China Monetary Policy Report
Quarter One, 2011

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the first quarter of 2011 the Chinese economy performed in a sound manner and continued to develop in the direction intended by the macroeconomic management policies. Consumption grew steadily and fixed-asset investment and external trade expanded rapidly. The output of the agricultural sector increased steadily and the performance of the industrial sector improved. Household incomes continued to increase, but the general price level increased fairly rapidly. In the first quarter of the year, the Gross Domestic Product (GDP) registered 9.6 trillion yuan, up 9.7 percent year on year. The Consumer Price Index (CPI) rose by 5.0 percent year on year.

Since the beginning of 2011, in accordance with the overall arrangements of the Central Economic Work Conference and the State Council, the PBC endeavored to strike a balance among maintaining stable and fairly rapid economic growth, adjusting the economic structure, and managing inflationary expectations; gave top priority to maintaining stability of the general price level as the main target of macroeconomic management, earnestly implemented a prudent monetary policy, and employed a combination of price-based and quantitative monetary policy tools to strengthen liquidity management and manage money and credit aggregates, to maintain a reasonable size of the all-system financing aggregate and to promote the stable and healthy development of the economy. The reserve requirement ratio was hiked four times by 2 percentage points cumulatively, and the benchmark deposit and loan interest rates were raised two times by 0.5 basis points cumulatively. A dynamic adjustment mechanism of the differentiated reserve requirement ratios was implemented, and a macro-prudential regulatory policy framework was put into place, so as to encourage financial institutions to adjust the scale and pace of credit extensions on a self-initiated basis. Efforts were made to guide financial institutions to optimize the credit structure and to implement the differentiated housing credit policies.

Overall, the prudent monetary policy promoted normalization of the growth of money and credit aggregates. At the end of March 2011, broad money supply M2 recorded 75.8 trillion yuan, up 16.6 percent from the same period of the previous year, a deceleration of 3.1 percentage points from the end of 2010. Outstanding RMB loans grew 17.9 percent year on year, a deceleration of 2 percentage points from the end of 2010, and 2.24 trillion yuan more than that at the beginning of 2011, a deceleration of 352.4 billion yuan year on year. In the first quarter of 2011, the all-system financing aggregate posted 4.19 trillion yuan, and the share of direct financing rose remarkably. Lending interest rates of financial institutions moved up steadily. At end-March, the weighted average lending rate offered to non-financial enterprises and other sectors reached 6.91 percent, up 0.72 percentage points over that at the beginning of the year; the central parity of the RMB against the US dollar was 6.5564 yuan, up 1 percent over end-2010.

Looking forward, the PBC will follow the theme of scientific development, transformation of the economic growth pattern, and the overall arrangements of the State Council, earnestly implement a prudent monetary policy, properly manage the pace and intensity of macroeconomic management, maintain policy consistency and stability, and make policy measures well-targeted, more flexible, and effective. Efforts will be made to strike a balance between controlling money aggregates and structural improvement, and between promoting economic growth and containing inflation. For the time being, as the economic growth and employment situations remain favorable, the key is to stabilize the general price level and to manage inflation expectations.

Efforts will be made to enhance liquidity management and properly manage the overall liquidity level. The PBC will use a number of price and quantitative instruments as appropriate, such as open market operations, reserve requirement ratios and interest rates, improve the macro-prudential framework as a supplement to conventional monetary policy instruments, so as to maintain a proper size and pace of the all-system financing aggregate and to manage inflation expectations. Efforts will be made to guide financial institutions to step up credit support to key areas and weak links in the economy, in particular to small- and medium-sized enterprises, agriculture, rural areas, and farmers, and to properly adjust the share of medium- and long-term loans versus short-term loans. The PBC will steadily promote the market-based interest rate reform and the reform of the RMB exchange rate regime, and will promote innovation in financial products to maintain the healthy development of the financial market. Direct financing will be expanded, and enterprises will be encouraged to raise funds by issuing equities and bonds. The reform of financial institutions will be deepened to facilitate the establishment of a modern financial enterprise system and to improve the organization system for financial services.

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Part 1 Monetary and Credit Performance

In Q1 2011 China's economy and financial system performed soundly. The trend in the growth of money and credit supply was in a normal direction. Liquidity in the banking system was adequate.

I. The growth of the money supply declined

At end-March 2011, outstanding M2 registered 75.8 trillion yuan, up 16.6 percent year on year, a deceleration of 3.1 percentage points over the end of 2010. Outstanding M1 stood at 26.6 trillion yuan, an increase of 15.0 percent year on year and a deceleration of 6.2 percentage points over the end of 2010. Outstanding M0 totaled 4.5 trillion yuan, up 14.8 percent year on year, a deceleration of 1.9 percentage points over the end of the previous year. Net cash injections reached 25.7 billion yuan, 57.5 billion yuan less year on year.

Aggregate money growth generally declined. With the use of a mix of monetary policy tools, including open market operations, the reserve requirement ratio, and interest rates, the prudent monetary policy produced some results. In January and February, year-on-year M2 growth declined by 2.5 percentage points and 1.5 percentage points compared with the previous months respectively, whereas in March there was a slight increase of 0.9 percentage points. At end-March 2011, M2 growth accelerated a little, mainly driven by the financial institutions' increase in deposits in order to meet the requirements for seasonal assessments.

At the end of March, outstanding base money registered 19.3 trillion yuan, up 29.0 percent year on year and 1.0 trillion yuan more than at the beginning of the year. At end-March, the money multiplier stood at 3.94, which was 0.02 higher than end-2010, showing strong money creation by the monetary base. Meanwhile, the excess reserve requirement ratio of financial institutions reached 1.5 percent, and that of rural credit cooperatives (RCCs) posted 3.7 percent.

