China Monetary Policy Report Quarter Four, 2008

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In 2008, under the correct leadership of the Central Committee of the Communist Party of China (CPC) and the State Council, the monetary policy stance was adjusted with improved preemptiveness, targeting, and flexibility according to the changing situation. Money and credit supply maintained a stable and relatively fast growth momentum, featuring adequate liquidity in the banking system and a streamlined credit structure, which greatly supported the stable and relatively rapid development of the economy. In 2008 the Gross Domestic Product (GPD) registered 30.1 trillion yuan, up 9 percent year on year, and the Consumer Price Index (CPI) grew 5.9 percent year on year.

At the beginning of the year, in order to prevent the rapid economic growth from becoming overheated and to prevent the structural price hike from turning into entrenched inflation, the People's Bank of China (PBC) adopted tight monetary policy. China's economy had grown 13 percent in 2007, and most economies in the world were facing with inflationary pressures. Commodity prices soared in the international market, China's CPI grew 8 percent in the first quarter of 2008, and the Producer Product Index (PPI) reached its peak of 10.1 percent in August. Taking into account uncertain factors such as the U.S. sub-prime crisis, the PBC strengthened the identification and forecasting of the domestic and external causes contributing to inflation and flexibly used a mix of quantitative and price instruments. After raising the benchmark deposit and lending interest rates on six occasions in 2007, the PBC kept the interest rate policy unchanged in the first half of the year. To deal with the widening "dual surplus" and massive capital inflows, the PBC sterilized excess liquidity mainly by increasing the required reserve ratios, which were raised by a cumulative 3 percentage points on five occasions in the first half of the year, freezing 70 percent of the increased liquidity as a result of foreign exchange purchases. At the same time, efforts were made to guide financial institutions to make reasonable credit planning. At the beginning of 2008, the planned new loans for the entire year were set at 3.87 trillion yuan according to the actual economic development. After the snow and sleet disaster, in order to provide sufficient funds for disaster relief efforts, the PBC in February guided financial institutions to speed up the credit supply for the first quarter on a differentiated basis according to the types of financial institutions and how severely the regions had been affected. After the Wenchuan earthquake in May, the PBC immediately lifted the credit ceilings for financial institutions incorporated in the disaster-stricken areas and guided national banks to strengthen allocation of intra-bank credit resources across regions so as to beef up credit support for the disaster-stricken areas.

In the middle of the year, as the U.S. sub-prime crisis spread and deepened and national macroeconomic policy underwent substantial changes, the PBC adjusted the orientation, priority, and intensity of monetary policy in a timely manner in accordance with the requirements for maintaining stable and relatively rapid economic growth and preventing price hikes. Efforts were made to reduce the intensity of open market operations, to raise the planned new loans in 2008 to over 4 trillion yuan, and to guide financial institutions to increase credit lending to agriculture, rural areas, and farmers, small- and medium-sized enterprises, and post-disaster reconstruction on a preferential basis, with a view to optimizing the credit structure. The international financial crisis deteriorated rapidly after September and took a heavy toll on China's economy. In accordance with the overall arrangements of the CPC Central Committee and the State Council, the PBC adopted moderately loose monetary policy, used a number of instruments, and took a series of flexible and effective measures to send the signal of maintaining economic growth and stabilizing market confidence, such as cutting the benchmark deposit and lending interest rates on five occasions, lowering required reserve ratios on four occasions, eliminating quantitative ceilings for financial institutions' credit lending, coordinating with the central government's economic stimulus package that aimed to boost domestic demand, and beefing up financial support for economic development.

At the end of 2008, outstanding broad money M2 posted 47.5 trillion yuan, representing a year-on-year increase of 17.8 percent and an acceleration of 1.1 percentage points from the previous year. Outstanding RMB loans recorded 30.3 trillion yuan, up 18.8 percent year on year. The distribution of RMB loans was more balanced, with the 4.9 trillion yuan of new RMB loans spread evenly among the four quarters (1.33 trillion yuan, 1.12 trillion yuan, 1.03 trillion yuan, and 1.43 trillion yuan respectively). RMB lending rates rose before declining. At end-2008, the weighted average interest rate of RMB loans issued by financial institutions stood at 6.23 percent, a decline of 1.96 percentage points from the peak in August and 1.66 percentage points lower than that at the beginning of the year. The RMB exchange rate remained basically stable at an adaptive and equilibrium level, with the central parity of the RMB against the U.S. dollar posting 6.8346 yuan per dollar at the end of 2008.

As the impact of the global financial crisis on China's economy intensified noticeably, external demand shrank markedly, some industries saw excess productivity, enterprises experienced production and operation difficulties, and urban unemployment increased, all of which contributed to greater downward pressures on economic growth. However, with a huge market and a great potential for future growth, and as the long-term trend and advantages for economic growth remain unchanged and the macroeconomic control policies gradually take effect, the Chinese economy is expected to continue growing in a stable and relatively rapid manner.

The PBC will, in line with the overall arrangements of the CPC Central Committee and the State Council, implement the scientific approach to development as well as the measures and policies of the State Council to increase financial support for economic development, to make stable and relatively rapid economic growth a priority task of financial macro management, to carry out a moderately loose monetary policy, to rationalize the monetary policy transmission mechanism, to ensure sufficient liquidity in the banking system, to promote a reasonable and stable growth of money and credit, and to guide financial institutions to optimize their credit structures. At the same time, efforts will be made to promote the market-based interest rate reform and the reform of the RMB exchange rate formation mechanism, to deepen the reform of foreign exchange administration, and to rigorously develop direct financing.

Contents

Boxes:

Tables:

Figures:

Attachment:

Part 1 Monetary and Credit Performance

In 2008, due to the comprehensive effect of the financial macro-adjustment measures, money and credit maintained a steady and relatively rapid growth momentum, along with sufficient liquidity in the banking system and a further optimized credit structure. The rational growth and improved structure of money and credit supported the steady and relatively rapid development of the national economy.

I. Higher growth of money supply than that in 2007

At end-2008 the outstanding balance of broad money M2 amounted to 47.5 trillion yuan, an increase of 17.8 percent year on year, up 1.1 percentage points from the growth in 2007. The outstanding balance of narrow money M1 reached 16.6 trillion yuan, an increase of 9.1 percent year on year, down 12.0 percentage points from the growth in 2007. Cash in circulation M0 grew 12.7 percent year on year to 3.4 trillion yuan, up 0.5 percentage points from the growth in 2007. Net cash injections in 2008 totaled 384.4 billion yuan, 54.1 billion yuan more than that recorded in 2007.

The growth of M2 accelerated at year-end. In the first 11 months, in general the growth of M2 decelerated; at year-end, the growth of the money supply gradually accelerated. In December, the growth of M2 and M1 increased by 3.0 and 2.3 percentage points month-on-month respectively. In terms of the structure of M2, due to the high level in 2007, the growth of M1 slowed down whereas the growth of quasi-money remained stable.

II. Deposits of financial institutions increased relatively rapidly

At end-2008 outstanding deposits of all financial institutions (including foreign-funded financial institutions) denominated in both RMB and foreign currencies increased 19.3 percent year on year to 47.8 trillion yuan, 4.1 percentage points higher than the growth in 2007, representing an increase of 7.7 trillion yuan from the beginning of the year and an acceleration of 2.4 trillion yuan year on year. In particular, outstanding RMB deposits rose 19.7 percent year on year to 46.6 trillion yuan, 3.7 percentage points higher than the growth in 2007, representing an increase of 7.7 trillion yuan from the beginning of the year and an acceleration of 2.3 trillion yuan year on year. Outstanding foreign currency deposits rose 12.0 percent to US$179.1 billion, 13.0 percentage points higher than the growth in 2007, representing an increase of US$18.3 billion from the beginning of the year and an acceleration of US$ 19.8 billion year on year.

Broken down by sectors and maturities, household RMB deposits grew rapidly, the growth of non-financial institutions' deposits moderated, and household and corporate time deposits accelerated significantly. At end-2008 the outstanding balance of household RMB deposits grew 26.3 percent to 22.2 trillion yuan, 19.5 percentage points higher than the growth in 2007, representing a growth of 4.6 trillion yuan from the beginning of the year and an acceleration of 3.5 trillion yuan year on year, because the capital market fell amidst fluctuations and households became more aware of wealth management risks. The outstanding balance of non-financial corporate deposits stood at 21.7 trillion yuan, an increase of 15.2 percent year on year, 7.2 percentage points lower than the growth in 2007, representing an increase of 2.9 trillion yuan from the beginning of the year and a deceleration of 575.9 billion yuan year on year, due to the moderated economic growth, higher production costs, slowdown in capital turnover, etc. Deposits tilted in the direction of time deposits remarkably, with time saving deposits and corporate time deposits accelerating by 3.3 trillion yuan and 722.6 billion yuan year on year respectively. At end-2008， the outstanding balance of fiscal deposits stood at 1.8 trillion yuan, representing a year-on-year growth of 1.4 percent or an increase of 26.9 billion yuan from the beginning of the year, a deceleration of 635.4 billion yuan year on year. Among these, in November and December fiscal deposits decelerated by 593.2 billion yuan mainly because of the rapid increase in fiscal expenditures to boost domestic demand and to promote economic growth and the declining fiscal revenues.

III. RMB loans issued by financial institutions grew steadily

Outstanding loans of all financial institutions in both RMB and foreign currencies stood at 32.0 trillion yuan at end-2008, representing growth of 18 percent year on year, 1.5 percentage points higher than the growth in 2007 and representing an increase of 5.0 trillion yuan from the beginning of 2008, or an acceleration of 1.1 trillion yuan year on year. In particular, the outstanding balance of RMB loans grew by 18.8 percent year on year to 30.3 trillion yuan, 2.7 and 4.6 percentage points higher than the growth at end-2007 and in the first half of 2008 respectively, and a growth of 4.9 trillion yuan from the beginning of the year, representing an acceleration of 1.3 trillion yuan year on year. Broken down by institutions, loans of state-owned commercial banks registered a larger acceleration. Broken down by periods, the distribution of loans was more even, with newly issued loans in the four quarters totaling 1.33 trillion yuan, 1.12 trillion yuan, 1.03 trillion yuan, and 1.43 trillion yuan respectively. Financial institutions increased credit lending remarkably after the 10 measures to boost domestic demand and promote economic growth were announced by the central government in November. In November and December, 1.2 trillion yuan of new loans was issued, representing an acceleration of 1.1 trillion yuan year on year. The outstanding balance of foreign currency loans stood at US$243.8 billion at end-2008, representing year-on-year growth of 11.9 percent, 18.3 percentage points lower than the growth in 2007 or an increase of US$25.9 billion from the beginning of the year, representing a deceleration of US$25.2 billion, due to the relatively stable RMB exchange rate expectations and the recent moderate trade growth.

Table 1: RMB loans of financial institutions in 2008

Unit: 100 million yuan

	2008		2007	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Policy banks	5917	1637	4280	862
State-owned commercial banks	18022	4967	13055	856
Joint-stock commercial banks	11479	3763	7716	358
City commercial banks	3952	974	2978	206
Rural financial institutions	5908	823	5085	808
Foreign-funded financial institutions	628	-1076	1704	735

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

Source: The People's Bank of China.

In terms of loan destinations, the growth of household loans moderated somewhat, whereas lending to non-financial institutions and other sectors grew steadily. Outstanding household loans at end-2008 grew 13.7 percent year on year, 16.7 percentage points lower than the growth in 2007, representing an increase of 701 billion yuan from the beginning of the year or a deceleration of 478.7 billion yuan year on year. As the real estate market recovered somewhat and demand for personal borrowing gradually declined, the extension of consumption-based loans moderated in 2008. The outstanding balance of household consumption-based loans grew 461 billion yuan from the beginning of the year, representing a deceleration of 407.6 billion yuan year on year. The outstanding balance of household business-oriented loans grew by 240.1 billion yuan, representing a deceleration of 71.1 billion yuan year on year. The outstanding balance of loans issued to non-financial institutions and other sectors at end-2008 grew 20.0 percent year on year, up 6.9 percentage points from 2007, an increase of 4.2 trillion yuan from the beginning of the year or an acceleration of 1.8 trillion yuan year on year. In particular, medium- and long-term loans accelerated by 455.9 billion yuan year on year, short-term loans decelerated by 85.8 billion yuan year on year, and paper financing accelerated by 1.1 trillion yuan year on year. The rapid acceleration of paper financing resulted from a combination of reasons, including the limited bond investment channels, greater pressures for capital utilization and profit growth on the part of financial institutions, and the massive adoption of paper discounting to meet funding requirements due to the declining paper discount rate for the purpose of better connecting production and sales and reducing financial costs on the part of enterprises. Meanwhile, the advantages of commercial paper, such as high liquidity, convenient turnover, and low risk, also made it one of the important choices for financial institutions in asset portfolio management.

The bulk of RMB medium- and long-term loans went to the infrastructure sector, the real estate sector, and the manufacturing sector.[1] In 2008 new 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) to the infrastructure sector (transportation, warehousing and postal services, electricity, gas, water production and supply, water conservation, environmental protection, and public facility management), and the manufacturing sector stood at 1.1 trillion yuan and 242.6 billion yuan respectively, accounting for 48.2 percent and 10.9 percent of all new medium- and long-term RMB loans, 5.0 percentage points and 3.4 percentage points higher than the growth in 2007 respectively. New medium- and long-term loans to the real estate sector amounted to 240.7 billion yuan, accounting for 10.8 percent of all new medium- and long-term loans, as opposed to 13.9 percent in 2007, due to the adjustments in the real estate sector.

IV. Liquidity in the banking system was sufficient

At end-2008 the outstanding balance of base money increased 27.5 percent to 12.9 trillion yuan, representing an increase of 2.8 trillion yuan from the beginning of the year and a deceleration of 3.1 percentage points year on year. The money multiplier at end-2008 was 3.68, slightly down 0.29 from the end of 2007. In the second half of 2008, with the great reduction in the intensity of open market operations and the successive cuts in the reserve requirement ratio, the liquidity supply in the banking system was sufficient. The excess reserve ratio of financial institutions rose substantially to 5.11 percent at end-2008, up 1.81 percentage points from end-2007. In particular, the excess reverse ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 3.93 percent, 5.73 percent, and 10.12 percent respectively.

V. The interest rate edged down after rising

In 2008 the RMB lending rate edged down after rising. In the first 8 months, the RMB lending rate of financial institutions generally maintained a steadily rising momentum. In August the weighted average lending rate of financial institutions stood at 8.19 percent, up 0.30 percentage points from the beginning of the year. Beginning in September, the People's Bank of China cut the RMB benchmark lending rate consecutively on 5 occasions, so the RMB lending rate of financial institutions continued to decline notably. In December the weighted average lending rate of financial institutions stood at 6.23 percent, down 1.96 percentage points from August and down 1.66 percentage points from the beginning of 2008. The proportion of loans that applied upward floating rates also declined after increasing. In December the proportion of loans that applied upward floating rates was 44.31 percent, down 6.31

[1] According to the National Bureau of Statistics standard sectoral definitions, commercial individual housing loans are not included in real estate loans.

percentage points from August.

Foreign currency interest rates witnessed a decline after an initial rise. Affected by movements in domestic fund demand and supply and interest rates on the international market, the domestic U.S. dollar lending rate for within three-month maturity, accounting for a large market share, reached a yearly high of 6.63 percent in April and then declined slightly every month thereafter. In December, it declined to 3.65 percent, down 2.39 percentage points from beginning-January. Similar to the U.S. dollar lending rate movement, the interest rate of domestic large-value U.S. dollar deposits for within 3-month maturity rose to a yearly record of 4 percent in May and October respectively and then declined dramatically to 1.22 percent in December, down 2.55 percentage points from the beginning of 2008. In December financial institutions cut the interest rate for U.S. dollar deposits (below US$3 million) by a large margin. In particular, the one-year U.S. dollar deposit rate was reduced from 3 percent to 0.95-1.25 percent, down 2.05-1.75 percentage points.

