. There was a downward trend in unemployment, with the quarterly unemployment rate registering 4 percent, 3.8 percent, 3.8 percent, and 3.8 percent respectively. In 2007 the trade surplus amounted to 10.8 trillion yen, an increase of 2.9 trillion yen over the same period of 2006.

In addition, growth in the major emerging market economies and developing countries (regions) remained robust, but inflationary pressures were on the rise. Driven by domestic demand and foreign trade, the Asian emerging markets continued to grow forcefully. Stable growth continued in the Latin American countries. In October 2007 the IMF projected that inflation in the emerging markets and developing countries (regions) would register 5.9 percent and 5.3 percent in 2007 and 2008 respectively, 0.8 and 0.2 percentage points higher than the actual inflation in 2006 respectively.

2. International financial market developments

The U.S. dollar weakened against the euro and the yen in 2007. On December 31 the euro to dollar and dollar to yen exchange rates closed respectively at 1.46 dollar per euro and 111.33 yen per dollar, indicating a depreciation of the greenback against the euro by 9.6 percent and against the yen by 6.5 percent since the beginning of 2007.

The yields of major bonds rebounded gradually in the first half of 2007, but showed a declining trend in the latter half of the year. The returns of ten-year government securities in the U.S., euro zone, and Japan closed at 5.29 percent, 4.68 percent, and 1.97 percent respectively in June and July, setting records for 2007. The returns of 10-year government securities in the U.S. closed at 4.03 percent on December 31 and

in Japan at 1.50 percent on December 28, down 0.64 and 0.22 percentage points respectively from the beginning of 2007. On December 31, the returns of 10-year government securities in the euro zone closed at 4.34 percent, up 0.4 percentage points from the beginning of the year.

Due to the turmoil associated with the sub-prime mortgage loans in the U.S. and uncertainties in the prospects for economic growth, interest rates in international financial markets fluctuated considerably. The dollar Libor in the London inter-bank borrowing market remained stable in the first half of 2007 due to a respite in the Fed interest hikes, but it declined at an accelerated speed from June 15 when it hit its highest point in 2007 of 5.51 percent due to consecutive Fed interest rate cuts and uncertainties of economic growth in the latter half of the year. On December 31 the one-year dollar Libor registered 4.22 percent, a decrease of 1.11 percentage points from the beginning of the year, hitting a record low for the year. Due to the economic growth and anticipated rate hikes by the European Central Bank, the Euribor climbed up continuously in 2007, reaching a peak of 4.89 percent on December 17 before declining when the impact of the U.S. sub-prime mortgage crisis began to be felt; the one-year Euribor tumbled to 4.75 percent on December 31, 0.72 percentage points higher than at the beginning of the year.

Major stock indices had large ups and downs. Major indices around the world rallied from the beginning of 2007 to February 26, but plummeted on February 27 before gradually recovering. Thereafter, global stock markets fluctuated greatly due to the turmoil in the U.S. sub-prime mortgage market. On December 31, the Dow Jones Industrial Average and the NASDAQ closed at 13265 points and 2652 points respectively, up 6.3 percent and 9.5 percent respectively from the beginning of the year; the STOXX50 and Nikkei 225 closed at 3684 points and 15308 points respectively, down 1.7 percent and 11.8 percent respectively from the beginning of the year.

3. Development of housing markets in the major economies

Due to the sub-prime mortgage loan turmoil, the U.S. housing market continued to slow down. In Q3 2007, the U.S. Housing Price Index rose by 1.8 percent year on year, the lowest increase since Q2 of 1995, while quarter-on-quarter growth posted its first-ever negative growth of minus 0.4 percent in almost 13 years. At the same time, the number of new home constructions, new home sales, and the inventory of new homes showed a general downward trend, posting annualized data after seasonal adjustments of 1.006 million, 604,000, and 495,000 respectively in December, down

14.2 percent, 4.7 percent, and 1.4 percent respectively year on year.

The housing market in Europe continued to adjust. In the U.K., housing prices dropped moderately at year-end, but still remained at a relatively high level, with the Housing Price Index in December growing by 4.6 percent year on year. Housing prices in Spain tumbled significantly, with some regions witnessing a drop as large as 20 percent. In addition, the housing markets in Germany and Portugal remained sluggish.

Average land prices in Japan continued to grow negatively but at a decelerated rate. At end-March and end-September 2007, the National Land Price Index declined by 2.1 percent and 1.0 percent respectively year on year. In addition, affected by factors such as the newly published *Basic Law on Construction* that required close scrutiny of construction projects, the number of new homes reached a record high in June 2007 from January 2000, but tumbled continuously from July 2007, with the drop in September posting the biggest slump since recording began of 44 percent. In 2007 the number of new homes dropped to 1.06 million, a decrease of 17.8 percent and the first year-on-year drop in five years.

4. Monetary policy in the major economies

Each Federal Open Market Committee meeting in the first half of 2007 decided to keep the federal funds target rate unchanged at 5.25 percent, but cut the federal funds target rate by 50, 25, and 25 basis points respectively on September 18, October 31, and December 11. The target rate was cut by 1 percentage point in cumulative terms. On January 21, 2008, during an ad hoc meeting, the Federal Open Market Committee decided to cut the federal funds target rate by 75 basis points to 3.5 percent, and on January 30 another 50 basis points were slashed to bring the federal funds rate down to 3 percent. On March 8 and June 6, 2007, the European Central Bank raised the major re-financing interest rate by 25 basis points respectively to 4.0 percent, and kept it on hold ever since. The Bank of Japan raised the uncollateralized overnight call rate by 25 basis points to 0.5 percent, and kept it unchanged thereafter. The Bank of England cut the official interest rate by 25 basis points on December 6 to 5.5 percent, the first rate cut in two years. On February 7, 2008, the Monetary Policy Committee of the Bank of England cut the official interest rate by another 25 basis points to 5.25 percent.