II. Deposit growth of financial institutions slowed down

At end-March 2011, outstanding deposits in domestic and foreign currencies of all financial institutions (hereafter including foreign-funded financial institutions) stood at 76.8 trillion yuan, up 18.7 percent year on year, 1.1 percentage points lower than the growth in 2010 and 4.0 trillion yuan more than that at the beginning of 2011, an acceleration of 77.6 billion yuan year on year. Outstanding RMB deposits registered 75.3 trillion yuan, up 19.0 percent year on year, a deceleration of 1.2 percentage points over the previous year and 4.0 trillion yuan more than that at the beginning of 2011, an acceleration of 54.5 billion yuan. The sharp increase at the end of the quarter was mainly attributed to the concentrated maturity of wealth management products of commercial banks, the flowing back of third party deposits, and the concentrated fiscal appropriations. Outstanding deposits in foreign currencies posted $236.9 billion, up $11.2 billion, or 9.4 percent year on year, an acceleration of $6.5 billion.

In particular, deposit growth of the household sector accelerated whereas that of non-financial institutions slowed down. At end-March, outstanding household deposits stood at 32.8 trillion yuan, up 17.9 percent year on year, an acceleration of 1.4 percentage points and an increase of 2.7 trillion yuan over the beginning of the year, an acceleration of 662.1 billion yuan year on year. Outstanding RMB deposits of non-financial institutions totaled 28.2 trillion yuan, up 16.6 percent over Q1 2010, a deceleration of 4.9 percentage points and 384.4 billion yuan more than that at the beginning of 2011, a deceleration of 951.1 billion yuan year on year. Within this total, the year-on-year growth of RMB deposits of non-financial institutions slowed down to 12.1 percent at end-January and gradually sped up in the following months as a result of the Spring Festival. Funds in the corporate sector continued their stable growth. At end-Q1 2011, outstanding fiscal deposits reached 3.0 trillion yuan, up 20.1 percent year on year and 346 billion yuan more than that at the beginning of 2011, an acceleration of 98.7 billion yuan year on year.

III. The trend in loan growth of financial institutions was in a normal direction

At end-March 2011, outstanding loans of all financial institutions in domestic and foreign currencies reached 52.6 trillion yuan, up 17.6 percent year on year, a deceleration of 2.1 percentage points and 2.4 trillion yuan more than that at the beginning of 2011, a deceleration of 400.8 billion yuan year on year.

The growth of RMB loans slowed down. At end-March 2011, outstanding RMB loans stood at 49.5 trillion yuan, up 17.9 percent year on year, a deceleration of 2.0 percentage points compared with end-2010 and 2.24 trillion yuan more than that at the beginning of 2011, a deceleration of 352.4 billion yuan year on year. Broken down by sectors, household loans gradually declined whereas the loan growth of non-financial institutions remained relatively stable. At end-March 2011, household loans grew 28.3 percent year on year, a deceleration of 9.3 percentage points compared with end-2010 and 755.7 billion yuan more than that at the beginning of 2011, a deceleration of 166.1 billion yuan. In Q1 2011, the increase in individual home loans slowed down. At end-March 2011, outstanding individual home loans rose 281 billion yuan over the beginning of the year, a deceleration of 201.5 billion yuan year on year. Loans of non-financial institutions and other sectors went up 14.6 percent year on year, a deceleration of 0.7 percentage points over end-2010 and 1.5 trillion yuan more than that at the beginning of 2011, a deceleration of 189.8 billion yuan. Within this total, medium- and long-term loans grew 983 billion yuan over the beginning of the year, a deceleration of 796.5 billion yuan year on year. Bill financing dropped by 262.2 billion yuan over the beginning of 2011, a deceleration of 362.1 billion yuan year on year. Broken down by institutions, the majority of Chinese-funded large banks operating nationwide saw a deceleration of year-on-year loan growth, and the growth of loans extended by small- and medium-sized local banks operating nationwide accelerated year on year.

Credit support for SMEs was strengthened further, and that for agriculture, rural areas, and farmers remained robust. In Q1 2011, new RMB loans extended to SMEs by Chinese banking financial institutions stood at 911.4 billion yuan. By end-March 2011, their outstanding value had risen 24.8 percent year on year, 21.6 percentage points faster than the year-on-year growth of new loans extended to large enterprises. Within this total, in Q1 new loans extended to small enterprises posted 497.9 billion yuan. By end-March 2011, their outstanding value had increased vigorously by 48.7 percent year on year. By end-March, outstanding agro-linked loans of major financial institutions, rural cooperative financial institutions, urban credit cooperatives, town and township banks, and financial companies stood at 12.7 trillion yuan. Within this total, 770.9 billion yuan was newly extended in Q1 2011, accounting for 32 percent of the total new loans in Q1.

Table 1: RMB loans of financial institutions, Q1 2011

Unit: 100 million yuan

	Q1 2011		Q1 2010	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	11024	-2753	13777	-14649
Chinese-funded Small and Medium Banks Operating Nationwide②	6589	336	6253	-5856
Chinese-funded Small and Medium Local Banks③	1867	176	1691	-590
Rural Cooperative Financial Institutions④	4592	-171	4763	538
Foreign-funded Financial Institutions	186	-325	511	775

Notes:

① Chinese-funded large banks operating nationwide refer to banks with assets denominated in foreign and domestic currencies worth no less than 2 trillion yuan (according to the total amount of assets in both domestic and foreign currencies of the financial institutions at end-2008).

② Chinese-funded small and medium banks operating nationwide refer to banks that operate across different provinces with assets denominated in domestic and foreign currencies worth less than 2 trillion yuan.

③ Chinese-funded small and medium local banks refer to banks that operate within a single *province with total assets of less than 2 trillion yuan.*

④ *Rural cooperative financial institutions refer to rural commercial banks, rural cooperative banks, and rural credit cooperatives.*

Source: The People's Bank of China

Foreign currency loans maintained stable growth. At end-March 2011, outstanding foreign currency loans of financial institutions reached US$477.5 billion, up 17.2 percent year on year and US$27 billion more than that at the beginning of 2011, a deceleration of US$1.8 billion year on year. Broken down by type, trade financing in support of imports and exports increased US$9.6 billion, accounting for 36 percent of the total of new foreign-currency loans. Overseas loans and medium- and long-term loans in support of "Going Global" rose by US$8.2 billion, accounting for 30 percent of the total new foreign currency loans.