Table 2: Average lending rates of financial institutions, January through December 2008

Unit: percent

Maturities	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.
Within 6 months	7.06	7.09	7.32	7.42	7.37	7.28	7.31	7.31	7.12	6.78	6.50	5.55
6 months to 1 year	8.33	8.40	8.72	8.70	8.62	8.47	8.58	8.69	8.38	8.18	7.66	6.64
1 to 3 years	7.98	7.99	8.69	8.31	8.35	8.41	8.43	8.47	8.20	8.00	7.54	6.26
3 to 5 years	7.68	7.82	7.98	7.91	7.77	8.04	7.95	8.00	7.91	7.61	7.17	6.18
5 to 10 years	7.66	7.63	7.72	7.74	7.70	7.78	7.73	7.78	7.84	7.51	6.96	6.11
Over 10 years	7.20	7.14	7.27	7.24	7.33	7.37	7.37	7.29	7.41	7.18	6.84	6.04

Source: The People's Bank of China.

Table 3: Shares of loans with rates floating at various ranges, January through December 2008

Unit: Percent

	Floating downward	At benchmark	Floating upward					
	[0.9，1)	1	Sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2.0
January	25.93	29.77	44.30	16.13	14.76	6.06	6.50	0.85
February	26.51	30.04	43.45	15.46	14.22	5.92	6.91	0.94
March	25.46	37.92	36.62	18.77	13.84	2.79	1.11	0.12

April	20.47	28.87	50.66	17.10	16.34	7.32	8.60	1.30
May	20.24	30.53	49.23	16.92	15.51	6.73	8.09	1.99
June	21.60	32.81	45.58	16.40	14.24	6.13	7.66	1.15
July	21.54	30.93	47.53	16.76	15.02	6.37	7.36	2.01
August	18.92	30.46	50.62	17.81	15.79	7.31	8.07	1.64
September	21.59	31.15	47.26	16.35	14.95	6.88	7.37	1.72
October	23.34	29.87	46.79	15.59	13.90	6.81	8.40	2.10
November	23.48	32.13	44.39	13.92	13.71	6.29	7.83	2.63
December	25.56	30.13	44.31	14.00	13.81	5.75	7.27	3.49

Source: The People's Bank of China.

VI. The RMB exchange rate remained broadly stable at an equilibrium level

Since 2008 the fundamental role of market demand and supply was further reflected and in general the RMB exchange rate appreciated. At end-2008 the central parity of the RMB against the U.S. dollar was 6.8346 yuan per U.S. dollar, an appreciation of 4700 bps or 6.88 percent from the end of 2007; the central parity of the RMB against the euro was 9.6590 yuan per euro, an appreciation of 10.43 percent from the end of 2007; and the central parity of the RMB against the Japanese yen was 7.5650 yuan per 100 yen, a depreciation of 15.32 percent from the end of 2007. In terms of the movement trend, in the first half of 2008 the RMB exchange rate appreciated relatively rapidly, whereas in the second half of 2008, the RMB exchange rate against the U.S. dollar remained stable, basically in a range between 6.81 yuan per U.S. dollar and 6.85 yuan per U.S. dollar. From the initiation of the exchange rate regime reform to end-2008, the RMB cumulatively appreciated by 21.10 percent against the U.S. dollar and 3.68 percent against the euro, whereas it cumulatively depreciated by 3.42 percent against the Japanese yen.

The RMB exchange rate fluctuated in both directions. In 2008 the peak and trough central parities of the RMB against the U.S. dollar were 6.80009 yuan per U.S. dollar and 7.2996 yuan per U.S. dollar respectively. The largest appreciation of the RMB central parity against the U.S. dollar in a single business day was 0.37 percent (255 basis points) and the largest depreciation in a single business day was 0.23 percent (162 basis points). Among the 246 trading days in 2008, the inter-bank foreign exchange market saw RMB appreciations on 130 days, RMB depreciations on 114 days, and a flat rate on two days.

Part 2 Monetary Policy Conduct

In 2008 the global economy was plagued by the most severe international financial crisis since the Great Depression. The situation was complex and changeable, and great uncertainties posed unprecedented challenges to policy-makers throughout the world. Under the leadership of the CPC Central Committee and the State Council, the PBC adjusted monetary policy in a timely manner and further improved the preemptiveness, targeting, and flexibility of monetary policy.

In 2007 growth of the Chinese economy climbed to 13 percent. In early 2008, in order to prevent the rapid economic growth from becoming overheated and to prevent the price hikes from turning into entrenched inflation, the PBC carried out a tight monetary policy. In terms of economic performance, the CPI was 8 percent in the first quarter of 2008, and the PPI continued to climb to 10.1 percent in August. During this period, commodity prices hovered at a high level and, in particular, in July the international crude oil price reached a historical high of US$147 per barrel. The global economy was facing fairly strong inflationary pressures. Many economies dealt with this situation by various means, such as increasing interest rates. Comprehensively taking into account various uncertainties including the U.S. sub-prime crisis, China strove to distinguish and forecast the internal and external causes of inflation and flexibly coordinated the application of quantitative and price instruments. Interest rates remained basically stable. In response to the widening "dual surplus" and the increased inflow of foreign exchange, the PBC mainly increased the reserve requirement ratio to drain the excess liquidity. In the first half of the year, the PBC raised the reserve requirement ratio five times, which had frozen about 70 percent of new RMB counterpart deposits for purchasing foreign exchange, while the liquidity of the banking system remained at a basically reasonable level. In the meantime, the PBC guided financial institutions to reasonably arrange their credit programming. The forecast at the beginning of the year for aggregate new loans for the full year was 3.87 trillion yuan, 240 billion yuan more than the high base in 2007. On this basis, the PBC continued to instruct financial institutions to extend loans in a balanced manner to meet the demands of the real economy, and particularly urged rural financial institutions to extend loans according to the timing of farming. In terms of practical applications, the guided credit programming was flexible in dealing with the impacts of external shocks. In order to meet the demand for disaster relief funds in the wake of the heavy snow and sleet disaster, , and in light of the types of financial institutions and how severely the areas were affected, in February the PBC instructed financial institutions to speed up the issuance of loans in the first quarter. After the May 12 Wenchuan earthquake, the PBC immediately relaxed the restriction on credit programming of the financial institutions with the legal person status located in the affected areas, and guided banks at the national level to allocate more financial resources to the quake-hit areas and to beef up credit support there.

At mid-year, as the U.S. sub-prime crisis deepened, a huge adjustment was made in the macroeconomic management policy. The PBC adjusted the direction, focus, and intensity of monetary policy in a timely manner. In accordance with the requirements for maintaining stable and relatively rapid economic growth as well as for curbing price increases, the PBC reduced the intensity of open market operations, increased the new loan quota for the full year to about 4 trillion, and guided financial institutions to increase credit inputs, optimize the credit structure, and tilt their credit resources to the agricultural sector, small- and medium-sized enterprises, and post-disaster reconstruction.

Beginning in September, the international financial crisis rapidly worsened, exerting greater impacts on the Chinese economy. According to the overall arrangements of the CPC Central Committee and the State Council, the PBC adopted a moderately loose monetary policy, used a mix of monetary instruments, took a series of flexible and forceful measures, timely sent signals to ensure economic growth and maintain market confidence, cut the benchmark deposit and lending interest rates on five occasions and the reserve requirement ratio on four occasions, explicitly lifted the rigid control of aggregate credit planning, ensured sufficient liquidity for the banking system, promoted the reasonable and stable growth of money and credit aggregates, actively supported other economic stimulus policies sponsored by the central government, and strengthened financial support to economic development.

I. Open market operations were carried out flexibly

Since the beginning of 2008, the PBC had been closely monitoring and dealing with the changing internal and external economic and financial situations. In accordance with the requirements of macro-monetary management and the changing financial market sentiments, the PBC flexibly adjusted open market operation strategies and reasonably managed the pace and frequency of monetary policy operations. Firstly, the PBC made flexible adjustments to the pace of issuing central bank bills to ensure ample liquidity for the banking system. In light of the demands in different periods, the PBC reasonably managed the pace and intensity and gradually decreased the amount and frequency of issuance of central bank bills. A total of 4.3 trillion yuan of central bank bills was issued for the full year, with the issuance in each quarter of 1.78 trillion yuan, 1.17 trillion yuan, 981 billion yuan, and 371 billion yuan respectively. At year-end, outstanding central bank bills stood at 4.65 trillion yuan. Secondly, the PBC continued to optimize the structure of operational tools in order to bring the role of preemptive macro-control and fine-tuning of open market operations into full play. The PBC scientifically designed and optimized the mix of open market operational tools on a continuous basis, timely added more short-term repo tools, gradually shortened the maturity of the operational structure, and further increased the flexibility of the banking system to cope with the impacts on short-term liquidity.

Total repos amounted to 3.3 trillion yuan for the full year and the outstanding balance of repos at year-end stood at 362.2 billion yuan. In light of the new situation of heightened turmoil on the international financial market, the PBC introduced the Term Auction Facility (TAF) in order to supply liquidity support to domestic financial institutions facing temporary liquidity difficulties. Thirdly, the PBC strengthened guidance for market interest rates in order to bring into play their role in adjusting the demand and supply of funds. In coordination with the movements of the benchmark deposit and lending interest rates and the reserve requirement ratio, the interest rates on the OMO market went down steadily. By the end of 2008, the interest rates on 1-year and 3-month central bank bills and 28-day repo decreased by 180, 240, and 230 basis points respectively from the peak values of the year. Fourthly, the PBC strengthened the coordination with the proactive fiscal policy. The PBC timely transformed central treasury funds from accounts in the central bank to time deposits in the commercial banks. A total of 170 billion yuan was transformed for the full year and the outstanding balance was 80 billion yuan at year-end. The launch of this business not only helped improve the efficiency of central treasury funds, but also improved the liquidity stability in the banking system.

II. The reserve requirement ratio was used flexibly

In the first half of 2008, in light of the widening “dual surplus” and the continuous rapid inflows of foreign exchange, and in order to sterilize the excess liquidity, the PBC increased the reserve requirement ratio cumulatively by 3 percentage points on five consecutive occasions. In the meantime, a lower reserve requirement ratio was applied to the RCCs and the financial institutions in the quake-hit areas. In the latter half of the year, with the heightened international financial turmoil and in order to ensure ample liquidity in the banking system, the PBC cut the RMB reserve requirement ratio of financial institutions on September 25, October 15, December 5 and December 25 respectively. Specifically, the reserve requirement ratio of large financial institutions was cut by 2 percentage points cumulatively, whereas that of small financial institutions was cut by 4 percentage points cumulatively. By the end of 2008, according to trend calculations, a total of 800 billion yuan of liquidity was released. The PBC continued to apply preferential reserve requirement ratios to rural financial institutions and to financial institutions in the quake-hit areas so as to improve their funding capacity. In addition, the PBC adjusted the recipients of the differentiated reserve requirement ratio. Those financial institutions whose capital adequacy ratio reached the required level could revert to the normal reserve requirement ratio and thus the number of financial institutions enjoying the differentiated reserve requirement ratio declined notably.

III. The leveraging role of the interest rate was brought into play

In order to cope with the impacts on China's economic growth caused by the worsening international financial crisis, to implement a relatively loose monetary policy, to stimulate domestic demand, and to maintain steady and relatively rapid economic growth, beginning in September 2008, the PBC lowered the benchmark deposit and lending rates of financial institutions on five occasions. The 1-year benchmark deposit rate was cut cumulatively by 1.89 percentage points, from 4.14 percent to 2.25 percent, and the 1-year lending rate was shaved cumulatively by 2.16 percentage points, from 7.47 percent to 5.31 percent. The deposit and lending rates applied to financial institutions by the PBC were cut twice; in particular, the deposit rates of statutory reserve and excess reserve with the PBC were cut from 1.89 percent and 0.99 percent to 1.62 percent and 0.72 percent respectively. The 1-year central bank liquidity lending rate was cut from 4.68 percent to 3.33 percent; the 1-year central bank lending to RCCs was cut from 3.96 percent to 2.88 percent; the rediscount rate was cut from 4.32 percent to 1.80 percent.

Efforts were made to ratchet up financial support for disaster relief and post-disaster reconstruction. First, preferential interest rates were applied to agro-linked loans in the quake-hit areas. Interest rates of all maturities were adjusted downward by 0.99 percentage points on the basis of the central bank lending rate to RCCs. The new interest rates began to be applied from May 1, 2008. In December 2008 the preferential interest rates were further extended from areas extremely badly hit and badly hit by the earthquake to other quake-hit areas. Second, the preferential interest rates were applied to Wenchuan quake-hit area residents who bought housing for their own use after the earthquake. For the affected people who bought housing for their own use, the floor lending rate was adjusted to 60 percent of the benchmark lending rate, and the proportion for the down payment was lowered to 10 percent. Third, for rural housing reconstruction loans that were fully guaranteed by guarantee companies (or guarantee funds) sponsored by local governments, or for those whose borrowers provided collaterals or pledges that fully conformed with the requirements of the commercial banks, the floor lending rate was cut to 60 percent of the benchmark lending rate.

Box 1 Comparison of the Domestic and Foreign Interest Rate Systems

Since September 2008 the PBC has lowered the benchmark deposit and lending rates on several occasions. At present, the 1-year benchmark deposit rate and 1-year benchmark lending rate stand at 2.25 percent and 5.31 percent respectively. The U.S. federal funds target rates have been compared with China's benchmark deposit rate and lending rate and the conclusion has been reached that since the former had fallen within the range of 0-0.25 percent, China's benchmark interest rates still had a large downward potential. Actually, interest rate systems across countries vary with the macroeconomic management approaches of the central banks, financial system, and financial market conditions. As China's market-based reform of the interest rate system is still underway, market interest rates coexist with administered interest rates, and there exist large differences between China's interest rate system and the systems in other advanced countries. When comparing interest rate levels in different countries, one needs to study the features of the interest rate, such as its nature and maturity.

1. A comparison of China's interest rate system and the systems in other advanced countries

According to the nature of fund borrowing and lending, China's interest rate system comprises central bank interest rates, financial market interest rates, and deposit and lending interest rates. The central bank interest rates refer to the interest rates between the central bank and other financial institutions, including the deposit rates of statutory reserves and excess reserves with the central bank, the central bank lending (rediscount) rates, and the operational interest rates on the open market. The central bank is assumed, based on the market, to set or determine the aforementioned interest rates (such as the open market interest rates) in an effort to influence the money base or the market interest rates and to achieve the monetary policy targets. The interest rates on the financial market mainly refer to the borrowing and lending rates among different institutions, which have already realized full marketization, including the lending rates and repo rates on the money market, the quotation-based Shibor, and the yields of government securities, financial bonds, and enterprise bonds. The depositing and lending rates, which are still in the process of marketization, are the retail rates to clients by financial institutions. The benchmark deposit and lending rates, promulgated by the PBC, are important monetary policy tools based on 0.9 times the benchmark lending rate as the floor rate (for commercial individual housing loans, the floor rate is 0.7 times the benchmark lending rate); using the benchmark deposit rate as the ceiling, financial institutions can set deposit and lending rates at their own discretion.