II. Analysis of China's macroeconomic performance

In 2007 China's economy grew steadily and rapidly. Industrial production growth accelerated. Consumer demand was relatively strong. Household income, corporate profits, and fiscal revenue all increased substantially. But problems such as the large trade surplus and excessive investment growth were not fundamentally resolved, and prices were on the rise. In 2007 GDP stood at 24.7 trillion yuan, up 11.4 percent, an acceleration of 0.3 percentage points over the previous year. The CPI rose by 4.8 percent, up 3.3 percentage points over that in the previous year. The trade surplus registered US\$262.2 billion, an increase of US\$84.7 billion.

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

Household income grew rapidly, and domestic consumer demand was relatively strong. In 2007 the per capita disposable income of urban residents was 13,786 yuan, up 12.2 percent in real terms, an acceleration of 1.8 percentage points over 2006. The per capita cash earnings of rural residents were 4,140 yuan, an increase of 9.5 percent in real terms and an acceleration of 2.1 percentage points. The rapid income growth of urban residents and other factors supported the rapid expansion of sales. In 2007 total retail sales posted 8.9 trillion yuan, up 16.8 percent, an acceleration of 3.1 percentage points. Total urban retail sales grew 17.2 percent, whereas total retail sales growth at the county level or below registered 15.8 percent. In 2007 commodity retail prices rose by 3.8 percent, and the gross volume of retail sales in real terms rose by 12.5 percent. The urban household survey results showed that consumption expenditures accelerated. The per capita consumption expenditures of urban households grew 15.0 percent year on year, or 10.0 percent in real terms, an acceleration of 2.1 percentage points.

Fixed-asset investment growth remained high. In 2007 fixed-asset investment reached 13.7 trillion yuan, up 24.8 percent, an acceleration of 0.9 percentage points over 2006. Urban fixed-asset investment totaled 11.7 trillion yuan, up 25.8 percent, an acceleration of 1.5 percentage points over the previous year. Among urban investments, investments in primary industry outpaced those in secondary and tertiary industries. Investments in primary, secondary, and tertiary industries grew by 31.1 percent, 29.0 percent, and 23.2 percent respectively. In a breakdown by region, investment in the western region outpaced that in the eastern region. Investments in the eastern, central, and western regions were up 21.0 percent, 34.0 percent, and 28.2 percent respectively. Urban and rural investments increased 25.8 percent and 19.2

percent respectively, featuring a widening gap.

Export growth moderated, but the trade surplus continued to widen. In 2007 total imports and exports registered US\$2.2 trillion, an increase of 23.5 percent. In a breakdown by imports and exports, total exports reached US\$1.2 trillion, up 25.7 percent, a deceleration of 1.5 percentage points over the previous year, whereas total imports stood at US\$955.8 billion, up 20.8 percent, an acceleration of 0.8 percentage points year on year. In 2007 the total trade surplus registered US\$262.2 billion, an increase of US\$84.7 billion over 2006. Due to a series of policies that aimed at adjusting the import and export structure and curbing the excessive growth of the trade surplus, the trade surplus decelerated modestly in the latter half of the year, resulting in a reduced surplus at year-end. However, because the root causes of the trade surplus were international industrial transfers, strong demand in the international market for Chinese products, and the competitiveness of Chinese products, the problem of the excessive trade surplus was far from being resolved.

2. Agricultural production was upbeat, and industrial production accelerated

In 2007 the added-value of primary industry was up 3.7 percent to 2.9 trillion yuan, a deceleration of 1.3 percentage points from a year earlier; the added-value of secondary industry was up 13.4 percent to 12.1 trillion yuan, an acceleration of 0.4 percentage points over 2006; the added-value of tertiary industry was up 11.4 percent to 9.6 trillion yuan, an acceleration of 0.6 percentage points from 2006.

There were good prospects for agricultural production, featuring stable growth of grain production. Total grain output in 2007 registered 501.5 billion kilograms, an increase of 3.5 billion kilograms and 0.7 percent from a year earlier. Summer grain output reached 115.35 billion kilograms, up 1.3 percent; the output of early rice was 31.95 billion kilograms, similar to the level in 2006; the output of autumn grain totaled 354.2 billion kilograms, up 0.6 percent. The price hike in producer prices of agricultural products (prices of agricultural products sold directly by producers) surpassed that of the price hike of agricultural production materials, hence being conducive to increasing the farmers' income. In 2007 the producer prices of agricultural products were up 18.5 percent, with the price hikes of plants, forestry, animal husbandry, and fishing posting 9.8 percent, 4.4 percent, 31.4 percent, and 8.1 percent respectively, and with the prices of animal husbandry products, pork in particular, rising remarkably.