IV. Growth of all-system financing aggregate decelerated year on year and the share of direct financing clearly rose

It is estimated that all-system financing aggregate increased 4.19 trillion yuan in Q1 2011, a deceleration of 322.5 billion yuan year on year, among which RMB loans went up by 2.24 trillion yuan, a deceleration of 352.4 billion yuan year on year. The growth of foreign currency loans reached 147.4 billion yuan, a deceleration of 45.7 billion yuan year on year. Entrusted loans reached 320.4 billion yuan, up 168.4 billion yuan year on year. Trust loans rose by 9.1 billion yuan, a deceleration of 204.7 billion yuan year on year. Bankers' acceptances rose 761.1 billion yuan, a deceleration of 147.1 billion yuan. Net financing of corporate bonds posted 455.1 billion yuan, 187.4 billion yuan more year on year. Non-financial institutions financed 155.8 billion yuan on domestic stock markets, an acceleration of 30.9 billion yuan year on year.

The financing structure showed the following features. First, the share of loan financing continued to decrease. RMB loan financing accounted for 53.5 percent of aggregate financing in Q1, 4.1 percentage points lower than that during the same period of the previous year. Second, the share of financial institutions' off-balance sheet financing dropped significantly. Economic entities' financing by way of entrusted loans, trust loans, and bankers' acceptances from financial institutions accounted for 7.6 percent, 0.2 percent, and 18.2 percent respectively, adding up to a total of 26 percent, a deceleration of 2.1 percentage points year on year. Third, the growth of direct financing as a percentage of the total was remarkable, reaching a record high in the quarterly year-on-year increase since 2002. The share of financing through corporate bonds and non-financial institutions on domestic stock markets stood at 10.9 percent and 3.7 percent respectively, accelerating by 4.9 percentage points and 1.0 percentage points year on year.

Box 1: All-system Financing Aggregate

The Central Economic Work Conference held in December 2010 and the 2011 Government Work Report pointed to the importance of "maintaining a reasonable size of all-system financing aggregate," making this a vital indicator of macroeconomic monitoring.

Aggregate financing refers to the total amount of funds the real economy (the corporate and household sectors) acquires from the financial system during a certain period (month, quarter, or year). Financial system refers to all-system financing as a whole. Broken down by institutions, it includes banking, securities, and insurance financial institutions. In terms of markets, it includes credit markets, bond markets, stock markets, insurance markets, and intermediate business markets. It is composed of three parts: first, funds channeled indirectly by financial institutions to the real economy, by way of RMB loans, foreign currency loans, trust loans, entrusted loans, corporate bonds and equities of non-financial institutions held by financial institutions, compensation of insurance companies, and real estate investment; second, direct financing provided to the real economy through formal financial instruments, traditional financial markets, based on the credits or services of financial institutions, mainly including bankers' acceptances, public offering on the domestic stock market by non-financial institutions, and net issuances of corporate bonds; third, other financing, mainly composed of loans extended by micro-credit companies, credit companies, and investments in sector funds.

There are altogether eight indicators for measuring all-system financing aggregate, namely RMB loans, foreign currency loans, entrusted loans, trust loans, bankers' acceptances, corporate bonds, funds raised on the domestic stock market by non-financial institutions, and other financing. With the development and deepening of China's financial market and financial innovation, there will be more financing channels for the real economy, such as private equity and hedge funds. In the future, when necessary these new ways will be calculated as part of the all-system financing aggregate.

It is observed that China's all-system financing aggregate has expanded rapidly in recent years, and financing has been playing a more important role in supporting economic development. From 2002 to 2010, China's all-system financing aggregate rose from 2 trillion yuan to 14.27 trillion yuan, with an average annual growth rate of 27.8 percent, 9.4 percentage points more than the growth of RMB loans. In 2010, all-system financing aggregate accounted for 35.9 percent of GDP, up 19.2 percentage points compared with 2002. At the same time, the financing structure has been diversified and finance has played a more important role in resource allocations. This is supported by the following data. First, in 2010, financing through corporate bonds and domestic equities market offering of non-financial institutions accounted for 8.4 percent and 4.1 percent respectively of the all-system financing aggregate during the same period, among which the share of financing through corporate bonds was up 6.8 percentage points compared with 2002. Second, off-balance sheet financing of financial institutions has played a more important role. In 2010, bankers' acceptances, entrusted loans, and trust loans accounted for 16.3 percent, 7.9 percent, and 2.7 percent respectively of the all-system financing aggregate, up 19.8 percentage points, 7.0 percentage points, and 2.7 percentage points respectively over 2002.

Traditionally, the link between finance and the economy refers to that between the banking system and the real economy. For quite a long time, M2 and new RMB loans were the key indicators for macroeconomic monitoring and analysis. In some years, new RMB loans received even more attention than M2. With the rapid growth of China's financial market in recent years, however, the relationship between finance and the economy has evolved. In the context of the innovation in the financial market and financial products, diversification of the financial structure, and the more important role played by securities and insurance institutions in support of the real economy, more financial variables are having a major impact on the real economy. Apart from the traditional variables such as money and credit, trusts, securities, equities, and other financial assets are also included. In 2010, new RMB loans stood at 7.95 trillion yuan, 1.65 trillion yuan less year on year, but new financing through bankers' acceptances and entrusted loans registered 3.47 trillion yuan, accounting for 24.2 percent of the aggregate financing and 2.33 trillion more than that in the previous year. In this context, a more appropriate and more comprehensive indicator is needed to improve macroeconomic monitoring to better reflect the evolving relationship between the real economy and the financial sector. The indicator of all-system financing aggregate has thus been chosen. In addition to loans, off-balance sheet financing of financial institutions, namely bankers' acceptances, entrusted loans, and trust loans and direct financing must be included in statistical coverage to comprehensively reflect and monitor financing to the real economy. This will help end the practice of merely attending to loan financing while having inadequate supervision over the other indicators.