Financial markets in advanced countries have fully realized the marketization of interest rates. Central banks in these countries guide the movement of market interest rates by adjusting policy interest rates in order to realize monetary policy targets. In general, the policy interest rates of the central banks in advanced countries are short-term operational rates on the open market, with a strong market-based nature, although the central bank has a large influence on the short-term open market interest rates. The interest rates on the financial market in advanced countries also include the wholesale interest rates between financial institutions and the retail rates for clients. There is a strong linkage between the wholesale rates and the retail rates, which is also the foundation for interest rate adjustments and transmission. Taking the U.S. as an example, the Federal Reserve publishes the federal funds target rate and guides the federal funds rate, or the overnight lending rate, to the target area via open market operations. The wholesale interest rates on the market, including the interest rates of government securities, the interest rates of commercial papers, the implied interest rates of financial derivatives, the Libor rates based on the quotation system, the retail interest rates for clients such as CDs (certificates of deposit), and the best lending rates of commercial banks, are determined by the market, with which the central bank does not directly intervene, although the federal funds target rate has a strong influence on the wholesale and retail rates.

2. Comparison between the interest rate level in China and the levels in other advanced countries

In comparing the interest rate level in China and the levels in other advanced countries, efforts should be made to select interest rates of the same nature and maturity. For example, the federal funds target rate is 0-0.25 percent, and its actual level is around 0.1 percent, whereas its Chinese counterpart, the overnight lending rate, is 0.82 percent. The 3-month dollar Libor is 1.24 percent, whereas China's 3-month Shibor is 1.34 percent. In terms of retail interest rates, the 1-year U.S. CD interest rate is 2.0-2.5 percent, which is quite similar to China's 1-year benchmark deposit rate of 2.25 percent. The best lending rate of U.S. commercial banks is 3.25 percent, whereas China's 1-year floor lending rate is 4.78 percent (0.9 times the benchmark lending rate). The best lending rate of individual housing loans with a yearly-adjusted floating rate is about 5.6 percent, whereas the floor of China's 5-year individual housing loans with a floating interest rate is 4.16 percent (0.7 times the benchmark lending rate for a maturity of over 5 years). In sum, China's interest rate level is quite similar to that in the U.S., whereas some Chinese interest rates are even lower than those in the U.S.

At present, the inter-bank borrowing rates and deposit and lending rates of commercial banks in the euro zone are generally lower than those in China. The wholesale overnight lending rate on the inter-bank market in the euro zone is 1.20 percent, 0.38 percentage points higher than that in China. The 3-month Euribor is 2.05 percent, 0.71 percentage points higher than that in China. The 1-year retail deposit rate of commercial banks to residents is 4.27 percent, 2.02 percentage points higher than that in China. The average 1-year corporate lending rate is 6.04 percent, 0.19 percentage points lower than the average lending rate of 6.23 percent in China. The housing lending rate for over 10 years is 5.27 percent, 1.11 percentage points higher than the floor of China's individual housing lending rate.[2]

IV. The PBC appropriately brought into play the role of rediscounts in guiding the direction of credit funds and promoting the credit structure adjustment

In 2008, in light of the changed direction of financial macro-management, the PBC further perfected its rediscount policy and appropriately brought into play the role of the rediscount tool in guiding the direction of credit funds and promoting the credit structure adjustment. First, the amount of rediscounts was increased in a timely

[2] The deposit and lending rates in the euro zone are based on November 2008 data. China's average lending rates refer to December 2008 data. Other interest rates refer to February 4, 2009 data.

manner. In the first half of 2008, for those provinces (regions and municipalities) hit by the heavy snow and sleet disaster and by the disastrous earthquake, an additional rediscount quota of 25.6 billion yuan was timely arranged to inject liquidity into the financial institutions located in the disaster-hit areas so as to increase their credit inputs for post-disaster reconstruction. In December, 34.6 billion yuan of the rediscount quota was added to 16 provinces (regions and municipalities) that experienced a relatively large amount of notes business so as to increase agro-linked loans and financing of small- and medium-sized enterprises. Second, the rediscount rate was lowered twice, cumulatively by 2.52 percentage points, in order to support financial institutions in further expanding their paper financing capacity. Third, efforts were made to perfect the institutional building of the rediscount system. The PBC headquarter released the *Notice on Perfecting the Management of the Rediscount Business and Increasing Agro-linked Loans and Financing to Small- and Medium-Sized Enterprises*, requiring PBC branch offices to appropriately increase the rediscount windows and to expand the scope of recipients and the institutional coverage of the rediscount business; to utilize the rediscount tool to expand the use of commercial bills so as to promote credit extension based on commercial papers; to use rediscounts to explicitly target the major recipients of the rediscounts and to give preference to note rediscounts related to the agricultural sector and small- and medium-sized enterprises. The *Notice* further reiterated that rediscounts could adopt the two means of repos and buyouts in order to improve efficiency.

V. Window guidance and credit policy guidance were strengthened

In early 2008 the PBC guided financial institutions to carry out annual credit programming in a down-to-earth manner, reasonably arrange the pace and frequency of credit extensions, appropriately restrict loans to enterprises with high-energy consumption, high emissions, and excess capacity, and strengthen credit support to priority areas such as the agricultural sector, small- and medium-sized enterprises, and weak links. The PBC encouraged financial institutions to extend financial services to the disaster-hit regions and arranged an additional 19.4 billion yuan of central bank lending for the full year so as to support the post-disaster reconstruction. In the second half of the year, in accordance with the changed situation, the PBC timely eliminated the rigid constraints on credit programming of commercial banks, guided financial institutions to reasonably extend loans in accordance with the effective demands of the real economy in the principle of “differentiated treatment for different sectors” and to strive to optimize the credit structure, improve and strengthen credit services, and increase credit inputs for civil well-being projects, the agricultural sector, major project construction, small- and medium-sized enterprises, the services industry, energy-conservation and emission-reduction, scientific and technological innovation, increased employment, mergers and acquisitions, coordinated regional development and so forth on the premise of controllable risks.. The PBC also perfected the housing credit policy and strengthened credit support for the construction of ordinary housing, affordable housing, and low-rent housing.

VI. The reform of financial institutions was steadily promoted

The shareholding reform of large state-owned commercial banks was basically completed with outstanding achievements. Beginning in 2003, the reform of large state-owned commercial banks was promoted in a preemptive manner. By the end of 2006, the shareholding reform of the Bank of China, the China Construction Bank, the Bank of Communications, and the Industrial and Commercial Bank of China was accomplished and the reformed banks got listed successfully. In 2008, against the background of the global financial crisis, the central government resolutely launched the reform of the China Development Bank and the Agricultural Bank of China, and injected US$20 billion and US$19 billion respectively into these two banks, highlighting China's determination to deepen the financial reform and its resolve to safeguard financial stability. By then, the reform of China's large commercial banks was basically completed. At present, whether in terms of assets, asset quality, earning capacity, the capital adequacy rate, or the liquidity ratio, the strength of the banking industry, including the large commercial banks, is at a historic crest. By the end of September 2008, the capital adequacy ratios of the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications were 12.6 percent, 13.9 percent, 12.1 percent, and 13.8 percent, respectively; their NPL ratios were 2.4 percent, 2.6 percent, 2.2 percent, and 1.8 percent, respectively; and their pre-tax profits were 120.6 billion yuan, 80.3 billion yuan, 108.7 billion yuan, and 29.6 billion yuan, respectively. The safety and stability of the financial system continued to improve, paving the way for the economy to fight the global financial crisis and to maintain healthy and stable operations.

The Agricultural Bank of China Ltd. Co. was formally established. According to the arrangements of the 2007 State Financial Work Meeting, the PBC, jointly with other departments, conducted an in-depth investigation and analysis and made some international comparisons, with the principle of "servicing the agricultural sector as its main task, commercialized operations moving at an opportune time," carried out research on the reform plan for the Agriculture Bank of China and steadily advance the reform. On October 21, 2008, the State Council convened its 32nd Executive Meeting and passed the *Guidelines for the Shareholding Reform of the Agriculture Bank of China*. On October 29, the China Investment Corporation, via the Central Huijin Investment Co., injected the RMB equivalent of US$130 billion into the Agricultural Bank of China. The Ministry of Finance and the China Investment Corporation each took 50 percent of the shares of the Agricultural Bank of China. The Agricultural Bank of China consecutively completed an asset assessment, land property rights verification, and divestiture of non-performing assets. In the meantime, the Agricultural Bank of China continued to expand the pilot projects of multidivisional structure reform at the county level and ratcheted up credit support for the agricultural sector. On January 9, 2009, the Agricultural Bank of China Co. Ltd. was formally established with the initial establishment of a “shareholders meeting, board of directors, board of supervisors, and senior management” structure. On January 16, 2009, the Agricultural Bank of China Co., Ltd. was officially inaugurated.

The China Development Bank Co. Ltd. was officially established, marking a breakthrough in its commercialized transformation. In February and April 2008, the overall plan and implementation measures of the China Development Bank were approved in succession. The overall plan specified management over losses caused by exchange of foreign currency-denominated capital funds in financial restructuring, co-managed funds, and risk provisions; specified the management plan for state shares, with the Ministry of Finance and the Central Huijin Investment Co. Ltd. as shareholders holding 51.3 percent and 48.7 percent stakes respectively. On December 1, 2009, the China Development Bank Co. Ltd. was officially established, and according to the procedural requirements of the *Company Law*, a new board of directors, board of supervisors, and senior management team were created. On December 16, the China Development Bank Co. Ltd. was officially inaugurated. The Export-Import Bank of China and the Agricultural Development Bank of China also deepened their internal reforms, strengthened risk management and internal control system, steadily launched new businesses, and paved the way for the comprehensive reform of these two banks.

The reform of the RCCs made significant progress and achieved initial results. The fund support for RCCs was basically put into place. In the fourth quarter of 2008, 2.096 billion yuan of special-purpose central bank bills were issued to the RCCs in Hainan province, highlighting the completion of the issuance of special-purpose central bank bills to rural credit cooperatives throughout the country. By the end of 2008, over 90 percent of the special-purpose central bank bills had been redeemed, totaling 153 billion yuan, and a total of 1.5 billion special-purpose loans were issued. With the supporting funds put into place, the historical burdens of the RCCs were effectively resolved, and the asset quality improved notably. According to the four-category asset classification for bank loans, as of end-2008 the outstanding NPLs and NPL ratio of the rural credit cooperatives throughout the country stood at 296.5 billion yuan and 7.9 percent respectively, down 218.2 billion and 28.9 percentage points from that at the beginning of the reform. The profitability of the RCCs went up year by year after it turned positive in 2004, which was for the first time in the past decade. The RCCs realized a total of 54.5 billion yuan of profits in 2008, 9.2 billion more than that in 2007. The fund resources of the RCCs increased notably. By end-2008, the outstanding loans of the RCCs totaled 3.7 trillion yuan, accounting for 12.3 percent of the outstanding loans of all financial institutions, compared to 10.6 percent at the beginning of the reform. The RCCs extended more credits to the agricultural sector. By end-2008, the outstanding agro-linked loans of the RCCs stood at 1.7 trillion yuan, accounting for 46 percent of all kinds of loans, compared to 40 percent at the beginning of the reform. The agro-linked loans of the RCCs accounted for 96 percent of all financial institutions, compared to 81 percent at the beginning of the reform. The shareholding reform of the RCCs moved ahead smoothly. By end-2008, there were 22 newly established rural commercial banks, 163 rural cooperative banks, and 1966 legal entities incorporated at the county level.

VII. Innovation in the foreign exchange administration system was deepened

Efforts were made to accelerate reform and innovation in the foreign exchange administration system, to actively promote the facilitation of trade and investment, to perfect the balanced management of cross-border capital flows, and to strive to improve the BOP situation. First, the facilitation of trade and investment made progress. Pilot projects of licensed small-value currency exchange business were launched. Eligible financial companies of enterprise groups were allowed to conduct spot sales and purchases of foreign exchange. A “green passage” was launched to streamline foreign exchange business procedures in order to conscientiously provide financial services for the Beijing Olympics and for anti-quake and disaster relief projects. In line with the changed situation, the percentage of exchange settlement quota of sales revenues received in advance and the percentage of deferred payments of ordinary enterprises was increased, so as to provide support to enterprises in coping with the global financial crisis. Second, supervision over cross-border capital flows was further strengthened. The *Regulations on the Foreign Exchange System of the People's Republic of China* were amended. The systems of online verification of collection and settlement of foreign exchange from exports and trade credit registration and management were implemented in order to improve examination of the authenticity and consistency of export transactions and the collection and settlement of foreign exchange. Off-site monitoring system of service trade was initially established. The information system for direct investment foreign exchange business was popularized. Measures to examine banks’ compliance with regulations of foreign exchange administration were implemented. The role of a coordinated supervisory mechanism for abnormal foreign exchange movements was put into better play in an effort to strike out illegal activities and underground banking. Third, the operation and management of the foreign exchange reserve system withstood major tests. Efforts were made to prudently cope with the widespread global financial crisis, strengthen risk management and internal supervision, and maintain and increase the value of foreign exchange reserves. Fourth, the early warning system over the BOP was further improved.

VIII. The RMB exchange rate formation system was perfected

In a self-initiated, controllable and gradual manner, measures were taken to further perfect the managed floating exchange rate system based on market demand/supply and in reference to a basket of currencies, to bring into play the fundamental role of market demand/supply in the RMB exchange rate formation, and to keep the exchange rate of the RMB basically stable at an adaptive and equilibrium level.

Part 3 Financial Market Analysis

In 2008 the financial market continued to perform in a sound and stable manner. RMB transactions were active on the money market, accompanied by a large decrease in money market interest rates. Activities on the bond market remained brisk, with the bond yield curve shifting downward sharply and the issue rate falling after climbing. The stock market tumbled amid fluctuations. Demand on the insurance market increased notably. The foreign exchange market developed at a steady pace.

The total financing by the domestic non-financial institution sector (including households, non-financial enterprises, and the government sector) continued to increase rapidly in 2008. In terms of the financing structure, the dominant role of loan financing was strengthened; enterprise bond financing grew at a rapid pace, playing a larger role in funds allocation; and the share of equity financing and government securities financing declined noticeably. Affected by the large fall in the stock market, equity financing by non-financial enterprises in 2008 decreased by 287.5 billion yuan, or 44.0 percent on a year-on-year basis. The declining share of government securities financing was mainly due to the large redemption of government securities at maturity in 2008, which increased 168.5 billion yuan year on year.

Table 4: Financing by domestic non-financial sectors in 2008

	Volume of financing (RMB 100 million yuan)		As a percentage of total financing (%)	
	2008	2007	2008	2007
Financing by domestic non-financial sectors	59984	49817	100. 0	100. 0
Bank loans	49854	39205	83. 1	78. 7
Equities [1]	3657	6532	6. 1	13. 1
Government securities[2]	1027	1790	1. 7	3. 6
Enterprise bonds[3]	5446	2290	9. 1	4. 6

Notes: 1. Equity financing in the table does not include financing by financial institutions on the stock market. 2. Government securities financing in 2007 does not include 1.55 trillion yuan of special government bonds. 3. Enterprise bonds include bonds issued by enterprises, short-term financing bills, medium-term notes, and corporate bonds.

Source: The People's Bank of China.

I. An overview of the financial market analysis

1. Brisk transactions on the money market were accompanied by a large decrease in interest rates and abundant market liquidity

RMB transactions on the money market were active, and the turnover of bond repos and inter-bank borrowing grew at a rapid pace. In 2008 the turnover of bond repos on the inter-bank market totaled 58.1 trillion yuan, with the daily turnover averaging 231.6 billion yuan and with year-on-year growth of 28.7 percent. The turnover of inter-bank borrowing reached 15.0 trillion yuan, with the daily turnover averaging 60 billion yuan and with growth of 40.2 percent year on year. Fund demand displayed an obvious trend of shortening maturities, and most of the transactions on the repo and borrowing markets were overnight products, accounting for 63.7 percent and 70.8 percent respectively. The turnover of government bond repos on the stock exchanges increased 32.3 percent year on year to 2.4 trillion yuan.