Industrial production expanded rapidly and industrial enterprises reported good profits. In 2007 the added-value of statistically large enterprises was up 18.5 percent, an

acceleration of 1.9 percentage points year on year. The sales rate of industrial enterprises was 98.1 percent, similar to the level a year earlier. From January to November 2007, statistically large industrial enterprises realized profits of 2.3 trillion yuan, up 36.7 percent, an acceleration of 6.0 percentage points year on year. The entrepreneurs' sentiment survey of 5,000 industrial enterprises conducted by the People's Bank of China showed that in Q4 2007, 39.5 percent of the respondents judged general business operations as "good," up 0.3 and 2.4 percentage points from the previous quarter and the same period of 2006 respectively, a record high since the survey began.

3. Stronger CPI growth

The growth of the CPI continued to accelerate compared with 2006. In 2007 the CPI was up 4.8 percent year on year, an acceleration of 3.3 percentage points from the previous year; the monthly average year-on-year CPI of the four quarters registered 2.7 percent, 3.6 percent, 6.1 percent, and 6.6 percent respectively. Soaring food prices were the major contributor to CPI inflation. Since November 2006, grain, meat, eggs, edible oil, fresh vegetables, and dairy products experienced price hikes one round after another; as a result, food price inflation edged up. In 2007 food price inflation reached 12.3 percent, driving the CPI up by 4 percentage points and contributing 83 percent to the CPI inflation. Growth of non-food prices was stable, up 1.1 percent in 2007 and representing an acceleration of 0.1 percentage points from 2006. Of consumer goods and services, the former experienced stronger inflation whereas the latter remained fairly stable. In 2007 consumer goods price inflation was 5.7 percent, 4.3 percentage points higher than 2006; service price inflation was 1.9 percent, an acceleration of 0.1 percentage points.

The prices of industrial goods were stable in the first half of 2007 but went up quickly in the second half. In 2007 the purchasing prices of raw materials, fuels, and power increased 4.4 percent, or 4.1 percent, 3.6 percent, 3.7 percent, and 6.3 percent in the four quarters respectively; the factory prices of industrial goods were up 3.1 percent year on year, or 2.9 percent, 2.7 percent, 2.6 percent, and 4.4 percent in the four quarters respectively. The prices of factors of agricultural production were up 7.7 percent, or up 4.2 percent, 6.2 percent, 8.7 percent, and 11.5 percent in the four quarters respectively. The surge in crude oil and iron ore prices in the international market, the significantly higher marine transportation costs, and the domestic demand boom drove up the prices of energy and ferrous metals and triggered the rallying of the production prices.

The growth of import and export prices was rapid, with import prices rising faster than export prices. In December 2007 import and export prices were up 8 percent and 6.6 percent year on year respectively, an acceleration of 2.7 percentage points and 3.9 percentage points respectively from a year earlier.

Labor compensation crept up quickly, and labor costs rose. In the first three quarters, the average monthly salary of employees in urban units was up 19 percent year on year to 1,839 yuan, whereas the average monthly salary of migrant rural workers was up 11.8 percent to 1,015 yuan.

The GDP deflator continued to rise. In 2007, with nominal GDP growth at 17.0 percent and real growth at 11.4 percent, the GDP deflator (nominal GDP growth minus real growth) was 5.6 percent, up 2.0 percentage points from 2006.

The pricing reform of resource goods proceeded smoothly. In 2007 reform measures were taken to further improve the coal pricing mechanism, and a new mechanism was established whereby buying and selling enterprises independently manage the resource link and negotiate prices; the practice of differentiated electricity tariffs was further implemented and the favorable tariff treatment to enterprises with high energy consumption was abolished. The localities also further differentiated water tariffs, raised the water charge collection standard, and collected sewage treatment fees. A new refined oil pricing mechanism was in place whereby the prices of Brent, Dubai, and Minas crude were used as a base plus a profit margin for oil refining enterprises to form domestic prices. In addition, in response to the persistently growing international oil price, the domestic prices of petroleum, diesel, aviation kerosene, and liquefied gas were hiked; the energy taxes on zinc and lead ore, copper ore, and tungsten ore were raised by a large margin. In January 2008 the State Council released the *Notice on Promoting Economical and Intensive Use of Land* to collect higher land prices from idle lands; the energy tax system will be further reformed to switch from a unit tax to an ad valorem tax and to impose an energy tax on more resources. The excessively low energy price is the major contributor to the internal and domestic imbalances in the Chinese economy. Although reforming resource prices might intensify inflationary pressures in the short run, it will facilitate transformation of the economic growth mode and the economic restructuring, reduce the trade surplus, and promote a more balanced BOP in the long run.

Box 4: In-depth Analysis of the Dynamics in the Price Hikes for More Effective Macroeconomic Management

Since the fourth quarter of 2006, driven by the massive food price hikes, China's CPI

experienced rapid growth. In the context of the changes in the inflation picture, the Central Economic Work Conference convened at the end of 2007 clearly pointed out that the first priority of macroeconomic management was to “prevent the slightly rapid economic growth from turning into overheating, and to prevent structural price inflation from evolving into a generalized inflation process.” Therefore, it is necessary to conduct in-depth analysis and research into the current round of price hikes in order to make the right choice of a policy response and to maintain stability in the general price level.