V. The lending rate of financial institutions registered a stable increase

Lending rates offered to non-financial institutions and other sectors increased stably month by month in Q1 2011. The weighted average lending rate reached 6.91 percent, up 0.72 percentage points compared with that at the beginning of 2011. The weighted average interest rate for general lending registered 7.10 percent, up 0.76 percentage points over the beginning of 2011, and the weighted average bill financing rate posted 6.26 percent, up 0.77 percentage points over the beginning of 2011. The home loan interest rate continued to grow. The weighted average residential mortgage rate rose by 0.82 percentage points over the beginning of 2011 to 6.17 percent in March.

Loans with interest rates higher than and flat with the benchmark rate accounted for a larger share of the total. In March, the share of loans with interest rates higher than and flat with the benchmark rate stood at 55.82 percent and 30.22 percent respectively, up 12.78 percentage points and 1.06 percentage points over that at the beginning of

2011, and loans with interest rates lower than the benchmark rate accounted for 13.96 percent of the total, down 13.84 percentage points compared with that at the beginning of 2011.

Table 2: Shares of loans with rates floating at various ranges of the benchmark rate in the first quarter of 2011

Unit：%

	Lower than the benchmark	At the benchmark	Higher than the benchmark					
	[0.9，1]	1	Sum	(1，1.1]	(1.1，1.3)	(1.3，1.5]	(1.5，2]	Above 2
January	21.35	29.45	49.20	15.97	15.01	6.08	8.67	3.48
February	19.94	31.80	48.26	17.91	14.55	5.61	7.29	2.90
March	13.96	30.22	55.82	18.25	17.76	6.96	9.24	3.60

Source: The People's Bank of China

The foreign currency deposit rate generally went up and the lending rate continued to increase due to changes in the supply and demand of funds in China. In March, the weighted average interest rate of large-value US dollar deposits with a maturity of less than 3 months grew 0.47 percentage points over the beginning of 2011 to 2.31 percent. The weighted average interest rate of US dollar loans with a maturity of less than 3 months and 3-6 months (including 3 months) stood at 3.04 percent and 3.26 percent respectively, up 0.47 percentage points and 0.41 percentage points over the beginning of 2011.

Table 3: The average interest rate for large-value deposits and loans denominated in US dollars, January through March 2011

Unit：%

	Large-value deposits						Loans				
	Demand Deposits	Within 3 months	3-6 months	6-12 months	1 year	Above 1 year	Within 3 months	3-6 months	6-12 months	1 year	Above 1 year
January	0.24	1.99	2.01	1.87	3.47	4.45	2.76	2.92	3.04	2.91	3.35
February	0.27	2.14	2.68	2.55	3.34	3.91	2.94	3.16	3.12	3.16	3.16
March	0.32	2.31	2.67	3.01	2.91	4.47	3.04	3.26	3.76	3.25	3.15

Source: The People's Bank of China

VI. The flexibility of the RMB exchange rate rose significantly

Since the beginning of 2011, the RMB exchange rate has moved in both directions and has appreciated slightly with much stronger flexibility, and expectations of RMB exchange rate movements remained generally stable. At end-March 2011, the central parity of the RMB against the US dollar was 6.5564 yuan per US dollar, up 663 basis points or 1 percent over end-2010. The central parity of the RMB against the euro registered 9.2681 yuan per euro, a depreciation of 4.98 percent, and the central parity of the RMB against the Japanese yen stood at 7.8883 yuan per 100 Japanese yen, an appreciation of 3.01 percent from end-2010. Beginning with the reform of the RMB exchange rate regime in July 2005 to end-March 2011, the RMB has appreciated 26.24 percent against the US dollar and 8.05 percent against the euro, and has depreciated 7.38 percent against the Japanese yen. According to the BIS, in Q1 2011 the nominal effective RMB exchange rate depreciated 1.2 percent and the real effective exchange rate depreciated by 1.9 percent. From the exchange rate reform in 2005 to end-March 2011, the nominal effective RMB exchange rate has appreciated 13.4 percent and the real effective exchange rate has appreciated 20.3 percent.

In Q1 2011, the central parity of the RMB against the US dollar peaked at 6.5564 yuan per dollar and reached a trough of 6.6349 yuan per dollar. Among the 58 trading days, the interbank foreign exchange market saw an appreciation on 38 days and a depreciation on 20 days. The largest appreciation in a single day was 0.20 percent (or 133 points) whereas the largest depreciation in a single day was 0.16 percent (or 103 points).

Part 2 Monetary Policy Conduct

In line with the spirit of the Central Economic Work Conference and the overall arrangements of the State Council, since the beginning of 2011 the PBC has implemented a prudent monetary policy in an effort to keep overall prices basically stable, which is the priority of China's macroeconomic management. To do so, the PBC used a combination of quantitative and price-based monetary policy tools as well as macro-prudential policy tools, strengthened management of liquidity and money and credit aggregates, and kept the all-system financing aggregate at a reasonable level. It encouraged financial institutions to improve the credit structures and to advance financial enterprise reforms. In the meantime, the PBC improved the RMB exchange rate regime and foreign exchange administration. All these efforts contributed to stable and healthy economic development.

I. Flexible open market operations and strengthened liquidity management

The PBC flexibly conducted open market operations to withdraw more liquidity from the market. In particular, it managed the mix and maturity of open market operation tools in response to liquidity supply and demand in the banking system. Combined with central bank bills and short-term repurchase operations, this helped withdraw more liquidity from the market. In the first quarter of 2011, the PBC issued 337 billion yuan of central bank bills and conducted 815 billion yuan of short-term repos on a cumulative basis. As of end-March, outstanding central bank bills totaled about 2.8 trillion yuan.

The PBC effectively used open market operations to pre-adjust and fine-tune liquidity so as to reduce the shock of seasonal factors on liquidity in the banking system. To address seasonal liquidity volatility around the Spring Festival, the PBC matched the maturity dates of different repos with peaks in cash supply before the festival by carefully arranging the use of repos of varied maturity, thus effectively removing short-term liquidity fluctuations caused by seasonal factors.

The PBC properly increased the flexibility of the interest rates of open market operations to better manage inflationary expectations. Initiated in response to developments in the market environment, and complemented by movements in the benchmark lending and deposit rates, this facilitated management of inflationary expectations and supported a greater role for market interest rates to balance financing supply and demand. As of end-March, interest rates for 3-month and 1-year central bank bills recorded 2.7944 percent and 3.1992 percent respectively, up 77.88 and 68.77 basis points from end-2010.