With respect to the lenders on the repo and borrowing markets, state-owned commercial banks reduced their lending whereas other commercial banks increased their supply of funds. With respect to the borrowers on the markets, the tumbling capital market dampened the financing demand of insurance companies. Fueled by the notably lowered market rates in the fourth quarter, the financing demand of securities and fund management companies rose remarkably. In the fourth quarter, funds borrowed by securities and fund management companies saw a year-on-year growth of 2 times, accounting for 96.6 percent of the year-on-year growth recorded in 2008.

Table 5: Fund flows among financial institutions in 2008

Unit: 100 million yuan

	Repo		Inter-bank borrowing	
	2008	2007	2008	2007
State-owned commercial banks	−136684	−132639	24597	11031
Other commercial banks	12690	9899	−35809	−28619
Other financial institutions[1]	92373	88364	2540	10868
Of which: Securities and fund management companies	33837	15175	2916	7670
Insurance companies	26538	31055	—	—
Foreign financial institutions	31621	34376	8672	6720

Note: 1. Other financial institutions in the table include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and fund management companies. 2. A negative sign indicates a net fund outflow; a positive sign indicates a net fund inflow.

Source: The People's Bank of China.

The interest rate derivatives market maintained a momentum of rapid growth, with the products increasingly diversified and the market size expanding rapidly. In 2008 both bond forward and interest rate swap transactions increased by nearly 100 percent from 2007. Trading of interest rate derivatives grew steadily in the first three quarters of 2008 but declined in the fourth quarter due to the financial crisis. The turnover of bond forward and interest rate swaps shrank notably compared with the first three quarters, whereas that of forward interest rate agreements continued to grow steadily. The Shibor played a larger role in the pricing of interest rate derivative products. In 2008 a total of 1,783 interest rate swaps were conducted based on the Shibor, with a notational principal amount of 89.919 billion yuan, increasing by 215 percent from the previous year and accounting for 22 percent of all interest rate swaps, up 9 percentage points year on year. A total of 137 forward interest rate agreements were traded with a notational principal amount of 11.36 billion yuan, all based on the 3-month Shibor.

Table 6: Transactions of interest rate derivatives

	Bond forward		Interest rate swaps		Interest rate forward	
	Transactions	Amount(100 million yuan)	Transactions	Notional principal amount (100 million yuan)	Transactions	Notional principal amount (100 million yuan)
2005	108	178	—	—	—	—
2006	398	664. 5	103	355. 7	—	—
2007	1238	2518. 1	1978	2186. 9	14	10. 5
2008	1327	5005. 5	4040	4121. 5	137	113. 6
Total	3071	8366	6121	6664. 1	151	124. 1

Source: China Foreign Exchange Trading System.

Money market interest rates fell after climbing. In the first half of the year, affected by such factors as strong expectations of inflation, the weighted average interest rates of inter-bank borrowing and pledged bond repo rose steadily to 3.07 percent and 3.08 percent respectively in June, 0.98 and 0.29 percentage points higher than those recorded in the previous December. In the third quarter, market interest rates were broadly stable. The moderately loose monetary policy and remarkably reversed market expectations in the fourth quarter drove down the interest rates. In December, the weighted average interest rates of inter-bank borrowing and pledged bond repo stood at 1.24 percent and 1.22 percent respectively, down 1.84 and 1.85 percentage points from June, and down 0.85 and 1.57 percentage points from the previous December, with the inter-bank borrowing rate hitting a record low and the repo rate reaching its lowest level since the end of 2005. At end-2008, the Shibor with maturities of one week and two weeks were 1.0058 percent and 1.1620 percent respectively, a decrease of 1.59 and 1.82 percentage points from the beginning of the year; the 3-month and 1-year Shibor registered 1.7782 percent and 2.3597 percent respectively, down 2.66 and 2.22 percentage points from the beginning of the year.

2. Transactions on the bond market were active and the bond issue rates increased before declining

Spot bond trading was active on the inter-bank bond market. The turnover in 2008 totaled 37.1 trillion yuan, with the average daily turnover reaching 147.9 billion yuan, representing a year-on-year growth of 1.4 times. The turnover of government bond spot trading on the stock exchanges registered 212.3 billion yuan, 92.2 billion yuan more than that during the same period of the previous year. On the inter-bank spot bond market, except for commercial banks that sold 1.5 trillion yuan on a net basis, other financial institutions were net purchasers, with the net purchases of state-owned commercial banks and other financial institutions amounting to 578.3 billion yuan and 603.1 billion yuan respectively.

The bond index went up. In 2008 both the inter-bank bond index and the stock exchange bond index displayed an overall upward trend. In particular, with the spread of the global financial crisis beginning September, there was a broad consensus in the market that policies tended to be accommodative, resulting in a soaring bond index. The inter-bank bond index climbed 14.99 percent from 114.84 points at the beginning of the year to 132.05 points at end-2008; the stock exchange T-bond index increased 9.50 percent from 110.78 points at the beginning of the year to 121.30 points at end-2008.

The yield curve of government securities on the inter-bank market moved down sharply, the movements of which in 2008 can be divided into three stages. The first stage (from January to April) saw a general decline in the yield curve, which was then followed by the second stage (from May to June), when the yield curve shifted steadily upward as the prices of government securities declined and investors became more cautious due to the tightening of the market and the heightened expectations of a tight monetary policy. The third stage started in July and went to the end of the year. With the adjustments in the macroeconomic policies, market liquidity was abundant and the yield curve moved down sharply at a rapid pace.

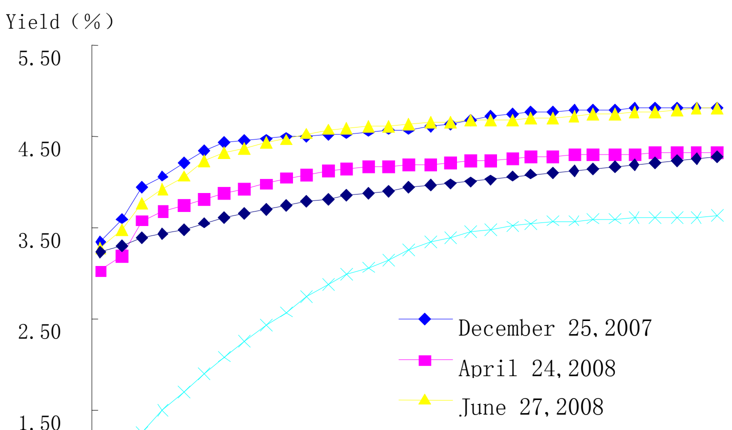

Figure 1: Yield curves of government securities on the inter-bank bond market in 2008

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

The issuance of bonds was stable, with the issue rates declining after climbing. In 2008 a total of 2938.1 billion yuan of bonds (excluding central bank bills) was issued, flat with that issued during the same period of the last year. Among this total, the issuance of enterprise bonds increased by 68.7 percent year on year, up 37.4 percentage points compared with the growth in 2007. The issuance of short-term financing bills, subordinated bonds, and asset-backed securities all grew substantially from the previous year. In terms of their maturity structure, the proportion of bonds issued with a maturity of less than 5 years was 61 percent, down 3.6 percentage points year on year, the proportion of bonds issued with a maturity of less than 1 year was 5.7 percentage points lower than that during the same period of the last year, and the proportion of bonds issued with a maturity of between 1 and 3 years rose by 2.6 percentage points year on year. At end-2008, outstanding bonds deposited with the China Government Securities Depository Trust & Clearing Co. Ltd. totaled 15.1 trillion yuan, a year-on-year increase of 25.7 percent (excluding special government bonds).

Table 7: Issuances of major bonds in 2008

Types of bonds	Issuances (100 million yuan)	Year-on-year growth (%)
Government securities [1]	8558	12. 1
Policy financial bonds	10823	−2. 4
Bank subordinated bonds and hybrid capital bonds	724	92. 3
Bank ordinary bonds	250	−44
Enterprise bonds [2]	8723	68. 7
Of which: Short-term financing bills	4332	29. 3
Asset-backed securities	302	69. 6

Note: 1. Special government bonds are excluded from the year-on-year growth of government securities.
2. Including enterprise bonds, short-term financing bills, medium-term notes, and corporate bonds.
Source: The People's Bank of China.

The Shibor played a larger role in the pricing of bonds. In 2008 three floating-rate bonds based on the Shibor rates were issued, namely policy financial bonds, commercial bank subordinated bonds, and enterprise bonds, totaling 12.2 billion yuan. Fifty-seven fixed-rate enterprise bonds were issued based on the Shibor rates, totaling 234.69 billion yuan. A total of 156 short-term financing bills were issued based on the Shibor rates, amounting to 178.63 billion yuan and accounting for 42 percent of the total issuance, flat with that during the same period of the last year. After the medium-term note was launched in April 17 medium-term notes based on the Shibor were issued, amounting to 44.9 billion yuan and accounting for 26 percent of the total issuance.

3. Paper financing grew rapidly

The acceptance of commercial bills maintained steady growth and the interest rates of commercial bills were market-based. In 2008 a total of 7.1 trillion yuan of commercial bills was issued by the corporate sector, up 20.7 percent year on year. Discounted bills totaled 13.5 trillion yuan, up 33.6 percent year on year. Rediscounted bills totaled 10.97 billion yuan. At end-2008 outstanding commercial bill acceptances amounted to 3.2 trillion yuan, an increase of 30.9 percent year on year. Outstanding discounted bills totaled 1.9 trillion yuan, up 50.4 percent year on year. With the PBC lowering the benchmark deposit and lending rates as well as the reserve requirement ratio, interest rates on both the money market and the bills market steadily declined, and the interest rates of discounted and rediscounted bills fell sharply, particularly in the fourth quarter.

Paper financing saw large fluctuations in 2008. At the beginning of the year, under the strengthened macroeconomic management, commercial banks adjusted their asset structure and reduced paper financing. Outstanding paper financing continued to decline and its growth decelerated. At end-March outstanding paper financing stood at 1.2 trillion yuan, hitting its lowest level of the year. In the second half of 2008, as the financial macro management policies were adjusted, commercial banks vigorously expanded their commercial bill business and paper financing grew at a fast pace and its outstanding amount rebounded rapidly. In 2008 the total financing through commercial bill acceptances and discounted bills exceeded 20 trillion yuan. Paper financing increased by 0.65 trillion yuan, and the proportion of new paper financing reached 13.2 percent of new loans. The rapid growth of paper financing effectively intensified financial institutions' credit support to SMEs. Paper financing served as the main short-term financing channel for SMEs, connected enterprises, and downstream enterprises. In recent years, although commercial bills were mainly issued by large enterprises, those issued by SMEs have been increasing.

4. The stock index tumbled amid fluctuations

Affected by several factors such as the weakened market confidence, the increasing impact of the global financial crisis on the Chinese economy, and the declining profits of listed companies, in 2008 the stock market went down substantially amid fluctuations, with transactions shrinking considerably. In 2008 the total turnover of the Shanghai and Shenzhen Stock Exchanges amounted to 26.71 trillion yuan, a decrease of 19.34 trillion yuan year on year, and the daily turnover averaged 108.6 billion yuan, down 43 percent year on year. As of the end of the year, market capitalization totaled 4.52 trillion yuan, down 51.4 percent from that at end-2007.

At end-2008, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Composite Index closed at 1821 points and 553 points respectively, down 65.4 percent and 61.8 percent respectively from the end of 2007. With the stock market going down amid large fluctuations, the risks due to the rapid stock price hikes in the last year were gradually eased. The average P/E ratios of A-shares on the Shanghai and Shenzhen Stock Exchanges declined respectively from 59 and 72 at end-2007 to 15 and 17 at end-2008.

Stock market financing declined notably. According to preliminary statistics, in 2008 a total of 365.7 billion yuan was raised by financial institutions and non-financial enterprises through IPOs (including secondary offerings), rights issues, and the issuance of convertible bonds on equity markets both at home and abroad, 502.3 billion yuan less than that raised during the same period of the last year, down 57.9 percent. Among this total, 328.1 billion yuan was raised through IPOs and rights issues on the A-share market, 438.8 billion yuan less than the increase recorded in the previous year, down 57.2 percent year on year.

5. The demand for insurance products increased notably, and the growth of total assets in the insurance industry moderated

The demand for insurance products increased notably. In 2008 the total premium income in the insurance industry amounted to 978.4 billion yuan, up 39.1 percent year on year or an acceleration of 14.3 percentage points. Among this total, life insurance premium income increased by 49.2 percent, an acceleration of 24.9 percentage points from the previous year; and property insurance premium income rose 17 percent. Claim and benefit payments in the insurance industry amounted to 297.1 billion yuan, 70.6 billion yuan more than that during the same period of the last year, representing a year-on-year growth of 31.2 percent. In particular, the growth of payments of property insurance and life insurance amounted to 39.8 billion yuan and 25.1 billion yuan respectively, up 39.0 percent and 23.5 percent over the previous year.

The growth of the total assets in the insurance industry moderated. At end-2008 total assets amounted to 3.34 trillion yuan, an increase of 15.2 percent year on year and a deceleration of 31.8 percentage points. In particular, investment-type assets grew by 11.2 percent year on year, a deceleration of 60.1 percentage points; bank deposits increased by 24.1 percent from the previous year, an acceleration of 15.3 percentage points.

Table 8: Use of insurance funds in 2008

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	2008	2007	2008	2007
Total assets	33418. 4	29003. 9	100. 0	100. 0
Of which: Bank deposits	8087. 6	6516. 3	24. 2	22. 5
Investment	22465. 2	20205. 7	67. 2	69. 7

Source: The China Insurance Regulatory Commission.

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

The spot foreign exchange market operated smoothly and the dominant role of OTC transactions was strengthened. RMB swap transactions were active, and the trading volume of currency pairs dropped notably. The spot foreign exchange transactions were mainly conducted through OTC transactions and in US dollars, with both the OTC transactions and the transactions in US dollars accounting for 99 percent of the total transactions. The turnover of the RMB foreign exchange swap market totaled USD$440.3 billion, an increase of 39.6 percent year on year. As a derivative, the RMB foreign exchange swap played an increasingly important role in hedging exchange rate risks on the foreign exchange market. The turnover of the RMB foreign exchange forward market totaled USD$17.4 billion, down 22.4 percent year on year. The turnover of eight currency pairs decreased by 30.9 percent year on year to USD$62 billion, with transactions in the USD/HKD and EUR/USD currency pairs accounting for 77.6 percent of the total trading volume.

II. Financial market institutional building

1. Financial product innovation was promoted

RMB interest rate swap transactions were launched on a comprehensive basis. Drawing on the experiences of the pilot RMB interest rate swap business, in January 2008 the PBC released the *Notice on Conducting RMB Interest Rate Swaps*, which expanded the coverage of participants, lifted the limitations on the forms of interest rate swaps, and strengthened risk-prevention requirements for participants so as to promote the sound and healthy development of the interest rate swap business. In 2008 a total of 4,040 interest rate swaps were conducted with a notational principal amount of 412.15 billion yuan, an increase of 104 percent and 88 percent respectively from the previous year.