At the moment, against the backdrop of globalization and the economic transformation, the factors behind domestic inflation are much more complex, including both demand and supply as well as domestic and international factors. There are several prominent factors. First of all, pass-through from imported prices are having a larger impact on domestic inflation as the economy is more and more integrated with the rest of the world. With the large upward movements in the international prices of bulk commodities, grain, and assets, stronger inflationary pressures have become a global challenge. The CPI inflation in the major advanced economies and emerging markets is approaching the highest level in almost a decade, and inflationary pressures are likely to intensify in the near future. Although appreciation of the yuan exchange rate somewhat offsets the external inflation, higher international prices still have a visible impact on domestic prices. Second, the lack of supply shored up the prices of pork and other important commodities. Third, on the cost side, rising prices of the factors of production pushed up prices. With the strong and sustained economic growth, the labor supply has gradually become a constraining factor and structural tensions have gradually built up. Higher labor costs have gradually become a factor behind the higher prices. In addition, resource products price hikes have pushed up prices to a certain extent. As many factors are at work, it is necessary to consider their impacts on price movements, to formulate an appropriate mix of demand and supply policy, to measure the impacts of various factors, and to adopt targeted policies so that they will be more effective.

In order for monetary policy to play its role as a demand-management instrument and to guide public expectations, it is necessary to measure the price indices that are closely linked to aggregate demand and signal the long-term trends of price movements. It is the practice of many countries to exclude food and energy prices that are volatile and seasonal or subject to pricing by the government and to compile a core CPI that reflects the medium and long-term trends. For example, the United States compiles a chained index of the core CPI and the core PCEPI in addition to the PCERI. Since food has a large weight in the consumption of an average household in China, and food prices to a certain extent are affected by demand, it is less appropriate to exclude food altogether. Therefore, a benchmark consumer price index can be compiled by excluding the unprocessed food and energy products that are subject to seasonal, climatic, and international factors. In addition, considering the small share of consumption in China’s aggregate demand, it might not be sufficient to use the consumer price index to measure movements in the general price level. Therefore, it is

necessary to compile a benchmark composite price index to measure price movements of investment, consumption, and other major variables, in addition to the CPI. This will measure the long-term trends of price movements in a comprehensive and timely manner, make it easier for monetary policy to respond to changes in the fundamental trend of overall price movements promptly, and prevent monetary policy decisions from being disturbed by price fluctuations caused by temporary supply shocks and external factors. Also, it is worth mentioning that the year-on-year price index is susceptible to a base change and a carryover effect, and it has a lag in signaling dynamic price movements. As such, we should pay attention to the month-on-month price index after the seasonal adjustments to obtain an accurate understanding of the trend in price movements and to better monitor its dynamics. The People's Bank of China will continue to closely monitor the trend in price changes and will fine-tune the strength of macroeconomic management policies in a timely manner in order to allow monetary policy to play a proper role and to prevent structural price hikes from evolving into a generalized inflation process.

4. Fiscal revenues grew in an accelerated manner

In the first eleven months of 2007, total fiscal revenues (excluding debt income) totaled 4817.7 billion yuan, up 33.5 percent year on year and representing an acceleration of 8.8 percentage points compared with the same period of 2006. Among this total, domestic VAT revenue increased by 21.4 percent year on year, domestic consumption tax revenue increased by 17.6 percent, enterprise income tax revenue increased by 39.2 percent, and personal income tax revenue increased by 30.1 percent. In the context of brisk trading in the capital market and higher stamp duty, revenue from the securities transaction stamp tax surged, as reflected in the 11.5-fold growth in the first eleven months of 2007 compared with the same period of 2006. Tax revenue from land and resources increased massively, with the urban land-use tax income, the land value added tax, and the income from the compensated use of state-owned resources up 102.7 percent, 80.3 percent, and 123.5 percent respectively in the first eleven months of 2007 over the same period of 2006.

From January through November, total fiscal expenditures amounted to 3708.5 billion yuan, up 25.2 percent year on year and an acceleration of 8.3 percentage points. Expenditures for transportation, medical services, science and technology, and industrial, commercial, and financial sectors witnessed large growth. In the first eleven months, transportation expenditures totaled 150.3 billion yuan, medical service expenditures totaled 141.9 billion yuan, expenditures for industrial, commercial, and financial sectors totaled 312.4 billion yuan, and science and technology expenditures

totaled 117.4 billion yuan, up 61.7 percent, 40.6 percent, 36.6 percent, and 33.0 percent year on year from the same period of 2006.

5. The BOP account still ran a large surplus

In 2007 the balance of payments account registered large-scale "twin surpluses." The current account surplus expanded rapidly, with the trade in goods remaining the major contributor. In 2007, the number of newly established foreign-invested enterprises (full coverage statistics, including those in the banking and securities sectors) totaled 37,888, a year-on-year decline of 8.7 percent; the actual utilization of foreign capital grew 13.8 percent to US\$82.7 billion. At end-2007, official foreign exchange reserves posted US\$1528.2 billion, an increase of US\$461.9 billion from end-2006 and an acceleration of US\$214.4 billion.

At end-September 2007, the outstanding external debt totaled US\$345.7 billion, up 7 percent from the end of 2007, including US\$119.7 billion of trade credits (up 15.1 percent from end-2007). The outstanding short-term debt amounted to US\$197.7 billion and accounted for 57.2 percent of the outstanding external debt.