The PBC properly conducted state treasury cash management operations. In the first quarter of 2011, the PBC deposited 30 billion yuan of 3-month state treasury funds in commercial banks in two separate operations.

II. The reserve requirement increases on four occasions and the dynamically differentiated reserve requirement

Against the background of a continued, large BOP surplus, since the beginning of 2011 the PBC raised the reserve requirement ratio for RMB deposits in depository financial institutions, a potent tool to mop up excessive liquidity, by 2 percentage points on a cumulative basis, including 4 increases of an increment of 0.5 percentage points on January 20, February 24, May 25, and April 21, with a view to strengthening liquidity management, controlling money and credit aggregates, keeping all-system financing at a reasonable level, and managing inflationary expectations.

The dynamic adjustment mechanism for a differentiated reserve requirement, which was introduced under a macro-prudential philosophy and designed to work along with conventional monetary policy tools, such as open market operations, reserve requirements, and interest rates, went into operation in early 2011. In applying the mechanism, the PBC considers a range of factors, including all-system financing, discrepancies between credit supply and economic development goals and the contributions of individual financial institutions to the discrepancy. The PBC also takes into account the importance of individual institutions in the system, and the soundness and compliance of credit policies, so that it is able to withdraw excess liquidity in a well-targeted way and to encourage a reasonable, proper, and steady credit supply and improvement in the credit structure. The mechanism serves as a flexible scheme to mobilize financial institutions to follow macro-prudential policy and to enhance their risk-prevention capacity by raising capital and improving asset quality. It is part of the macro-economic management and prevents the build-up of pro-cyclical systemic risks, and leaves plenty of room for market competition.

III. Benchmark deposit and lending rates increase on two occasions

To address the growing inflationary expectations and the rapid money and credit supply, the PBC raised the benchmark deposit and lending rates on February 9 and April 6, increasing the 1-year benchmark deposit rate from 2.75 percent to 3.25 percent, and the 1-year benchmark lending rate from 5.81 percent to 6.31 percent, both up by 0.5 percentage points cumulatively. Building on the two increases in the fourth quarter in 2010, this led to a gradual increase in the lending rate for non-financial enterprises and other sectors, thereby playing a role in influencing borrowing needs. Rising funding costs also help guide inflationary expectations and improve the leveraging role of interest rates.

IV. Credit structure improvements to support shifts in the development pattern and strategic economic restructuring

The PBC enhanced the coordination of money and credit policy with other policies and strengthened window guidance to encourage financial institutions to improve the credit structure following a differentiated credit policy. The PBC guided financial institutions to support the reinvigoration of key industries, avoid haphazard investment and inefficient and duplicated construction, and endorse energy conservation, outdated capacity elimination, and low-carbon development. The PBC also urged financial institutions to explore new guarantee services and to design credit products and services tailored to the service sector. Financial institutions stepped up support for agriculture, rural areas, and farmers, spring farming activities, drought relief, grain production, and SMEs, as well as for financial programs designed to promote the people's livelihood, including plans to support employment for specific groups, students with financial difficulties, and rescue and disaster relief efforts. They continued to support regions listed by the central government to be in need of assistance and areas with state pilot reform programs. They also extended financial support to the quake-hit zones and to Zhouqu after a devastating mudslide struck the area. In the meantime, efforts were made to strengthen management of lending to local government financing platforms and to explore new financing channels for such financing platforms.

V. Agro-linked central bank lending and rediscounts to improve county and rural financial services

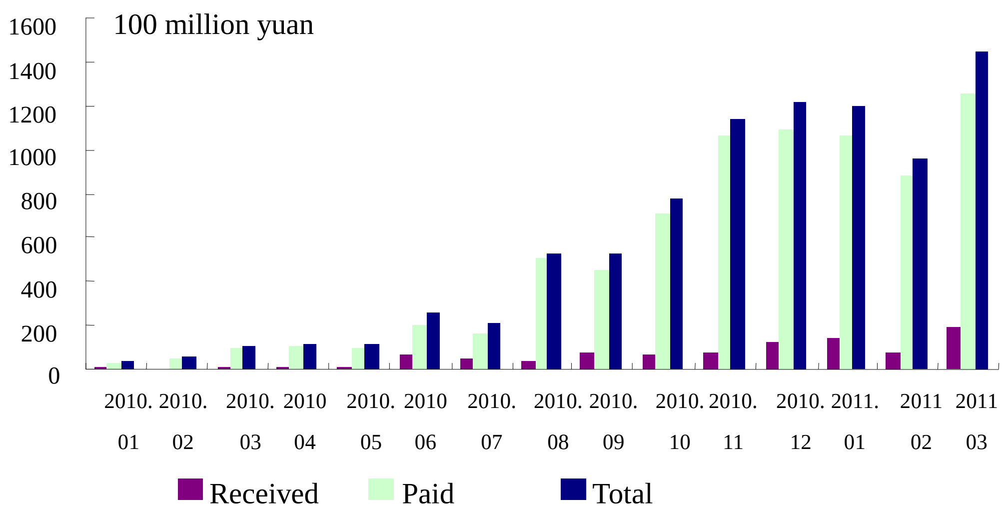
The PBC increased central bank lending and rediscounts, guiding financial institutions to provide more agro-linked loans. Since the beginning of 2011, a total of 15 billion yuan of extra agro-linked central bank lending was granted to the western regions, main grain-producing regions, and disaster-stricken areas, including 5 billion yuan to Xinjiang, Guangxi, and other western provinces and the main grain-producing regions, and 10 billion yuan to eight drought-hit provinces including Henan, Shandong, and Hebei. As of end-March, central bank lending for agriculture recorded 79.1 billion yuan, a rise of 33 billion yuan from the same period of the previous year, playing a positive role in supporting spring farming activities and drought relief and encouraging more agro-linked lending. Taking advantage of the rediscounts' role in guiding credit flows and promoting structural adjustments, the PBC allocated an additional 5 billion rediscount quota for Liaoning and four other provinces. Rediscount operations totaled 55.2 billion yuan in the first three months, up 35.1 billion year on year. Outstanding rediscounts at end-March registered 76.6 billion, a year-on-year increase of 50.3 billion yuan. About 32 percent of this total was agro-linked, and 89 percent was issued by SMEs, effectively expanding the financing for agriculture, rural areas, farmers, and SMEs.