Medium-term notes were introduced to further expand direct financing channels for enterprises. Medium-term notes were allowed to be registered in April 2008, and enterprises (companies) could register a relatively large quota on a one time basis so as to enjoy the convenience of issuing medium-term notes in installments according to market conditions when they are in temporary need of funds. The market supply of and demand for medium-term notes remained buoyant after it was launched, and 39 medium-term notes were issued by 24 enterprises in 2008, totaling 167.2 billion yuan.

2. Infrastructure building of the inter-bank bond market was strengthened

First, the self-regulating mechanism of the inter-bank bond market was reinforced. In April 2008, the *Administrative Rules on Debt Financing Instruments for Non-financial Enterprises on the Inter-bank Bond Market*, released by the PBC, clarified that the National Association of Financial Market Institutional Investors (NAFMII) should strengthen the market self-regulation of non-financial enterprises in terms of the issuing and trading of debt financing instruments, which signaled a major transformation in the regulation of the inter-bank bond market. In October 2008, approved by the State Council, the PBC required the NAFMII to accept registration of the issuance of medium-term notes handed in by listed companies. with priority given to large heavy-weight listed companies, to allow listed companies to channel the proceeds from the issuance of medium-term notes into buying back their own shares in line with the relevant regulations of the government, and to grant priority to the registration reports of major enterprises in the basic sectors of the national economy, such as coal, electricity, oil, and transportation, so as to strengthen the financing role of the bond market, stabilize the capital market, and promote the sound and rapid growth of the economy.

Second, Delivery versus Payment (DVP) settlement was launched on a comprehensive basis. In July 2008 the PBC issued *Announcement No.12 [2008]*, describing the channels for DVP settlement and related arrangements for non-banking institutions and stipulating the provisions for DVP settlement on the inter-bank bond market in a comprehensive manner. This announcement signaled the launch of DVP settlement on China's inter-bank bond market, improved settlement efficiency, and effectively reduced and controlled settlement risks. In 2008 a total of 101.32 trillion yuan was settled on the inter-bank bond market, among which 60.64 trillion yuan was processed through DVP settlement, accounting for 59.85 percent of the total settlements.

Third, non-legal entities were encouraged to access the inter-bank bond market. In April and December, the PBC in succession released the *Notice on Opening Depository Bond Accounts in the Name of Products by Insurance Institutions* and *Announcement No. 22* on opening trust-tailored bond accounts by trust companies, which allowed the funds raised through insurance and trust products to be invested in the inter-bank bond market.

3. The fundamental institutional building of the securities market made progress

First, the building of a sound operating mechanism in the stock market was strengthened. In April 2008 the China Securities Regulatory Commission (CSRC) released the *Guidance Opinions on the Transfer of Stock Shares with Terminated Sales Limits of Listed Companies* to promote the legal and orderly transfer of original shares released from trading restrictions. In August, the *Administrative Rules on the Acquisition of Listed Companies* were revised to enhance the flexibility of the controlling shareholders of listed companies to increase their shareholding. In October the CSRC issued the *Supplementary Rules on the Repurchase of Shares by Listed Companies through Bidding*, which simplified the verification procedures for the repurchase by listed companies so as to give play to the role of the intrinsic stabilizing mechanism of the market. Second, efforts were made to promote the building of multi-layered capital markets and to prepare for the Growth Enterprise Market (GEM). Third, the legal framework for the securities market was further improved, with the *Rules on Supervision over Securities Companies* and the *Rules on Risk Disposal of Securities Companies* released to improve regulations for supervision and risk disposal over securities companies.

4. The insurance protection fund was further improved

In September 2008 the China Insurance Regulatory Committee (CIRC), the Ministry of Finance, and the PBC jointly released the *Administrative Rules on the Insurance Protection Fund*, which clearly state the nature of the insurance protection fund and revise the management system, payment basis, payment scope and ratio, and investment channels of the fund. The issuance of the *Rules* further improved the insurance protection fund system and regulated the operation of the fund.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In 2008, as the financial crisis spread from the earliest affected regions to the entire world, from the developed countries to the emerging markets and the developing countries, and from the financial realm to the real economy, global economic growth slowed down notably, accompanied by heightening turbulence in the international financial market and increasing destabilizing factors in the international economic environment. The U.S., the euro area, and Japan slid into recession, and growth in the emerging market economies slowed noticeably. Commodity prices fell precipitously after reaching a new high in July. Global inflationary pressures eased but deflation risks grew. In response to the crisis, the major economies subsequently cut interest rates, pumped liquidity into the market through various channels, handed out various bailout aids to troubled financial institutions, and launched massive economic stimulus packages. At the "Financial Market and the World Economy Summit" in November the leaders of the G20 nations pledged to strengthen international cooperation, coordinate crisis resolution, and reform the international financial system. In the wake of the Summit, a number of policies were issued in an effort to implement the Declaration and Action Plan of the Summit. On January 28, 2009, the International Monetary Fund announced that world economic growth in 2008 was 3.4 percent, 1.8 percentage points lower than that in 2007.

1. The economic development of the major economies

The U.S. slid into recession. Affected by shrinking consumer spending, a contraction of enterprise investment, a weaker export sector, and a persistently bearish property market, annualized quarter-on-quarter GDP growth after seasonal adjustments posted merely 1.3 percent, 0.7 percentage points lower than that in 2007, with quarterly GDP growth registering 0.9 percent, 2.8 percent, -0.5 percent, and –3.8 percent respectively. The employment situation continued to deteriorate, with the unemployment rate soaring from 4.9 percent at the beginning of the year to 7.2 percent in December, the highest level in the past 16 years. Foreign trade contracted notably, and the trade deficit decreased by US$23.16 billion from 2007 to US$677.1 billion in 2008. Under the combined influence of the economic slowdown and the massive fiscal plan, the fiscal deficit of the U.S. Federal Government rose substantially. The federal budget deficit reached a historic high of US$455 billion in the 2008 fiscal year ending on September 30, an increase of 180.9 percent year on year, and the fiscal deficit to GDP ratio climbed from 1.2 percent in the 2007 fiscal year to 3.2 percent. Inflationary pressures built up and then eased. The year-on-year CPI grew from 4.3 percent at the beginning of the year to an 18-year-high of 5.6 percent in July, and dropped rapidly thereafter all the way down to 0.1 percent in December.

The euro area slid into its first recession since inception. Affected by the financial crisis, consumption, investment, and exports in the euro area slowed down simultaneously, with GDP in the four quarters posting 2.1 percent, 1.4 percent, 0.6 percent, and –1.2 percent. The employment situation in the first half of 2008 remained stable but worsened in the latter half of the year, with the unemployment rate rising from 7.4 percent in June to 8.0 percent in December. The trade deficit increased, amounting to 32.1 billion euros cumulatively over the whole year, compared to 15.8 billion euros in the same period of the last year. The price level first edged up and then declined. The year-on-year Harmonized Index of Consumer Prices (HICP) grew from 3.2 percent at the beginning of the year to a historical high of 4.0 percent in July, but rapidly decreased starting from August and dropped to 1.6 percent in December, within the 2 percent target set by the European Central Bank.

The Japanese economy was in recession. Due to weakening household consumption and fixed-asset investment, contraction of industrial production, and export stagnation, the annualized quarter-on-quarter GDP growth after seasonal adjustments posted 0.6 percent in the first quarter but fell to -3.6 percent, -2.3 percent, and –12.7 percent in the next three quarters respectively, witnessing the steepest fall in the past 35 years. The job market was also gloomy. The unemployment rate increased from 3.8 percent at the beginning of the year to a two-year high of 4.2 percent in August. Following a slight decline in the next few months, the unemployment rate climbed to 4.4 percent in December. Affected by weakening external demand and a dwindling trade surplus, the cumulative trade surplus in 2008 registered 2.156 trillion yen, a drastic decrease of 80 percent from that in 2007. Price indices dropped from an elevated level. The year-on-year CPI growth, after climbing from 0.7 percent at the beginning of the year to a ten-year high of 2.3 percent in July, slid rapidly in the fourth quarter and fell to 0.4 percent in December. The average CPI for the year increased by 1.4 percent.

The impact of the financial crisis on the major emerging market economies and developing countries (regions) gradually became apparent, with obvious economic slowdowns. In the first half of the year, India, Vietnam, and a few other countries experienced economic volatility, but the emerging market economies as a whole maintained a momentum of stable growth. Under the combined influence of rising energy and food prices, capital inflows, and strong domestic demand, inflation surged. In light of the build-up of price hike pressures, most emerging market economies frequently raised interest rates by small margins. After mid- and late September, due to the unwinding of the weakening external demand and other negative effects of the intensifying financial crisis, the emerging market economies and the developing economies deteriorated rapidly, characterized by a slowdown in industrial growth, sluggish exports, and accelerating capital outflows. Some economies that were highly dependent on exports and capital inflows were severely affected.

2. Global financial market development

In 2008 the exchange rates of the major currencies fluctuated within broad bands. The U.S. dollar weakened and then revalued, and the Japanese yen appreciated amidst fluctuations. As a result of the downbeat forecast by investors about the U.S. economy, the dollar depreciated rapidly against the euro and the yen at the beginning of the year. From the end of the first quarter, with the massive deleveraging of financial institutions, a large amount of risky dollar assets was liquidated. This, combined with flight to the safety of the dollar when the financial crisis spread to Europe and the entire world, sent the dollar appreciating. At end-2008 the euro to dollar and pound to dollar exchange rates closed at 1.3978 dollar per euro and 1.4626 dollar per pound, with the dollar revaluing by 4.4 percent and 35.7 percent against the euro and the pound respectively from the beginning of the year. Moreover, affected by the squaring of carry trade positions due to interest rate cuts and capital flow-backs, the yen appreciated amidst fluctuations and closed at 90.60 yen per dollar at end-2008, revaluing by 22.9 percent from the beginning of the year and reaching a record high for the past 16 years.

Interest rates in the international financial market exhibited great volatility. In the first half of the year, affected by the financial crisis and expectations that the Federal Reserve might put an end to interest rate cuts, the 1-year U.S. dollar Libor plunged and then rose appreciably. In the latter half of the year, affected by successive rate cuts by the Federal Reserve and a plentiful liquidity supply, the 1-year U.S. dollar Libor reached a yearly peak of 4.23 percent on October 9 and then slid precipitously to its lowest point of 2.00 percent on December 31, about 2.22 percentage points lower than that at the beginning of the year. Affected by interest rate hike by the European Central Bank and the heightening volatility in the international financial market, the 1-year Euribor fluctuated after crawling up to its previous level, and rose to a yearly peak of 5.53 percent on October 2. Thereafter, due to the interest rate cuts by the European Central Bank, the Euribor dropped to its lowest point of the year of 3.05 percent on December 31, about 1.70 percentage points lower than that at the beginning of the year.

The major bond yields in the international market fluctuated downward. Following the substantial slump from the beginning of the year, the major bond yields rallied from end-March and edged down marginally in June. After the bankruptcy of Lehman Brothers in September, there was more demand for safety. After the frequent interest rate cuts, a large amount of capital flowed into the bond market, pushing down the yields of the major T-bonds. At end-2008 10-year T-bond yields closed at 2.061

percent, 2.944 percent and 1.168 percent in the U.S., the euro area, and Japan respectively, a drop of 2.026, 1.398, and 0.334 percentage points respectively from the beginning of the year.

The major stock markets plunged considerably. Affected by the financial crisis, the major stock markets tumbled amidst fluctuations, and the retreat accelerated after September when the financial crisis deteriorated. At end-2008 the Dow Jones Industrial Average, the Nasdaq, the STOXX50, and the Nikkei 225 closed at 8776.4 points, 1577.0 points, 2451.5 points, and 8859.6 points respectively, down 33.8 percent, 40.5 percent, 44.3 percent, and 42.1 percent respectively from the beginning of the year.

3. Housing market developments in the major economies

The U.S. housing market continued to worsen. After posting its first negative growth in the past two decades in the fourth quarter of 2007, the U.S. federal housing price index (OFHEO index) slid more sharply in 2008, declining by 3.04 percent, 4.82 percent, and 6.02 percent in the first three quarters respectively. The start of new homes and new home sales were recorded at 904,000 and 482,000 respectively, down 33.3 percent and 37.8 percent from the previous year.

The European housing market cooled down noticeably. According to ECB statistics, the year-on-year growth of the housing commodity price index registered 2.5 percent, 2.3 percent, and 2.3 percent in the first three quarters of 2008 respectively. Housing prices in Britain spiraled downward, with the Halifax housing index[2] shedding 1.4 percent, 5.1 percent, 5.6 percent, and 5.2 percent in the four quarters respectively, and the average housing price at end-2008 falling to where it was five years earlier. The French housing market bid farewell to its almost a decade-long boom, with substantially fewer new home sales and less starts of new home construction and falling housing prices. Housing prices in Spain and Ireland also dropped. Housing markets in Germany, Portugal, Belgium, and Denmark were sluggish.

The Japanese housing market cooled down. Affected by the amendment to the basic law on construction and the rising prices of raw materials, the start of new home construction in the first half of the year continued to decline in year-on-year terms. From the latter half of the year, affected by the financial crisis, overseas capital withdrew from the Japanese housing market and domestic financial institutions tightened lending activities, which cooled down the housing market. At end-September 2008, the land price index in the six largest cities in Japan exhibited

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[2] Provided by Britain's largest mortgage lender, Halifax Bank, from 1984.

its first year-on-year drop[3] since 2006 of 1.2 percent. Because enforcement of the new basic law on construction resulted in reduced starts of new home construction in the first half of the year, this figure rebounded in the latter half of 2008, registering 19.0 percent, 53.6 percent, 54.2 percent, and 19.8 percent from July to October respectively. But due to the domestic economic downturn, the start of new home construction in November kept par with that in the same period of the previous year. There is still not a rosy picture for the future.

4. The monetary policies of the major economies

In 2008, while trying to balance price stability and economic growth and to inject liquidity into the market through various channels, the central banks of the major economies coordinated policies and conducted currency swaps in order to deal with the crisis. With global inflationary pressures eased in the fourth quarter and economic recession risks growing, the major central banks shifted priority toward economic growth and a loosened monetary policy.

The Federal Reserve cut the Federal Fund target rate on seven occasions in 2008, from 4.25 percent to 0-0.25 percent, and cut the discount rate on eight occasions, from 4.75 percent to 0.5 percent. At the same time, in order to deal with the persistent credit crunch, the Federal Reserve pumped liquidity into the market through innovative liquidity management instruments. The ECB kept the interest rate unchanged in the first half of the year in order to balance inflation and growth. On July 9, the ECB raised the interest rate by 25 basis points in order to fight the acute inflationary pressures. After the third quarter, the inflationary pressures eased remarkably due to the liquidity squeeze and the rising risks of recession as a result of the spread of the crisis, and the ECB cut the benchmark interest rate on three occasions by 175 points cumulatively and cut the minimum bid rate on the main refinancing operations from 4.25 percent to 2.50 percent. On January 21, 2009, the ECB cut the minimum bid rate on the main refinancing operations by another 50 basis points to 2 percent. The Bank of Japan kept the interest rate unchanged from the beginning of the year and increased the liquidity supply through open market operations from September 16. The benchmark interest rate was cut by 20 basis points on October 31 and December 19 respectively, and the uncollateralized overnight call rate was slashed to 0.1 percent. The Bank of England cut the official interest rate on February 7 and April 10, each by 25 basis points to 5 percent. The magnitude and frequency of the interest rate cuts intensified in the fourth quarter, with the official interest rate cut by a cumulative 300 basis points on three occasions to 2.0 percent. On January 8 and February 5, 2009, the interest rate was cut by 50 basis points on each occasion to 1.0 percent, a historical low.

[3] Data source: Japan Association for Real Estate Sciences.