6. Industrial analysis

In 2007 the production of major industries continued to register rapid growth, and their profit gains remained in the two digits. From January through November, the gain in the profit margin was over 50 percent in the building materials, chemical fibers, chemical industry, metallurgy, and machine-building sectors. The restructuring of various industries progressed smoothly. First of all, the output of some high energy-consuming sectors fell. In 2007 total output of raw steel, steel, and cement was 490 million tons, 560 million tons, and 1350 million tons respectively, up 15.7 percent, 22.7 percent, and 13.5 percent year on year, representing a deceleration of 2.8, 1.8, and 5.6 percentage points respectively. Second, the supply of coal, electricity, and transportation services continued to grow steadily. In 2007 the output of coal, crude oil, and electricity totaled 2290 million tons, 190 million tons, and 3208.7 billion kilowatt hours, up 9.4 percent, 1.6 percent, 14.9 percent respectively year on year. Transported freight totaled 22.15 billion tons, up 11.1 percent year on year.

(1) The real estate sector

In 2007, in order to restructure the housing supply and stabilize housing prices, the State Council took a series of policy measures to increase the supply of guaranteed

housing and to curb housing demand for investment purposes. The People's Bank of China and the China Banking Regulatory Commission jointly issued the *Notice on Strengthening Regulation over Credit for Commercial Real Estate* (PBC Document [2007] No. 359) and the *Supplemental Notice on Strengthening Regulation over Credit for Commercial Real Estate* (PBC Document [2007] No. 452) to specify requirements for further strengthening regulation over commercial real estate credit. With a variety of macroeconomic management policies working together, the structure of real estate development investment began to optimize; although growth of home sales prices across the nation remained strong, it showed signs of moderation in some cities.

Real estate development investment increased by a large margin, and the development structure improved. In 2007 a total of 2.5 trillion yuan was invested in real estate development, up 30.2 percent year on year and an acceleration of 8.4 percentage points from 2006, outperforming fixed-asset investment growth by 5.4 percentage points. Among this total, 1.8 trillion yuan, or 71.2 percent (one percentage point higher than that in 2006), went to commercial housing development, representing an increase of 32.1 percent year on year; 16.6 percent was invested in development of housing units with floor plans of less than 90 square meters, 5.2 percentage points higher than at the beginning of 2007; 83.38 billion yuan, or 3.3 percent of the total investment, was in affordable housing projects, up 19.7 percent from that in 2006.

Demand for housing remained strong. The growth of completed areas of commercial housing was still lower than that of sales, but areas under construction increased rapidly. In 2007 a total of 580 million square meters of commercial housing was completed, up 4.3 percent; the area of sold units grew 23.2 percent to 760 million square meters. The growth of completed areas was 18.9 percentage points lower than that of sold units, 6.1 percentage points higher than the differential between the two in the last year. Areas of commercial housing under construction grew 21.1 percent to 2360 million square meters, an acceleration of 4 percentage points from 2006. At end-2007, the area of commercial real estate vacancies declined by 8 percent from a year earlier to 130 million square meters; among this total, commercial housing vacancies declined 16.6 percent to 67.56 million square meters.

Home sales prices surged during the entire year but moderated in the run-up to year-end. In the four quarters, national home sales prices were up 5.6 percent, 6.3 percent, 8.2 percent, and 10.2 percent respectively. In December, year-on-year growth of national home sales prices was 10.5 percent and on a par with that in November, whereas month-on-month growth accelerated by 0.2 percent, a decline of 0.6 percentage points from November. Regionally, although the growth of local home

sales prices in Urumqi and Beihai accelerated in December year on year, 22 out of the nation's 70 large and medium cities witnessed negative month-on-month growth in local home sales prices.

Commercial real estate loans grew rapidly during the entire year, but noticeably moderated in the last quarter. At end-2007, outstanding commercial real estate loans totaled 4.8 trillion yuan, growth of 1126.1 billion yuan or 30.6 percent from the beginning of 2007, representing an acceleration of 8.5 percentage points from 2006; in particular, outstanding real estate development loans amounted to 1.8 trillion yuan, growth of 361.3 billion yuan or 25.7 percent from the beginning of 2007, a deceleration of 1.3 percentage points from 2006; home mortgage loans reached 3.0 trillion yuan, growth of 762.2 billion yuan or 33.6 percent from the beginning of 2007, an acceleration of 14.6 percentage points from 2006. Due to seasonal reasons (the winter being too harsh for construction and for launching projects) and monetary policy tightening, real estate loans increased at a moderate pace in the fourth quarter. New loans in the fourth quarter totaled 185.8 billion yuan, only half of that in Q3. Among this total, 12.2 billion yuan went to real estate development projects and 159.6 billion yuan went to home mortgage loans, representing only 12.5 percent and 60 percent of that in Q3 respectively.

(2) The power industry

In recent years, the rapidly developing power industry has served as a strong buttress for the country's economic growth and social progress. However, the industry faces prominent problems such as the less-than-optimal structure of power sources, the under-developed power grid, and the meager role of the market in power allocation. In particular, the distorted relationship between coal and power prices gives power producers a strong disincentive to generate electricity. This phenomenon reflects the problems in the energy pricing and management mechanism in China. An arduous task in the development of the power industry will be the deepening of the power-system reform, establishing a power pricing mechanism that allocates resources efficiently and shifting the focus from capacity expansion to restructuring and the efficient use of energy.

Driven by strong demand, power generation surged and the pace of capacity installation and grid building accelerated. In 2007 total power output increased 14.9 percent to 3208.7 billion kilowatt hours, with thermal and hydropower up 14.6 percent and 15.4 percent respectively. The newly installed capacity amounted to 100.09 million kilowatts.