To encourage prudential operations and agro-linked lending by rural financial institutions, the PBC implemented relevant incentive policies, encouraging financial institutions incorporated at the county levels to channel a certain share of new deposits to local borrowers, and encouraging rural credit cooperatives (RCCs) to meet follow-up monitoring and assessment standards after redemption of special bills. Specifically, the PBC decided to arrange 20 billion yuan of additional agro-linked central banking lending to 425 county-level RCCs and 16 township banks that meet these two standards. RCCs that meet assessment standards receive greater policy support from central bank lending and rediscounts, whereas those who fail to meet the standards face restrictions.

VI. Rapid growth of RMB settlement in cross-border trade

In the first quarter of 2011, RMB settlement in cross-border trade amounted to 360.32 billion yuan, an increase of 19.0 billion yuan from the last quarter of 2010. This included 20.23 billion yuan in goods exports and 285.37 billion in goods imports, and 19.59 billion in exports of services and other items under the current account and 35.13 billion yuan in imports of services and other items under the current account. During this period, actual RMB receipts and payments recorded 258.47 billion yuan, including 39.25 billion yuan in receipts and 219.22 billion yuan in payments. The receipt-to-payment ratio was 1:5, representing a slight drop from end-2010. RMB settlement in trade with Hong Kong SAR made up the largest share of the total. As of end-March, mainland agent banks had opened 800 interbank RMB accounts for participating overseas banks, with a total outstanding amount of 85.86 billion yuan, an average of 107.33 million yuan in each account.

Figure 1: Monthly RMB Settlement of Cross-border Trade



Source: The People's Bank of China

Box 2: Hong Kong RMB Business Progressed Steadily

RMB business in Hong Kong began in 2004 in response to market needs. Supported by policies and endogenous drives, it gained momentum and developed through the various stages of serving individual clients, RMB bond businesses, and RMB settlement of cross-border trade to RMB businesses independently run by Hong Kong financial institutions in accordance with the local law.

As economic and trade ties between the mainland and Hong Kong have grown closer due to progress in the reform and opening up and the rapid economic growth in the mainland, circulation of RMB cash in Hong Kong has expanded and the stock of RMB cash has accumulated in Hong Kong. In 2003, with the approval of the State Council, Hong Kong banks were allowed to offer four local RMB businesses, including deposits, exchange, bank cards, and remittances. This program was designed to meet the needs of travel and the small amount of consumption by tourists, and did not cover large-value transactions under the current account or RMB lending, investment, financing, or other capital account transactions. On December 24, 2003, with the authorization of the PBC, the Bank of China (Hong Kong) Limited (hereinafter referred to as BOC HK) became the clearing bank for personal RMB businesses in Hong Kong and it signed the Clearing Agreement on RMB Business with the PBC. This provides squaring arrangements for RMB clearing and exchange between the mainland and Hong Kong, laying the foundation for further development of Hong Kong RMB business. On February 25, 2004, local banks in Hong Kong officially opened RMB services for individuals.

After the launch, Hong Kong RMB business grew steadily. Backed by smooth clearing channels, RMB deposits increased, producing needs for RMB investment and asset management. With the approval of the State Council, the PBC released Notice ([2007] No.3) on January 14, 2007, allowing mainland financial institutions to issue RMB bonds in Hong Kong and to remit the proceeds back to the mainland. The PBC also expanded the scope of clearing for RMB business in Hong Kong to accommodate this development. The first RMB bond issue in Hong Kong, totaling 5 billion yuan, was issued by the China Development Bank on July 28, 2007. On September 28, 2009, with the approval of the State Council, the Ministry of Finance issued 6 billion yuan of RMB government bonds in Hong Kong, bringing more RMB investment products to the Hong Kong market.

To promote trade and to facilitate investment, on April 8, 2009 the State Council decided to launch a pilot RMB settlement program for cross-border trade between five mainland cities(Shanghai and four cities in Guangdong) and Hong Kong, Macao, and the ASEAN countries. The pilot program went into operation on July 2, 2009 and RMB business in Hong Kong was expanded to cover corporate business, mainly RMB settlement and financing. RMB settlement of trade with Hong Kong accounted for a dominant share under the pilot program, and the share of settlement of the actual amount of RMB received and paid during this process exceeded two-thirds of the total. RMB settlement of cross-border trade became a major source of RMB funds in Hong

Kong. At end-March 2011, RMB deposits in Hong Kong reached 451.4 billion yuan, constituting about 15 percent of Hong Kong's foreign currency deposits.

In an effort to further boost RMB business in Hong Kong and to strengthen economic and trade cooperation and visits between the mainland and Hong Kong, on July 19, 2010 the PBC signed a Supplementary Memorandum of Cooperation with the Hong Kong Monetary Authority (HKMA), and a revised Clearing Agreement on RMB Business with the BOC HK. These allowed participating banks in Hong Kong to offer RMB banking services to corporate and institutional clients in accordance with the local law, with fund flows in and out of the mainland subject to the relevant regulations on the mainland. As a result, Hong Kong's RMB business expanded rapidly. Restrictions on opening RMB accounts and RMB transfers were removed. Banks were allowed to freely develop different RMB exchange services and balance sheets products, and a variety of new RMB products soon emerged, including deliverable forwards, certificates of deposit, structured wealth management products, and investment trusts. Many international development institutions and overseas and multinational financial institutions and enterprises issued RMB bonds in Hong Kong. At end-march, 82 billion yuan of RMB bonds were issued in Hong Kong. On April 11, 2011, the first RMB-denominated fund in Hong Kong, Huixian Real Estate Investment Trust, was launched.