5. World economic outlook

In light of the current situation, the developed economies might slide into an even bigger recession, and the emerging market economies and developing economies will further slow down. The International Monetary Fund (IMF) predicted on January 28, 2009 that world economic growth would drop from 3.7 percent in 2008 to 0.5 percent in 2009, the lowest level since World War II, with the U.S., the euro area, and Japan slowing to –1.6, -2.0, and –2.6 percent respectively in 2009 and that of the emerging market economies slowing from 6.3 percent in 2008 to 3.3 percent. According to the IMF forecast, the growth of goods and services trade will decline from 4.1 percent in 2008 to –2.8 percent in 2009. At the same time, inflation in the developed economies, emerging market economies, and developing economies will fall from 3.5 percent and 9.2 percent in 2008 to 0.3 percent and 5.8 percent respectively in 2009.

Looking to the future, the financial institutions' on-going deleveraging, uncertainties under the easing policy environment, effectiveness and potential impact of measures aiming to contain the recession and boost confidence, influence of the endeavors to implement the Washington Summit deliverables and the upcoming London Summit on the present international financial system and international order will become major factors weighing on the world economic outlook.

In addition, given the deepening crisis and worsening economic and employment situation in various countries, vigilance is needed against trade, investment, and finance protectionism and anti-globalization sentiments that might be on the rise. Global trade and investment liberalization should be promoted with special attention to various forms of protectionism in times of financial instability.

II. Analysis of China's macroeconomic performance

In 2008, given the sleet and snow disaster, the devastating Wenchuan earthquake, and the world economic and financial market turbulence that took a toll on China, pressures to downsize economic growth mounted. In light of the changing economic scenario both at home and abroad, the Chinese government adjusted its macroeconomic policy stance in a timely manner by resolutely carrying out a proactive fiscal policy and a moderately loose monetary policy, expeditiously launching ten demand-boosting measures, unveiling an economic stimulus package with a mix of policies, combining efforts to expand domestic demand with industrial restructuring and revitalization, scientific and technological innovation and social security undertakings, aligning investment with consumption, focusing on both immediate difficulties and long-term development, attaching equal importance to driving economic growth and improving the people's living standards, and mobilizing all walks of life in the great endeavor to fight the crisis.

Though the economy slowed down somewhat in 2008, it maintained a stable and relatively fast development momentum. In 2008 the GDP registered 30.1 trillion yuan, up 9 percent year on year but 4 percentage points lower than the growth in 2007. Broken down by quarters, GDP growth posted 10.6 percent, 10.1 percent, 9 percent, and 6.8 percent respectively in the four quarters. The CPI grew 5.9 percent year on year, 1.1 percentage points higher over the previous year. The trade surplus posted US$295.5 billion, a year-on-year increase of US$32.8 billion.

1. External demand contracted sharply, but consumption and investment maintained relatively rapid growth and the trade surplus continued to grow

Urban and rural household income continued to rise and driven by strong consumption demand, sales in the domestic market continued to grow at a relatively rapid pace. The per capita disposable income of urban residents registered 15,781 yuan, up 8.4 percent in real terms, 3.8 percentage points lower than the growth in the previous year; the per capita cash income of farmers grew by 8.0 percent in inflation-adjusted terms to 4,761 yuan, a deceleration of 1.5 percentage points. In 2008 gross retail sales totaled 10.8 trillion yuan, posting a nominal year-on-year growth of 21.6 percent, an acceleration of 4.8 percentage points, or an inflation-adjusted real growth of 14.8 percent, representing an acceleration of 2.3 percentage points from 2007. Broken down by quarters, gross retail sales grew 20.6 percent, 22.2 percent, 23.2 percent, and 20.6 percent in the four quarters respectively, presenting a stable trend among the quarters.

Fixed-asset investments grew relatively rapidly. In 2008 fixed-asset investments totaled 17.2 trillion yuan, representing year-on-year growth of 25.5 percent and an acceleration of 0.7 percentage points. The inflation-adjusted real growth stood at 15.2 percent, down 4.9 percentage points over the previous year. Broken down by quarters, growth in the first quarter, the first half of the year, the first three quarters, and the whole year stood at 24.6 percent, 26.3 percent, 27 percent, and 25.5 percent respectively, with the fourth quarter witnessing noticeably slower growth compared with the first three quarters.

Import and export growth declined and the contribution of net exports to economic growth fell sharply. In 2008 imports and exports totaled US$2.6 trillion, up 17.8 percent year on year, representing a deceleration of 5.7 percentage points from the previous year. Among this total, exports grew 17.2 percent to US$1.4 trillion, representing a deceleration of 8.5 percentage points, whereas imports grew 18.5 percent to US$1.1 trillion, representing a year-on-year deceleration of 2.3 percentage points. The trade surplus in cumulative terms was US$295.5 billion, an increase of US$32.8 billion or 12.5 percent from the previous year, representing a deceleration of 35.5 percentage points. The contribution of net exports to economic growth posted 9.1 percent, down 10.7 percentage points from the previous year. Broken down by quarters, exports grew by 21.4 percent, 22.4 percent, 22.9 percent, and 4.3 percent respectively in the four quarters, and imports grew by 28.6 percent, 32.6 percent, 26 percent, and –8.8 percent respectively in the four quarters, shoring up the trade surplus quarter by quarter.

Box 2 Correctly handle the relationship between savings and consumption

It is of great importance to correctly handle the relationship between savings and consumption for maintaining stable and relatively rapid economic development. Consumption growth is a stable and sustained driving force for economic growth; however, consumption growth should be based on a certain level of savings. Over-consumption without adequate savings will ultimately hurt the economy. One of the major causes behind the current crisis is that the development pattern of some economies, featuring long-term low savings and high consumption, was unsustainable, and we must draw lessons from this. In contrast, China has the problem of a high savings ratio and weak consumption. For a long time, China’s economic growth has been mainly driven by investment and exports, and the final consumption rate in general has presented a downward trend. The investment ratio grew from 36.6 percent in 1992 to 43.5 percent in 2008, whereas the consumption rate fell from 62.4 percent in 1992 to 48.6 percent in 2008, much lower than the world’s average. High investment and exports and low consumption are also detrimental to the healthy and stable development of the economy. The world economy has slowed down markedly and is facing tremendous downside risks, which will directly impact China’s exports and investment in the trade sector. Without a strong external demand, economic growth must rely on boosting investment or consumption. The economic development pattern dominated by investment will put increased pressures on resources and the environment, widen the income gap between the urban and rural areas, and lead to severe over-capacity in some sectors and a drastic fluctuation of economic growth, hence it will be unsustainable. Therefore, efforts must be made in accordance with the scientific outlook on development to speed up the shift of the economic development pattern and to enhance the role of consumption in driving economic growth so as to achieve a more rationalized pattern whereby growth is driven in coordination with consumption, investment, and exports.

The low consumption and high savings in China can be attributed to the small share of household income in the national income distribution and household income growing slower than economic growth. Since the 1990s, the household income level in both the urban and rural areas has been outpaced by the economic growth, with the real growth of per capita disposal income of the urban households in 2008 about 0.6 percentage points lower than the economic growth and the real growth of the per capita cash income in the rural areas about 1 percentage point lower than the economic growth. In light of the changes in the composition of national disposable income, the income of the corporate and government sectors in general presented an upward trend as a share of national income, whereas income of the household sector as a share of national income presented a downward trend. The percentage of household income in national disposable income has been declining year by year since 1999. As of 2007, this figure was 57.0 percent, 11.3 percentage points lower than that in 1992. At the same time, due to the poor social security network and other factors, the marginal consumption propensity of households presented a downward trend. To be specific, the marginal consumption propensity of urban households fell from 0.85 in 2002 to 0.56 in 2008, and the marginal consumption propensity of rural households dropped from 0.85 in 2002 to 0.71 in 2008, slightly higher than that of urban households. The marginal consumption propensity of low-income groups is higher than that of high-income groups, and this holds true for both urban and rural households.

Given that consumption demand is a real and sustained driving force for economic growth, we need to strive to expand consumer demand, and household consumption demand in particular, and to overcome institutional and policy obstacles that constrain consumption in order to gradually increase the contribution of consumption to economic growth. In the immediate term, priority consideration should be given to providing consumption incentives, such as subsidies and consumer credits, to low- and middle-income households in the rural areas and to low-income urban households to directly boost consumption; in the medium term, the focus of consumption-boosting policies should be on improving the consumption of middle-income urban households; in the long run, the fundamental way to promote consumption growth is by improving social security and the national income distribution structure and by bridging the income gap.

2. Agricultural production remained stable and industrial production slowed

In 2008 the added value of primary industry was up 5.5 percent to 3.4 trillion yuan, an acceleration of 1.8 percentage points from the previous year; the added value of secondary industry was up 9.3 percent to 14.6 trillion yuan, a deceleration of 5.4 percentage points; the added value of tertiary industry was up 9.5 percent to 12 trillion yuan, a deceleration of 4.3 percentage points.

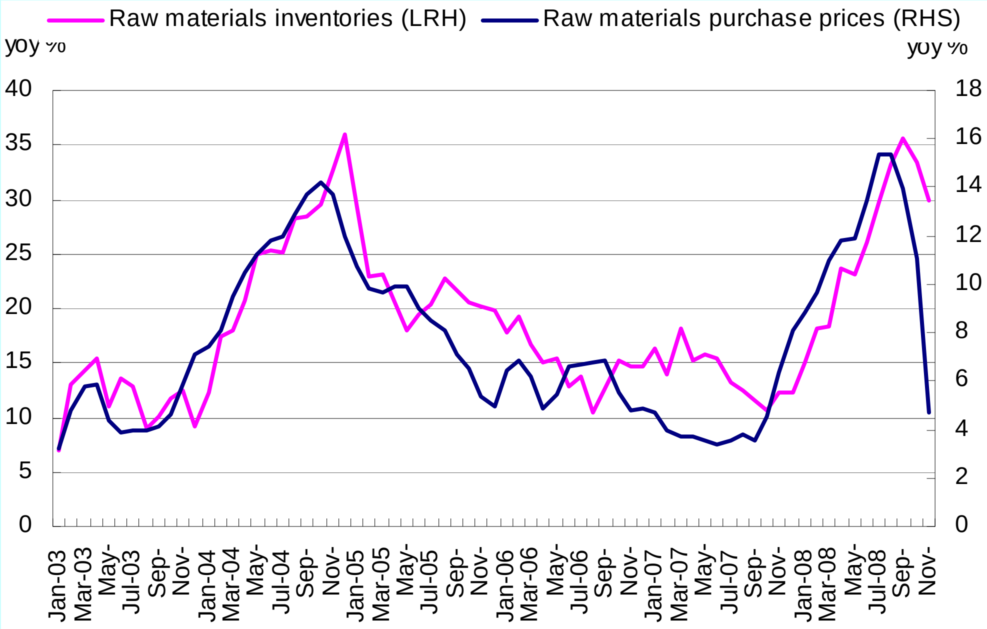
Agricultural production maintained a momentum of stable growth and grain production increased for the fifth consecutive year. Grain production reached 530 million tons, an increase of 26.9 million tons or 5.4 percent from the previous year.

Meat production continued to increase, registering 72.5 million tons, up 5.9 percent year on year. In 2008 the national producer prices of agricultural products (the price at which farmers sell their products) rose 14.1 percent year on year, a deceleration of 4.4 percentage points from the previous year, lower than the 20.3 percent growth in the prices of agricultural capital goods, exerting greater pressures on the income gains of farmers.

Industrial production slowed down and corporate profits declined rapidly. Affected by the changing international economic and financial situations, downward pressures on industrial operations built up in the latter half of the year, and industrial production grew faster in the first half of the year than in the latter half of the year. In 2008 the added value of statistically large enterprises rose 12.9 percent year on year, a deceleration of 5.6 percentage points from the previous year. Growth in the four quarters posted 16.4 percent, 15.9 percent, 12.9 percent, and 6.4 percent respectively. Corporate profit growth moderated due to the global economic downturn and increased inventories. In the first eleven months, profits of statistically large enterprises were recorded at 2.4 trillion yuan, an increase of 4.9 percent and a deceleration of 31.8 percentage points from the previous year. According to the PBC's survey of 5,000 industrial enterprises, the business activity index in the fourth quarter of 2008 stood at 12.7 percent, about 21.5 percentage points lower than that during the same period of the previous year.

Box 3 Analysis of the inventory adjustment by industrial enterprises and the economic cycle

In a market economy changes in inventory carry an obvious pro-cyclical feature. During an economic upturn, strong social demand pushes up the prices of raw materials and manufactured goods; therefore, inventories of manufacturers increase notably as a whole. In contrast, during an economic downturn, inventories diminish. The inventory adjustment of enterprises might intensify economic and price fluctuations and reduce the pace of production and imports. As a result, output volatility is greater than that real demand during a switch in the cyclical phases.



Source: CEIC, and PBC's survey on 5,000 enterprises

Figure 2 Close relationship between raw material inventories and price movements

When the economic cycle switches from an upturn to a downturn, inventories experience drastic adjustments from accumulation to liquidation. Beginning in the latter half of 2006, aggregate domestic and external demand remained strong, which rapidly shored up the prices of raw materials and semi-finished products, and many enterprises built up inventories. From July 2006 to August 2008, the 5,000 enterprises surveyed by the PBC saw their inventory stocks up by 58 percent. As the economic situation reversed from the third quarter of 2008, industrial enterprises had to absorb the excessively high inventories that they had built up earlier, and they began a drastic inventory adjustment. Inventory investment (the difference in the inventory value at the end and the start of the period) by the 5,000 surveyed businesses shrank by 63.8 billion yuan in September, and was reduced to –44.8 billion yuan in November. In the current round of inventory adjustment, affected by the radical ups and downs of raw material prices, the inventory adjustment of raw materials has been particularly significant, with the inventory stock of the 5,000 surveyed businesses dropping by 25.5 billion yuan, accounting for 55 percent of the total reduced amount. In the inventory adjustment process, especially in the adjustment process of the raw material inventories, manufacturing businesses reduced raw material purchases by a large margin, leading to a dramatic slide in imports and upstream industrial production activities and worsening the price slide of some capital goods. First, import growth fell substantially; second, upstream manufacturing businesses passively increased inventories of finished products and were forced to cut production; third, raw material prices were pushed down, accelerating the decline in the PPI. Manufacturing businesses slashed raw material purchases considerably, which reduced the demand for raw materials. Manufacturers might sell off raw material inventories, which will intensify the price drop of capital goods in upstream industries.

Though inventory investment only accounts for a small portion in the GDP, it is an important factor that intensifies macroeconomic fluctuations, and this is particularly the case in times of recession. In the current inventory adjustments resulting from the economic cyclical change, drastic fluctuations in commodity prices heightened the inventory adjustments, raw material inventory adjustments in particular, and had a greater impact on the production of upstream enterprises and the prices of their products. As the adjustments gradually come to an end and the enterprises begin operations, the prices of capital goods will gradually stabilize and industrial production will resume steadily.

3. Price inflation remained high before dropping

In 2008 the price level experienced rapid growth and then declined sharply. Affected by global inflation and structural supply shortages in the domestic market, in the first half of 2008, major price indices such as the CPI and the PPI continued their 2007 trend and reached their peaks in February and August 2008 respectively. Thereafter, the major price indices fell rapidly with the improved supply of agricultural products in the domestic market, the tumble in prices of commodities, and the inventories adjustment and tail factors.