Work to improve energy efficiency and reduce emissions produced results. In 2007 coal consumption per kilowatt-hour declined by 10 grams, leading to a decline of 40 million tons of coal consumption in 2007 compared with that in 2006. Installation of large-scale and highly efficient generators and the shutting down of small thermal power units reduced coal consumption by a large margin. In the past five years, coal consumption for power generation declined by a total of 26 grams per kilowatt-hour. In 2007, the capacity of the closed-down small thermal power units totaled 14.38 million kilowatts. With their replacement by large-scale, highly efficient, and low-emission coal combustion generators, 18.80 million tons of unprocessed coal is saved annually, resulting in emissions reductions of 37.60 million tons of carbon dioxide and 290,000 tons of sulfur dioxide.

Profits in the power industry remained high, but grew in a moderate manner. From January through November, profits in the industry totaled 166.3 billion yuan, up 38.2 percent. Due to the soaring coal prices after April, profits in the power industry increased at a moderate pace. Growth of profits in the first eleven months was 2.6 percentage points lower than that in the first five months.

Due to the short energy supply and the ensuing price hikes, the price of power coal climbed continuously, pushing up the cost of the power industry. As power tariffs were subject to price controls and could not adjust in response to the higher costs, power plants were under enormous pressures. In the current power-source structure, coal fired units account for more than 70 percent of the total installed capacity, and 60 percent of the nation's coal sales are used for power generation. In 2007 the price of power coal surged in the range of 10 to 20 percent in real terms. At the 2008 Coordinating Conference of Coal Producers, Transporters, and Users, the contract price of power coal from key mines went up in the range of 30 to 40 yuan per ton, or by 10 percent, adding to the cost of power plants by almost 42 billion yuan. In addition, the bottlenecks in railway transportation, the higher transportation costs of coal, the more expensive steel, copper, and aluminum (which are major raw materials for power generation equipment) all point to higher financial costs to be incurred by power plants. Therefore, attention should be given to how to establish a proper power pricing mechanism that allows prices to play a fundamental role in resource allocation.

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

I. World economic and financial outlook

Affected by the continuing financial market turmoil, the global economy slowed down after showing strong momentum in the first three quarters of 2007, and the fundamentals remained sound. In its forecast issued on January 29, 2008, the IMF stated that global economic growth will slow to 4.1 percent in 2008 from its 4.9 percent in 2007. Growth in the U.S., euro zone, and Japan will slide by various degrees to 1.5 percent, 1.6 percent, and 1.5 percent respectively. The emerging market economies and some developing countries will grow at a relatively fast pace of 6.9 percent, down from the 7.8 percent (estimated) in 2007. The major risks facing the global economy are that the persistent turbulence in the financial markets will further dampen domestic demand in the industrial countries and ripple effects will be felt in the emerging market economies and developing countries.

Since the outbreak of the U.S. sub-prime mortgage crisis, financial markets around the world have witnessed strong turbulence. Even though rescuing and stabilizing efforts were offered by various government agencies, including the major central banks, the international financial markets still suffered from tight liquidity and fragile confidence, increasing the systemic risks and uncertainties in the global economy.

Affected by the rapid rise in the prices of agricultural produce, oil, and gold, global inflation pressures heightened. Ever since mid-2007, headline inflation and core inflation rose to various degrees in the industrial countries and emerging economies. Caught between the persistently turbulent financial markets and the upward inflation pressures, central banks are facing an increasingly difficult policy dilemma of curbing inflation while simultaneously maintaining economic growth.

In order to mitigate the rippling effect of the sub-prime mortgage crisis, the Federal Reserve lowered the policy rate on several consecutive occasions, leading to a continued depreciation of the US dollar against the euro and yen. The resulting increased appreciation pressures on the major currencies such as the euro gave rise to a resurgence of protectionism in the euro zone. Against this backdrop, the concerns of the U.S. and the EU countries regarding the emerging market sovereign wealth funds heightened and trade frictions escalated. This may have an adverse impact on the healthy development of the global economy and the orderly adjustment of global

imbalances.

II. Outlook for the Chinese economy

Pushed by the combined factors of industrialization, urbanization, globalization, and the structural upgrading of industrial production and consumption, the Chinese economy is expected to maintain relatively rapid growth in 2008. With the domestic and external uncertainties looming larger, growth may slow somewhat from its elevated path during last year.

Strong investment growth may moderate but will remain high. Domestic demand may be contained by weaker external demand. The fourth quarter PBC business survey indicated that after reaching its peak in the second quarter of 2007, the market demand index declined quarter by quarter to 24.2 percent in the fourth quarter, down by an accumulated 0.4 percentage points. The fourth quarter banking survey also showed that the demand for loans index tripped down 2.6 percentage points from that in the third quarter. It cannot be ignored that against the background of faster urbanization and industrialization, industrial upgrading, the change in the production paradigm, the coordinated regional growth, and the improved housing supply are all creating investment demand. Furthermore, development enthusiasm in different regions, improved profitability of enterprises and financial institutions, and mutually enhanced financing and investment activities will also boost investment demand. As a result, growth in investment demand will remain high. Since the second half of 2007, the planned investment of new start-up and on-going projects grew very rapidly, with the total investment for planned urban projects and new start-ups reaching 26.1 trillion yuan and 8.6 trillion yuan, up year on year by 21.3 percent and 28.7 percent respectively.