Hong Kong's role as a key window for economic and trade exchanges between the mainland and other economies makes it important to develop an offshore RMB business center and global asset management center in Hong Kong and expand RMB business there. First, this will help strengthen Hong Kong's status as an international financial center and ensure its long-term prosperity under the one country, two systems framework. Second, it will provide an important platform for overseas access to and use of RMB, thus promoting trade and investment. Third, it will provide useful experiences for financial reform in the mainland. Fourth, while the capital account is not yet fully liberalized, effective management of cross-border RMB flows will help prevent risks associated with cross-border uses of RMB.

VII. Improvement in the RMB exchange rate regime

In line with the principle of being self-initiated, controllable, and gradual, the PBC further improved the RMB exchange rate regime reform. Focusing on the role of market supply and demand, the PBC enhanced RMB exchange rate flexibility with reference to a basket of currencies and kept the RMB exchange rate basically stable at an adaptive and equilibrium level.

VIII. Progress in financial institution reform

The PBC continued to deepen reform of large commercial banks and to advance reform of policy financial institutions. It encouraged large commercial banks to modernize their corporate governance to improve decision-making, and asked them to ensure sound operations and to avoid a rebound in non-performing assets by enhancing awareness of capital, costs, and risk control and improving their asset, liability, and profit structures. As of end-2010, for the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), the China Construction Bank (CCB), and the Bank of Communications, the capital adequacy ratio was 12.27 percent, 11.59 percent, 12.58 percent, 12.68 percent, and 12.36 percent respectively; the non-performing loan (NPL) ratio posted 1.08 percent, 2.03 percent, 1.10 percent, 1.14 percent, and 1.22 percent; and the before-tax profits registered 215.4 billion yuan, 120.7 billion yuan, 142.1 billion yuan, 175.2 billion yuan, and 50 billion yuan. The PBC continued the reform of the ABC to build a multi-divisional structure for financial services to the rural areas. To review the progress of this pilot program and agro-linked financial services, the PBC completed a case-by-case assessment of 561 ABC county-level branch offices in 8 provinces where the pilot program was operating, including Sichuan, Chongqing, and Hubei. The PBC also released favorable policies on business revenue, regulatory fees, and the reserve requirement to support the pilot program. The transition to commercial operations in the China Development Bank made steady progress, thereby playing an active role in supporting the “Going Global” initiative and in improving the people’s livelihood. In the meantime, the PBC studied the reform plans for the Export and Import Bank of China and the China Export and Credit Insurance Corporation, and promoted a deepening of the internal reform at the China Agricultural Development Bank.

Notable achievements were made in terms of RCC reform. First, the RCCs’ asset quality and risk-prevention capacity were strengthened significantly. Based on the five-category loan classification, outstanding NPLs at RCCs at end-March totaled 402.0 billion yuan, down 18.4 billion yuan from end-2010. Their share of total RCC lending dropped 0.8 percentage points to 6.6 percent. The capital adequacy ratio stood at 8.6 percent. Second, the financial position of RCCs was strengthened remarkably, greatly boosting their financial services to the rural areas. At end-March, total RCC deposits posted 9.3 trillion yuan, accounting for 12.3 percent of the total deposits in financial institutions, up 0.4 percentage points from end-2010. RCC lending registered 6.1 trillion yuan, or 12.4 percent of the total lending by financial institutions, an increase of 0.6 percentage points from end-2010. This included 4.1 trillion yuan of agro-linked loans and 2.2 trillion yuan of lending to rural households, up 245.4 billion yuan and 156.2 billion yuan respectively from end-2010.

IX. Deepening the reform of foreign exchange administration

To facilitate enterprises using cross-border funds, and drawing on the experiences from a pilot program in selected regions, on January 1, 2011, coverage of the policy that allows exporters to deposit export proceeds in overseas banks was expanded to cover enterprises throughout the country. This allows overseas enterprises to deposit proceeds from goods exports in overseas banks, helping Chinese enterprises take full advantage of resources on both the global and domestic markets and easing the pressures to transfer export proceeds back to the mainland.

Regulation of cross-border capital inflows and the selling of foreign exchange was strengthened. In particular, to encourage reasonable cross-border capital flows and to prevent illegal capital inflows, actions were taken to enhance management of the banks' overall position for foreign exchange sales and purchases as well as for foreign exchange receipts and sales for entrepôt trade. The share of advance payments and delayed payments for goods trade was lowered. The overall quota for the short-term external debt for mainland financial institutions in 2011 was further reduced, as was the outstanding external debt quota for banks with large interbank deposits and lending. In the meantime, the transparency of foreign exchange administration was increased to promote sound public understanding of developments in cross-border capital flows and in irregular flows and to guide market expectations.

Part 3 Financial Market Analysis

In the first quarter of 2011, China's financial market continued to perform in a healthy and sound manner, and in general market liquidity was adequate. Interest rates on the money market fluctuated somewhat, and transactions were buoyant. Indices on the bond market moved up steadily, and bond issuances grew significantly. Stock indices rose slightly, and trading on the stock market was buoyant.

I. Financial market analysis

1. The money market traded briskly and interest rates fluctuated somewhat

Repo transactions and interbank borrowing on the money market were brisk, with the trading volumes increasing significantly. In Q1 2011, the turnover of bond repos totaled 21.5 billion yuan, with an average daily turnover of 357.8 billion yuan, up 25.6 percent year on year. The turnover of interbank borrowing reached 6.0 trillion yuan, with an average daily turnover of 100 billion yuan, an increase of 14.3 percent year on year. Overnight products still dominated bond repo and interbank borrowing transactions, accounting for 76.2 percent and 85.0 percent of their respective turnovers, down 4.2 and 2.8 percentage points from the same period of the previous year. The total turnover of government securities repos on the stock exchanges soared 160 percent to 3.12 trillion yuan.

In terms of financial institutions, net lending of state-owned commercial banks declined noticeably from the same period of the previous year; among non-banking financial institutions, net borrowing of insurance companies declined considerably from the same period of the previous year, whereas net borrowing of securities companies and fund management companies declined slightly.