The CPI increased on a year-on-year basis before it declined. The CPI rose 5.9 percent year on year in 2008, representing an acceleration of 1.1 percentage points. From May 2007, affected by such factors as the swine disease, rising production costs, and the excessively low prices in the prior months, multiple agricultural products including pork spiraled upward, pushing up the CPI to successive new highs. In particular, the CPI surged 8.7 percent after February due to the snow and sleet disaster in southern China and due to the Spring Festival, the highest level since 1996. Thereafter, given the improved supply and demand of agricultural products and lower prices as well as the diminishing tail effects, the CPI started to fall from its elevated level. The quarterly CPI stood at 8 percent, 7.8 percent, 5.3 percent, and 2.5 percent respectively. Broken down into food items and non-food items, the prices of food items increased 14.3 percent, an acceleration of 2 percentage points, whereas the prices of non-food items rose 1.5 percent, an acceleration of 0.4 percentage points. Broken down into consumer goods and services, the prices of consumer goods rose 7.3 percent, 1.6 percentage points higher than in 2007, whereas the services price index grew 1.3 percent, about 0.6 percentage points lower than that in the previous year.

The prices of industrial products rose precipitously in the first half of the year but declined sharply thereafter. In 2008 the Producer Price Index (PPI) rose 6.9 percent year on year, an acceleration of 3.8 percentage points. The purchasing prices of raw materials, fuel, and power registered year-on-year growth of 10.5 percent, representing an acceleration of 6.1 percentage points. Affected by the soaring commodity prices on the international market, the PPI increased substantially in the latter half of 2007, with the purchasing prices of raw materials, fuel, and power up 15.4 percent in year-on-year terms in July 2008 and the PPI up 10.1 percent in August 2008 year on year. Thereafter, as commodity prices plunged and domestic producers began an inventory adjustment in September, the raw material purchasing price dropped, which led to a sharp fall in the prices of capital goods such as crude oil, coal, and steel and sent the PPI tumbling. The year-on-year PPI growth registered 6.9 percent, 8.4 percent, 9.7 percent, and 2.5 percent in the four quarters respectively; the purchasing prices of raw materials, fuel, and power hiked 9.8 percent, 12.4 percent, 14.9 percent, and 4.8 percent year on year in the four quarters respectively; and the prices of agricultural production capital goods grew 17.5 percent, 23.8 percent, 23.8 percent, and 16.2 percent in the four quarters respectively.

In tandem with the commodity prices, import and export prices presented the same upward and then downward trend. In the first half of the year, soaring commodity prices persistently drove up import prices and created greater inflationary pressures on the domestic market. After July, the import prices fell rapidly as the commodity prices continued to decline. Compared with the import prices, the export prices were less volatile, but they also rose before declining. The import prices crawled up by 16.8 percent, 20.9 percent, 20.7 percent, and 0.9 percent in year-on-year terms in the four quarters respectively, whereas the export prices were up 9.1 percent, 10.5 percent, 8.7 percent, and 6.3 percent in the four quarters respectively.

Labor compensation grew rapidly. In the first three quarters, the national average monthly salary of urban employees was 2,192 yuan, up 18.3 percent year on year. Broken down by entity, employees in state-owned entities, urban collectively owned entities, and other types of entities earned 2,332 yuan, 1,333 yuan, and 2,132 yuan per month respectively, up 17.8 percent, 20 percent, and 18.9 percent year on year. A sampling survey revealed that in the first three quarters of the year, the wage income of farmers averaged 1,358 yuan per month, an increase of 19.2 percent year on year.

The GDP deflator moderated. The GDP in 2008 registered 30.1 trillion yuan, representing real growth of 9.0 percent. The GDP deflator (as a ratio of nominal GDP versus real GDP) was 7.2 percent, 0.2 percentage points lower than that in the previous year.

The pricing reform of resource goods advanced. On December 18, 2008, the State Council released the *Circular on the Reform of Oil Product Prices and Taxes*, deciding to initiate an oil product tax reform on January 1, 2009, to raise the tax rate on oil products, and, at the same time, to improve the pricing mechanism for oil products. Domestic oil product prices will be indirectly linked to the crude oil prices in the international market and will be based on the crude oil prices plus the average refining costs, taxes, distribution expenses, and appropriate mark-up.

4. The fiscal account was in the red

In 2008 total fiscal revenues (excluding debt income) reached 6131.69 billion yuan, up 19.5 percent year on year and representing a deceleration of 12.9 percentage points from the previous year; fiscal expenditures totaled 6242.7 billion yuan, up 25.4 percent year on year and representing an acceleration of 2.8 percentage points. As a result, expenditures exceeded revenues by 111.01 billion yuan.

The fiscal deficit is a result of the drastic decline in fiscal revenues in the latter half of the year and the increase in fiscal expenditures. Tax revenue growth was rapid at the beginning of the year but decelerated month by month thereafter. In the first half of the year, national fiscal revenues grew by 33.3 percent, due to the rapid economic growth, decent corporate earnings, collection of the overdue corporate income tax in 2007, and additional tax revenue from the tail effects of the tax policy adjustment. In the latter half of the year, national fiscal revenues declined gradually, as a result of the economic slowdown and the deceleration of corporate profit growth at the conjuncture of the international financial crisis, the substantial cut in the corporate income tax rate, and a series of tax relief policies that aim to improve macroeconomic management through fiscal means and to promote stable and relatively rapid economic development. In the latter half of the year, national fiscal revenues grew 5.2 percent, and fiscal revenues in central finance fell 0.9 percent. The Wenchuan earthquake in May 2008 and the 4 trillion yuan economic stimulus package drove up central government fiscal expenditures.

5. The balance of payments (BOP) surplus remained

In 2008 the BOP generally improved. The current account remained the primary source of the BOP surplus, but the share of the current account surplus in GDP dropped somewhat. Foreign capital inflows grew steadily, foreign debt growth slowed down, and the capital and financial account surplus fell. As of end-2008, the foreign exchange balance reached US$1.95 trillion, an increase of US$417.8 billion or 27.3 percent, a deceleration of 16 percentage points from the previous year.

As of end-September 2008, outstanding foreign debt posted US$441.95 billion, up 18.3 percent over the previous year. Among this total, the registered foreign debt balance was US$288.15 billion, up 19.8 percent from end-2007; the short-term foreign debt balance stood at US$280.04 billion, an increase of 27.2 percent from end-2007, accounting for 63.4 percent of the total, an acceleration of 4.5 percentage points from end-2007.

6. Industrial analysis

Production of most industries decelerated and various industries experienced negative profit growth. The profit growth of many industries has been declining since September. From January to November, 31 out of 39 major industries saw a decline in profit growth compared with that in the first eight months in year-on-year terms. In the first eleven months, profit gains in the iron and steel, power, non-ferrous metals and chemical fiber industries fell 13.7 percent, 84.1 percent, 34.1 percent, and 74.9 percent respectively; the oil refinery industry and the coking industry incurred net losses of 126 billion yuan in contrast to 24.5 billion yuan in profits during the same period of the previous year. The output of the highly energy-consuming industries continued to fall, demand for energy fell substantially, and the supplies of coal, electricity, oil, and transportation grew steadily. In 2008 coal production, power generation, and freight transportation posted 2.62 billion tons, 3404.7 GWH, and 24.45 billion tons respectively, representing growth of 12.8 percent, 5.5 percent, and 9.3 percent year on year, a deceleration of 2, 7.4, and 2.6 percentage points from the previous year. In 2008 crude oil production registered 190 million tons, a year-on-year increase of 2.3 percent.

(1) The real estate industry

In 2008 the real estate sector went through adjustments, with a reduction in both commercial housing turnover volume and price growth. Changes in the real estate market drove down growth in real estate development investment, growth of acreage for the start of new construction, acreage of land purchases, and growth of new commercial real estate loans.

The growth of real estate development investment declined and market supply fell in year-on-year terms. In the first half of 2008, growth of real estate development investment inherited the upward trend of 2007 and remained over 30 percent, posting 33.5 percent at its peak in June, but the growth declined month by month thereafter, affected by shrinking sales. Throughout 2008 completed real estate development investment registered 3.06 trillion yuan, up 20.9 percent from the previous year, a deceleration of 9.3 percentage points. In 2008 completed land purchases nationwide reached 370 million square meters, down 8.6 percent from the previous year; the acreage for the start of new construction was recorded at 980 million square meters, an increase of 2.3 percent and a deceleration of 18.1 percentage points; the acreage of completed housing construction stood at 590 million square meters, representing a decrease of 3.5 percent.

Demand for commercial real estate waned and sales acreage fell greatly but remained at a relatively high level. From the beginning of 2008, the year-on-year decline of the cumulative acreage of sold commercial real estate widened month by month. In 2008 the acreage of sold commercial real estate nationwide reached 621 million square meters, a decrease of 19.7 percent from the previous year; the sales revenue of commercial housing posted 2.41 trillion yuan, down 19.5 percent year on year. At end-2008, the acreage of unsold commercial housing stood at 164 million square meters, up 21.8 percent from the previous year; among this total, the acreage of unsold residential housing totaled 90.60 million square meters, up 32.3 percent year on year. Though sales of commercial housing fell from 2007, the sales acreage in 2008 remained at a relatively high level, up 11.9 percent from 2005 and 0.37 percent from 2006, representing the second historical high, next only to 2007.

The sales prices hike dropped, and housing prices at year-end fell year on year. The attitude of wait-and-see heightened in 2008, the sales volume of commercial housing fell, some developers had a tight capital supply, and the year-on-year increase of sales prices declined month by month from the beginning of 2008 and in December recorded its first negative growth since July 2005. The month-on-month price change turned negative from August and the price decline accelerated thereafter. In 2008 home sales prices in 70 large- and medium-sized cities rose by 6.5 percent, a deceleration of 1.1 percentage points from 2007; prices dropped in December by 0.4 percent in year-on-year terms and by 0.5 percent in month-on-month terms. About 22 out of 70 large- and medium-sized cities experienced a year-on-year home sales price decline in December, with prices in Shenzhen falling by 11.2 percent; about 55 cities experienced a month-on-month price decline.

Commercial real estate loans slowed down and their share in outstanding loans dropped. As of end-December 2008, outstanding commercial real estate loans issued by financial institutions registered 5.28 trillion yuan, up 10.4 percent year on year, representing a deceleration of 20.2 percentage points. Among this total, outstanding real estate development loans posted 1.93 trillion yuan, an increase of 10.3 percent and a deceleration of 15.5 percentage points from the previous year; outstanding home purchase loans posted 2.98 trillion yuan, an increase of 10.5 percent year on year and a deceleration of 25.6 percentage points from the previous year. As of end-2008, outstanding commercial real estate loans extended by financial institutions accounted for 18.3 percent of the balance of various RMB loans, representing a drop of 0.9 percentage points.

In the latter half of 2008, to put into play the important role of the real estate industry in expanding domestic demand and improving the people’s living standards, the central government adopted relevant policies in a timely manner to promote the healthy development of the real estate market. The PBC, after lowering the benchmark lending interest rate on five occasions from September 2008, lowered the floor interest rates on commercial individual housing loans to 70 percent of the benchmark lending interest rate and reduced the minimum down payment ratio to 20 percent. These consecutive moves alleviated the mortgage debt servicing burden on households. Citing a 20-year mortgage loan of 500,000 yuan as an example: the lending rate was cut from 6.6555 percent (the benchmark lending interest rate for loans with a maturity of over 5 years was 7.83 percent and the floor interest rate was 85 percent of the benchmark rate) to 4.158 percent (the benchmark interest rate of loans with a maturity of over 5 years was 5.94 percent and the floor interest rate was 70 percent of the benchmark rate). In the case of matching the repayment of the principal and the interest, the monthly repayment fell from 3,773.78 yuan to 3,071.69 yuan, a decrease of 702.09 yuan or 18.6 percent. The Ministry of Finance decided to cut the contract tax rate for first-time home buyers purchasing ordinary housing with acreage of no more than 90 square meters to 1 percent on a temporary basis; to exempt individuals' sale or purchase of housing from the stamp tax; to exempt individuals' sales of housing from the VAT on land. The State Council issued *Opinions of the General Office of the State Council on Promoting the Healthy Development of the Real Estate Market* on December 27, which raised requirements to a higher level for intensifying efforts for guarantee-purchase housing, improving the people's living conditions, and promoting the healthy development of the real estate sector.

Box 4 Lending policies for commercial individual housing

In order to handle the potential impact of the international financial crisis on China, support the expansion of domestic demand, improve financial services for households purchasing ordinary self-occupied housing, and improve the people's welfare, the PBC adjusted credit policies for commercial individual housing when appropriate. The floor mortgage interest rate for commercial individual housing was lowered to 70 percent of the benchmark lending rate and the minimum down payment ratios were lowered to 20 percent, effective October 27, 2008. Financial institutions shall set loan rates and down payment ratios for customers on a differentiated basis above the lowest level according to whether the borrower is a first-time house buyer, whether the house is purchased for self-use, whether the floor space and other conditions of the house meet the standards for ordinary housing, and according to risk factors such as the borrower's credit record and repayment ability. Financial institutions can grant preferential mortgage rates and down payment ratios to first-time home buyers of ordinary housing for self-use and non first-time home buyers for the purpose of improving their living conditions, whereas the financial institutions can raise the loan rates and down payment ratios if the housing is not purchased for self-use or the housing does not belong to ordinary housing.

Such a policy adjustment granted financial institutions more autonomy in decision-making and accommodated the demand for loans in different regions and at different levels, reflecting the concept of a harmonious society that advocates putting the people first and handling different matters on their own merits. On the one hand, more policy leeway was created for improving financial services and making housing affordable because financial institutions were allowed to decide on lending rates within their capacity in compliance with government policies and to grant preferential interest rates for low-risk loans so as to provide financial support for households purchasing ordinary housing. On the other hand, lowering the mortgage rate on individual housing was different from cutting the benchmark lending rates, with the former focusing on institutional changes and the latter reflecting an adjustment in interest rate levels. Such a move is a continuation of the market-based interest rate reform, helping financial institutions to assess risks based on the borrowers' credit standing and to improve their pricing capacity, risk control ability, and internal management, hence giving a bigger role to the market-based pricing mechanism.

After the policy was announced, various financial institutions published detailed rules on how to determine individual housing loan rates and down payment ratios, which not only took into account the interests of the borrowers and granted preferential treatment within the purview of the policy, but also reflected the differences of the financial institutions in terms of capital and operational costs, marketing strategy, and regional conditions, emphasizing risk identification and prevention and making interest rates reflect the principle of differentiated treatment. In general, most financial institutions adopted relatively preferential rates for new loans for first-time purchases of ordinary housing or for housing for improvement purposes, and raised the lending criteria for non-first-time homebuyers and the purchase of non-self-occupied housing or non-ordinary housing. For outstanding loans, financial institutions conducted comprehensive appraisals according to the loan contracts in order to reasonably determine the lending rates. Facing the new policy requirements, financial institutions need to improve management, enhance financial services, and explain policies more patiently and carefully to customers in order to play an increasingly important role in providing affordable housing for the people.

(2) The power industry

Electric power plays an important role in supporting national economic development. In 2008 the power supply was tight in the first half of the year but it was adequate in the latter half. In the first half of the year, many provincial grid controllers experienced brownouts; in the latter half of the year, especially after September, the economic slowdown reduced the demand for power and in general resulted in an adequate power supply. Affected by the rapid increase of power coal prices in the first three quarters and the decrease in demand for power, profits in the power industry fell drastically. The power resource pricing reform must be promoted in order to achieve sustainable development of the industry.