Consumption will maintain a steady and upward trend. With the structural economic adjustment quickly moving forward, policies aimed at increasing household demand and the propensity for consumption gradually taking effect, and labor supply becoming tighter, household income is tending to increase and household expectations for future income growth are relatively optimistic. The household survey indicated that in 2007 the future income confidence index fell back somewhat from a historical high in 2006 but still remained at a high level, reaching 25.8 in the fourth quarter. In recent years, the improvement in the social security system contributed to growth in consumption, especially among low-income households. The coverage of social security expanded and by the end of 2007, basic pension insurance and basic medical

insurance covered a population of 200 million people and 220 million people respectively; unemployment insurance and occupational injury insurance covered 110 million and 120 million people respectively. In the past three years, the basic pension for enterprise retirees increased by RMB 270 yuan. In the near future, policies to promote consumption and improve living conditions will be implemented. These policies, combined with the improved consumption environment, will stimulate household consumption desires. Nevertheless, it should be noted that inflation may curb the people's willingness to spend to some extent. The household survey showed that the propensity of households to consume declined to a new low every quarter since the fourth quarter of 2006 and reached its lowest point of 18.3 percent in the history of the survey in the third quarter of 2007. In the fourth quarter the index slightly bounced back.

The trade surplus will remain large, yet its growth will gradually slow down. External demand is expected to weaken as a result of the aftermath of the sub-prime mortgage crisis, the weaker global economy, adjustments in the export tax rebate and processing trade policies, and the RMB appreciation. The PBC business survey showed that in the fourth quarter of 2007 the export order index declined further by 0.8 percentage points to 6.4 percent, in addition to a decline of 2.5 percentage points in the third quarter. However, the emerging market economies will maintain relatively high growth and diversification in trade will alleviate the impact on trade due to a regional slowdown. In sum, although the growth of China's trade surplus may moderate somewhat, until the structural problems in the global division of labor and high domestic savings rate can be drastically changed, the trade surplus will remain at a significantly high level.

Inflation pressures will remain. Against the background of rapid globalization and economic transformation, the underlying reasons for this round of inflation have become more complicated than previously. The transmission of world prices, domestic supply constraints, and price adjustments of natural resources exerted a combined effect on domestic prices. In addition, the snowstorm in early 2008 also pushed prices higher for the short term. In general, inflation will remain at a high level in the near future. The first reason is that short-term price shocks, such as the external price transmission and the domestic supply constraints, will not change. International oil prices will continue to fluctuate at a high level; development of bio-energy and the rapid growth of emerging markets will lead to a greater demand for food and heighten the supply constraints; and given the limited farmland, population growth, upgrading of consumption, and greater demand for grain for industrial purposes, upward pressures will be created on farm product prices. The

second reason is that inflation expectations are high. The PBC household price expectation index has been on an upward trend quarter after quarter since the beginning of 2007. The 2007 fourth quarter survey showed that 64.8 percent of those interviewed expected inflation would go up further in 2008, the highest percentage since the survey was first conducted. Inflation expectations put pressures on wage increases and force businesses to adjust pricing behavior. This may well lead to a spreading and self-reinforcing of the price hikes. In addition, due to the lagging effects of the price hikes, even without any new factors pushing up prices, year-on-year price increases in 2008, especially in the first half of the year, will be significant. Given the mechanism and special characteristics of the formation of this round of inflation, attention shall be given not only to the role of monetary policy to curb aggregate demand growth, but also to strengthening supply management and the domestic and external price shocks, so as to understand mid- to long-term price developments, to guide inflation expectations to prevent structural price rises from turning into generalized inflation, and to keep the overall price at a level appropriate to the present stage of economic development and the market-oriented reform.

In sum, on the one hand, with the implementation of measures strengthening and improving the macroeconomic adjustment, the acute imbalances in the economy will be alleviated to some extent. On the other hand, it is also noteworthy that after many years of rapid economic growth, accumulated deep-rooted imbalances are emerging and being released rapidly. The overall trend of rapid growth in the direction of overheating has not yet been reversed, whereas inflationary pressures are increasing.

III. Monetary policy stance in 2008

The Central Government Annual Economic Work Conference decided that an appropriately tight monetary policy will be implemented and monetary policy will be allowed to play a greater role in macroeconomic adjustment. This is a requirement for adopting a scientific development approach and building a harmonious society. This also serves as an extension of the sound monetary policy and appropriately tight monetary policy adopted since 2003, sending an unmistakable signal that uncertainties in the economy are growing and pointing out the policy direction. This will help guide and adjust the expectations and behavior of all economic entities and will help prevent rapid growth from turning into overheating and will prevent structural price rises from turning into a generalized inflation, and will enhance the understanding of the urgency of the structural reform. Against the background of greater globalization and further opening to the outside world, the PBC will follow the

coordinated instructions of the CPC Central Committee and the State Council, implementing a tight monetary policy, increasing the effectiveness and predictability of the adjustment policy, using comprehensive monetary policy measures, restraining the rapid growth of money and credit, guiding market expectations, controlling the strength and intensity of the adjustment in a scientific manner based on the changing domestic and external environment, creating a sound monetary and financial environment for economic growth and structural adjustments by fine-tuning policies when appropriate.

1. Deploying comprehensive sterilization measures and strengthening liquidity management

The PBC will continue to use policy tools such as open market operations and the reserve requirement ratio to absorb liquidity in the banking system, restraining the lending capacity of financial institutions. The tools used and the manner applied will be in accordance with the need for macro-adjustments to ensure the efficiency of all policy measures.