Demand for power slowed down, and power generation and power use declined sharply. In 2008 total power generation and power use registered 3404.7 GWH and 3426.8 GWH, up 5.5 percent and 5.2 percent respectively year on year, representing a deceleration of 9.4 and 9.2 percentage points from the previous year. Changes in power use directly reflected the operations of enterprises. In 2008 industrial power use grew 3.6 percent year on year, a deceleration of 12.3 percentage points.

Energy conservation and pollution reduction efforts showed their effects with a swiftly improved power source investment structure. In 2008 small coal-fired capacity of 16.69 MW was closed down; the standard coal consumption for power plants with 6,000KW capacity and above was 349g/KWH, a reduction of 7g/KWH from the previous year. In 2008 the completed investment in power industry infrastructure posted 576.33 billion yuan, up 1.5 percent year on year. Among this total, completed investment in nuclear and wind power infrastructure grew 71.9 percent and 88.1 percent respectively, but investment in coal-fired capacity dropped 22.0 percent.

Profits in the power sector slowed down and a large proportion of the enterprises suffered losses. In the first eleven months, the sector achieved profits of 25.15 billion yuan, down 84.1 percent year on year; 33.8 percent of the enterprises were loss-makers and incurred losses of 88.94 billion yuan. In particular, profits of coal-fired power plants fell by a large margin of 164.6 percent year on year. In 2008 prices of power coal fluctuated greatly, with a 90 percent hike at the maximum in the middle of the year, but the prices at year-end fell to where they were at the beginning of the year. The rapid increase in the prices of power coal at the beginning of the year led to huge losses for power generators. Even though the prices of power coal plunged after October, the shrinking demand for power widened the losses. As of end-January 2009, the five power generation company groups had not reached agreement with coal producers on power coal prices for 2009, highlighting the lack of an energy product pricing mechanism.

At present, the rapid fall in power generation and consumption volume, the generally balanced supply and demand of power, the fall in the CPI, and the decline in commodity prices provide opportunities to improve the pricing mechanism for coal power prices and to rationalize the relationship between coal and power prices so as to improve the operations of power generators. Opportunities should be seized to proactively and prudently promote power sector reforms in accordance with the scientific approach to development, to establish a power pricing mechanism that can fully put into play the role of resources allocation, and to promote the sound and rapid development of the power industry.

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

I. Outlook for the Chinese economy

As the impact of the global financial crisis on China's economy intensified noticeably, external demand shrank markedly, some industries saw excess productivity, enterprises experienced production and operation difficulties, and urban unemployment increased, all contributing to greater downward pressures on economic growth. However, with a huge market and a great potential for future growth, and as the long-term trend and advantages for economic growth remain unchanged and the macroeconomic control policies gradually take effect, the Chinese economy is expected to continue growing in a stable and relatively rapid manner.

China's economic performance will face many uncertain factors as a result of a number of risks and challenges. Under the multiple shocks from the global financial crisis and other events, the world economy may continue its downturn for a period of time and it may take time before it can recover, thus presenting a gloomy external environment for China's economic growth. The major domestic industries, including the real estate industry, still face downward adjustment pressures, which will have implications for many relevant industries. Consumption growth will be affected by low employment and by the negative wealth effect triggered by the slump in the capital market. Corporate profits will suffer as demand weakens, which in turn will take a toll on fiscal revenues. According to the business survey conducted by the PBC in the fourth quarter of 2008, 17.9 percent of the surveyed managers expected domestic orders to decrease in the following quarter, and 19.0 percent forecasted a drop in export orders in the following quarter, up 10.2 percentage points and 10.7 percentage points respectively from the third quarter of 2008; the corporate profits forecast index stood at -2.0 percent, down 14.5 percentage points from the previous quarter. The urban depositors' survey in the fourth quarter of 2008 suggested that willingness for household consumption declined slightly, with the percentage of people planning to buy houses in the next three months dropping 0.6 percentage points over the previous quarter, hitting a historical low since the survey began in 1999. Given the sliding demand from the international market and key domestic industries, such as the real estate industry, the recent slowdown in industrial output, energy consumption, and imports was accelerated to some degree by the inventory adjustments by enterprises. Future economic growth will depend on inventory adjustments on the one hand, and on changes in internal and external demand and the effectiveness of the macroeconomic policies on the other.

With sound fundamentals and development advantages, China still enjoys a great potential for sustainable economic growth. First, as industrialization, urbanization, internationalization, and industrial and consumption restructuring drives advance, the long-term trend of China's economic development remains unchanged. Second, the advantages for economic development remain unchanged. Sound economic, technological, and institutional foundations have been established, the ability of market players to adapt to adjustments and changes has been improved, and the self-adjustment of the market brings about structural upgrading and presents new opportunities. The business survey in the fourth quarter suggests that, in contrast to less willingness for investment in most industries, willingness to invest in a number of high value-added industries increased. For example, the equipment investment indices for listed companies in the instrument and pharmaceutical industries jumped by 20.0 percentage points and 6.4 percentage points respectively over the previous quarter. Third, considerable progress has been achieved in reforming the financial sector and the financial system generally remains sound and secure. Fourth, macroeconomic management has been continuously improved. The central government has decided to adopt a proactive fiscal policy and a moderately loose monetary policy, and has promptly released a package of policies that both addresses immediate challenges and promotes long-term development. At present, the macroeconomic management is taking effect, which helps iron out the economic fluctuations. In summary, while the complexity and severity of the current situation is fully recognized, the potential for long-term economic development and the opportunities arising from the economic restructuring must also be acknowledged.

Prices will still face downward pressures in the near future. The weakening overall demand, coupled with the low prices of primary commodities in the international market and the excess domestic capacity as a result of falling foreign demand, will contribute to strong downward pressures on prices, posing great deflation risks. The urban depositors' survey conducted by the PBC in the fourth quarter shows that the percentage of consumers expecting price falls in the following quarter rose to a record high level of 22.3 percent, up 13.5 percentage points over the third quarter and 18.7 percentage points over that in the same period of 2007. However, given the current generally easy monetary conditions throughout the world and the fact that some key economies have taken or may take quantitative easing monetary policies, commodity prices in the international market may regain their surging momentum once market confidence is restored. It is also worth noting that the sizable recapitalization programs and financial bailout plans implemented by many economies and central banks will lead to rising currency issuances and growing fiscal deficits, which will stoke inflation pressures in the medium- and long-term.

II. Monetary policy in the next stage

Maintaining stable and relatively rapid economic growth was highlighted as the top priority of economic work in 2009 at the Central Economic Work Conference. During the next stage, in accordance with the overall arrangements of the CPC Central Committee and the State Council, and thoroughly carrying out the scientific approach to development, the PBC will take promoting stable and relatively rapid economic growth as the overriding task of financial macroeconomic control. The PBC will earnestly implement the moderately loose monetary policy, further streamline the monetary policy transmission mechanism, maintain adequate liquidity in the banking system, and promote reasonable and stable money and credit growth. At the same time, in line with the policy measures formulated by the State Council on how the financial sector can promote economic growth, the PBC will extend greater financial support to economic growth. Aiming for aggregate annual money supply growth about 3 to 4 percentage points higher than the combined growth of GDP and prices, the PBC will work to ensure that the supply of broad money M2 grows around 17 percent.

First, the PBC will ensure adequate liquidity in the banking system. In line with the changing economic situation and particularly the changes in the balance of payments, the PBC will reasonably arrange the mix, maturity structure and intensity of open market operations and manage the liquidity in the banking system in a flexible and proper manner. The PBC will use a range of instruments and means to provide liquidity support to financial institutions suffering from a temporary liquidity shortage.

Second, the PBC will promote stable money and credit growth. Taking into account the changes in the domestic and international economic and financial situations and the need for macroeconomic management, the PBC will properly employ various instruments, including interest rates and the reserve requirement ratio, to ensure that money and credit grow in a reasonable and stable manner so as to meet the need for bank lending as the economy develops. The PBC will guide financial institutions to continue to actively lend on a balanced and reasonable basis as they extend support to economic growth.

Third, the PBC will guide financial institutions to optimize the destinations of credit funds. Following the principle of "differentiated treatment to different sectors," the PBC will encourage financial institutions to increase their lending to projects aimed at improving the people's livelihood, major construction projects, small- and medium-sized enterprises, agriculture, rural areas, and farmers, consumption, energy conservation and emission reduction, technological innovation, mergers and restructuring, as well as programs to promote balanced development among the different regions. The PBC will encourage banking financial institutions to extend credit support to competitive enterprises with sound fundamentals, good credit records, and market demand but face temporary operational or financial difficulties. The PBC will continue to provide financial support and services for post-disaster reconstruction.

Fourth, the PBC will steadily advance the market-based interest rate reform and the reform of the RMB exchange rate formation mechanism. The PBC will accelerate the establishment of the benchmark interest rate system in the money market, improve the central bank interest rate system, enhance the pricing capabilities and expertise of financial institutions, and give greater play to the market in determining interest rate levels. The PBC will closely watch the movement in the exchange rates of the major currencies in the international market, and, following the principle of making the RMB exchange rate reform a self-initiated, controllable, and gradual process, improve the formation mechanism of the RMB exchange rate, make the exchange rate more flexible, and keep it basically stable at an adaptive and equilibrium level. The PBC will also vigorously promote development of the foreign exchange market and develop more tools to manage exchange rate risks.

Fifth, the PBC will continue to deepen the reform of the foreign exchange administration system. The PBC will further facilitate trade and investment and reform the verification and write-off system for sales and purchase of foreign exchange from import and export activities. It will improve foreign exchange administration in the services trade to support the opening up and healthy development of the services sector and will actively and steadily facilitate outbound investment to support the Going Global efforts of Chinese enterprises. The PBC will advance the pilot program for RMB settlement in goods trade, strengthen the balanced management of cross-border capital flows, and improve the management of foreign assets and liabilities as well as direct investment. The PBC will press ahead with the foreign exchange account reform and improve the supervisory framework for foreign exchange administration with the supervision focusing on import and export entities. The PBC will work to establish an early warning framework based on two-way monitoring of balance of payments risks and further improve the BOP emergency response system. The PBC will beef up compliance reviews on foreign exchange businesses and combat practices that violate relevant laws and regulations. It will guide the foreign exchange market to develop in a sound manner, enhance regulation of the performance of the foreign exchange market and derivatives innovation, and strengthen foreign reserve management and risk management.

Sixth, the PBC will vigorously develop direct financing. It will enhance the competitive edge of financial institutions, improve the efficiency of the market in resources allocation, and develop a multi-layered direct financing system by deepening the reform of financial institutions, and promoting financial innovations. It will increase bonds issuance, develop short-term financing bills, medium-term notes, and other debt financing instruments and will steadily proceed with asset securitization and its innovation. At the same time, the PBC will provide regulation and guidance to ensure that private financing develops in a healthy manner.

It is worth noting that, in the context of a weakening external demand and an accelerating adjustment of the global economic imbalances, the fundamental approach to achieve stable and relatively rapid economic growth is to expedite economic restructuring and reform focusing on expanding domestic consumption demand, to shift the economic development pattern, and to make the economic development more cost-effective. The key is to optimize the distribution of national income among households, corporate, and government sectors and to offer greater incentives for market players to unleash their dynamism and creativity through tax reductions and deregulation, thus laying a solid groundwork for a new round of sustainable economic growth.

Attachment

Monetary Policy Glossary

1. Base money and money multiplier

Base money is the central bank's liabilities to financial institutions and the general public, including the reserve deposit of financial institutions in the central bank and cash held by financial institutions and the public. By regulating the supply of base money, the central bank is able to meet its money supply target. The money multiplier is the numerical representation of the expansionary relation between base money and broad money supply, i.e., how many times by which broad money supply can be expanded or contracted through the deposit creation mechanism of commercial banks when one unit of base money is injected or withdrawn by the central bank. Money supply = base money × money multiplier.

2. Open market operations

Open market operations refer to the buying or selling of securities and the adjustment of the base money supply by the central bank in order to regulate the money supply. Open market operations are proactive in nature, and can be conducted in a flexible manner with immediate effects. Currently, the People's Bank of China (PBC) mainly conducts open market operations by issuing central bank bills, buying or selling bonds, and conducting bond repurchases.

3. Benchmark deposit and lending interest rates

As one of the monetary policy tools, benchmark deposit and lending rates are decided and announced by the PBC. Efforts are being made to make the formation of deposit and lending rates more market-based. Financial institutions now independently decide on the level of deposit rates with the benchmark deposit rates as the ceiling and the level of lending rates with 0.9 times the benchmark lending rates as the floor (the floor for individual housing loan rates is 0.7 times the benchmark lending rates).

4. Required reserve ratio

Required reserve ratio is the ratio of deposit reserves, i.e., the money required to be deposited in the central bank by a financial institution to guarantee that it is able to meet the need for money from withdrawals and fund settlements to the total deposits of a financial institution. By adjusting the required reserve ratio, the PBC manages the liquidity in the banking system and influences the lending capacity of financial institutions, thus indirectly influencing the money supply.

5. Central bank lending

Central bank lending is the money the central bank lends to commercial banks and other financial institutions as a way to adjust base money. The timely adjustment in the aggregate volume and interest rates of central bank lending helps the central bank meet its target for money and credit supply aggregates and to steer fund flows and credit destinations.

6. Rediscounts

Rediscount is the central bank's discounting of discounted undue commercial drafts held by financial institutions. The central bank adjusts the amount and interest rates of rediscounting and decides on papers eligible for rediscounting in a timely manner in order to meet its target for money and credit supply aggregates and to steer fund flows and credit destinations.

7. Acceptances, discounting, and interbank discount of commercial drafts

A commercial draft is a bill issued by an enterprise that demands the payer pay the prescribed amount of money unconditionally to the payee or the draft holder upon presentation of the draft or on a specified date. A commercial draft is accepted when the payer promises to pay the money on the maturity date. Commercial drafts can be accepted either by commercial banks, i.e., bank acceptance drafts, or by enterprises, i.e., commercial acceptance drafts. Discounting is a process whereby the draft holder transfers the claim on the draft to a financial institution before the draft comes due in exchange for liquidity at a certain interest cost, as a way of liquidity provision by the financial institution to the draft holder. A financial institution can also get liquidity from another financial institution by transferring undue discounted drafts to the latter, a process called interbank discount of drafts. The repo-based interbank discount and outright interbank discount are the two major forms of the interbank discount.

8. Bill financing

Bill financing is a way for a commercial draft holder to access liquidity through discounting and the interbank discount of the draft. Bill financing data released by the PBC is about the face value of bills obtained by financial institutions through discounting and the outright interbank discount. In practice, bank acceptance drafts are the major instruments used for bill financing.

9. Central bank bills

Central bank bills are short-term bonds issued by the central bank on the interbank bond market. Central bank bill issuance is a type of open market operations in China. By adjusting its liability structure, the PBC can directly mop up liquidity in the banking system and guide the movement of market interest rates.

10. Corporate debt financing

Corporate debt financing instruments mainly include short-term financing bills, medium-term notes, enterprise bonds, and corporate bonds. Generally, short-term financing bills and medium-term notes are financing bills issued by enterprises on financial markets. Short-term financing bills in China refer to debt financing instruments issued on the interbank bond market by non-financial enterprises with the principal and interest to be paid within one year, whereas medium-term notes are debt financing instruments issued on the interbank bond market by such enterprises with the principal and interest to be paid within a prescribed period of time. Enterprise bonds are securities issued by enterprises in line with legal procedures and with the principal and interest to be paid within a prescribed period of time, and corporate bonds are securities issued by companies in line with legal procedures and with the principal and interest to be paid after one year. Enterprise bonds are mainly issued to finance projects and their issuance is subject to approval by the National Development and Reform Commission. Corporate bonds are issued by public companies upon examination and approval of the China Securities Regulatory Commission.