2. Using appropriate pricing tools

Based on the development of the domestic and external economic and financial situations, the PBC will adjust interest rates discreetly and allow them play a role in curbing demand inflation and in stabilizing inflation expectations. At the same time, measures will be taken to carry forward the interest rate reform, speed up construction of the money-market benchmark rate system, guide financial institutions to improve their interest rate pricing ability, and improve the discount rate formation mechanism.

3. Improving the managed floating exchange rate regime.

The role of the exchange rate in adjusting the balance of payments and promoting balanced economic growth will be put into full play. In line with the self-initiated, controllable, and gradual approach, more will be done to improve the managed floating exchange rate regime, to enable market supply and demand to play a fundamental role in the formation of the RMB exchange rate, to increase the flexibility of the RMB exchange rate, and to keep the RMB exchange rate basically stable at an adaptive and equilibrium level. Measures will also be taken to carry forward the development of the foreign exchange market, to encourage commercial banks to create exchange rate risk hedging products to meet the needs of enterprises, and to quicken implementation of the “going overseas” policy to build a multilayer diversified foreign exchange investment system. At the same time, attention will be

paid to the influence of developments in global financial markets on balance of payments, in which case the market monitoring and crisis warning system will be strengthened.

4. Strengthening window guidance and credit policy guidance to financial institutions

The PBC will remind financial institutions to strengthen credit policy management and risk prevention, and will allocate funds in an appropriate pattern, progress, and rhythm. It will also guide financial institutions to implement national policies for industrial structural adjustment and upgrading, treating different projects in a different manner by establishing sectoral priorities, especially by issuing farming credits and improving agricultural finance. Attention will be paid to the aftermath of snow, rain, and ice disasters, guiding financial institutions to take into consideration the credit needs of the disaster-hit regions, ensuring loans for farmers, students, unemployed and rural migrant workers, and strengthening loan allocation management. Active measures will also be taken to implement a real estate credit policy to promote the healthy development of the housing market and to guide financial institutions to explore fee-based businesses, financial innovations, and new income-generating businesses.

5. Fostering and developing financial markets

The PBC will devote great efforts to promoting direct financing, improving the financial asset structure, and encouraging financial innovation to meet the needs for market diversification. Progress will be made in fostering and developing institutional investors, strengthening capacity building and industry self-discipline, enhancing transparency and strengthening market discipline and incentives. Earnest measures will be taken to strengthen financial market monitoring and risk prevention to balance the relation between market development and risk prevention. In order to adapt to the integration of domestic and external markets, efforts will be made to build a multilayer, comprehensive market monitoring and management system, and to strengthen the inter-related construction of market infrastructure to promote the coordinated development of various markets.

6. Deepening financial enterprise reform

The PBC will continue to promote reforms in the Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Bank of Communications in areas such as corporate governance and branch system reform in accordance with the requirements of building modern commercial banks. The reform of the Agricultural Bank of China will be carried out steadily according to the principles of “servicing

the agricultural sector, applying a comprehensive reform, maintaining commercial operations, and becoming listed when possible”; reforms of China Development Bank and Everbright Bank of China will move forward as planned; reform plans for the China Export-Import Bank and China Agricultural Development Bank will be further explored.

7. Improving foreign exchange administration

Efforts will be made to further deepen the foreign exchange administration reform, to improve the balance of payments performance, to make innovations in trade-related foreign exchange administration, to implement service-related foreign exchange administration, to strengthen construction of market infrastructure, to improve foreign exchange services, to lend support to foreign direct investment by domestic enterprises, and to strengthen the qualified domestic institutional investors program. Actions will be taken to strengthen monitoring of the implementation of the foreign exchange administration policy, urging commercial banks to improve self-monitoring of foreign exchange receipts and expenses, improving dynamic monitoring and ex post examination of goods trade-related and services trade-related foreign exchange receipts and expenses, standardizing foreign exchange receipts and expenses of households, strengthening short-term foreign debt management through relevant indicators, improving foreign debt management of foreign-funded enterprises, and strengthening examination of cross-border fund flows, as well as promoting capacity building in terms of laws and regulations and administration.

It is noteworthy that the above sterilization and credit policy measures cannot tackle the excess liquidity and structural problems in the economy at their roots; instead, they are mainly aimed at creating a stable monetary and financial environment for economic growth and structural adjustments. Efforts will be made to deepen the structural reforms, and to make substantial progress and breakthroughs in achieving balanced growth and a balance of payments equilibrium. On the other hand, good opportunities provided by the present rapid economic growth and significant increase in fiscal revenue shall be seized to implement the structural reform package aimed at stimulating domestic consumption through a further detailing, strengthening, and deepening of actual policies. Efforts should be made to increase household income to the national income ratio and to explore the consumption market comprehensively; to accelerate the transition to public finance, to increase public consumption expenditures, and to improve the social security system; to promote a comprehensive personal income tax reform and adopt a scientific tax and revenue system; to adjust government savings, letting the market play its role in allocating investments and

introducing non-government investment into the health, education, and cultural service sectors; to increase the housing supply and maintain the healthy development of the housing market; to encourage enterprises to lower retained earnings and improve distribution of profits; to strengthen adjustment and standardization of international trade, foreign investment, and industrial policy; and to reform the pricing mechanism of natural resources and enforce environmental and labor protection standards to promote transformation of the economic growth mode.