Table 4: Fund flows among financial institutions, Q1 2011

Unit：100 million yuan

	Repo		Interbank borrowing	
	Q1 2011	Q1 2010	Q1 2011	Q1 2010
State-owned commercial banks	-48621	-62499	1360	-9800
Other commercial banks	13487	17958	-5328	6282
Other financial institutions	31909	38133	4327	1962
Of which: securities companies and fund management companies	13091	19943	2502	224
Insurance companies	6494	3335	——	——
Foreign-funded financial institutions	3226	6408	-359	1556

Note: "Other financial institutions" include the China Development Bank, policy banks, associations

of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, fund management companies, and so forth. A negative sign indicates net lending; a positive sign indicates net borrowing.
Source: China Foreign Exchange Trade System.

Trading of RMB interest-rate swaps grew rapidly. In Q1 2011, a total of 4,775 transactions was conducted, with an aggregate nominal principal of 566.79 billion yuan, up 170.2 percent year on year. In particular, trading of interest rate swaps with a maturity of less than 1 year was the most buoyant, with an aggregate nominal principal of 341.54 billion yuan, accounting for 60.3 percent of the total turnover. The base interest rate, or the floating end of the RMB interest-rate swaps, included the Shibor, the 1-year time deposit rate, and the 7-day fixing repo rate, and their notional principal accounted for 31.7 percent, 3.0 percent, and 65.3 percent of the total, respectively.

Table 5: Transactions of interest rate derivatives, Q1 2011

	Bond forwards		Interest-rate swaps		Forward-rate agreements	
	Transactions	Amount[1] (100 million yuan)	Transactions	Amount of nominal principal (100 million)	Transactions	Amount of nominal principal (100 million)
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
2009	1599	6556.4	4044	4616.4	27	60.0
2010	967	3183.4	11643	15003.4	20	33.5
Q1 2011	159	212.6	4775	5667.9	2	2.0

Source: China Foreign Exchange Trade System

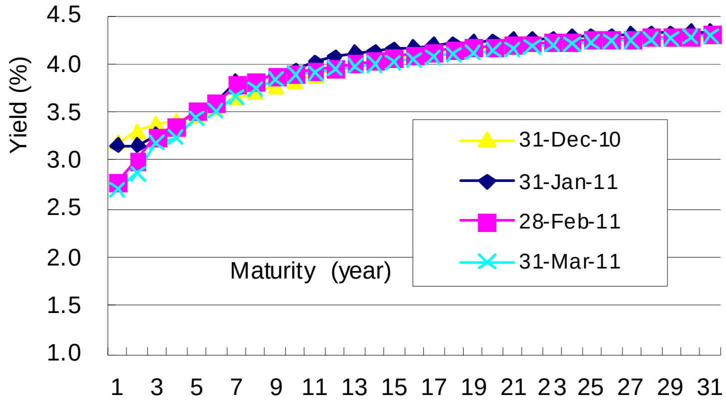
Interest rates on the money market fluctuated somewhat. Due to the impact of the Spring Festival, in January interest rates of all maturities on the money market reached their yearly high, and then declined somewhat month by month. In March, the weighted average interest rate of bond-pledged repo and interbank borrowing was 1.98 percent and 1.93 percent respectively, down 1.04 and 0.8 basis points from February, and down 1.14 and 0.99 basis points from December 2010. In Q1 2011, the short-end rates of the Shibor showed a decreasing trend after a period of rapid increases. At end-March, the overnight and 7-day Shibor stood at 1.80 percent and 2.82 percent respectively, down 2.72 and 3.57 basis points from the beginning of the year.. Shibor interest rates of a maturity of over 3 months steadily moved up. At end-March, the 3-month and 1-year Shibor registered 4.17 percent and 4.66 percent respectively, up 0.87 and 103 basis points from the beginning of the year.

[1] In 2009, statistics on transactions of bond forwards were changed to the settlement amounts of the transactions.

2. Indices on the bond market moved up steadily and bond issuances grew significantly

Indices on both the interbank bond market and the stock exchanges went up slightly. The index of total returns on the interbank bond market rose 0.48 percent, from 132.9 points at the beginning of 2011 to 133.6 points at end-March 2011; the index of government securities on the stock exchanges rose 1.01 percent, from 126.3 points at the beginning of 2011 to 127.6 points at end-March 2011. Since the beginning of 2011, interest rates on the money market declined slightly amid fluctuations, and the yield curve of government securities at the short-ends declined correspondingly, whereas the yields of medium and long-ends picked up somewhat due to heightened inflation expectations and interest-rate hikes. The yield curve of government securities showed an overall steepening upward trend.

Figure 2: Yield Curve of Government Securities on the Interbank Market, Q1 2011



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

Spot trading on the interbank bond market increased steadily. In Q1 2011, the turnover of spot bond trading on the interbank bond market totaled 12.62 trillion yuan, with a daily average turnover of 210.3 billion yuan, up 22.1 percent year on year. In terms of trading entities, state-owned commercial banks were mainly net bond buyers on the interbank spot bond market, with net purchases of 130 billion yuan; other commercial banks were mainly net sellers, with net sales of 163.8 billion yuan; and insurance companies became net buyers after being net sellers during the same period of the previous year, with net purchases of 6.5 billion yuan. A total of 27.2 billion yuan of spot government securities was traded on the stock exchanges, 25.6 billion yuan less than that during the same period of the previous year.

Affected by hikes in the benchmark deposit and loan rates and heightened inflation expectations in the market, bond issuance rates showed an overall upward trend, but because financial institutions had a stronger demand for bond investments in Q1, the increase in bond issuance rates was somewhat restrained The fixed interest rate of 2 batches of 10-year government securities issued in Q1 averaged 3.89 percent, up 15 basis points from those of the same maturity issued in Q4 2010. The interest rate of 3-year policy financial bonds issued by the China Development Bank was 4.02 percent, up 32 basis points from the end of the previous year. The Shibor played a greater role in bond pricing. In Q1 2011, 72 fixed-rate bonds based on the Shibor were issued on the primary bond market, with a total issuance volume of 80.6 billion yuan. A total of 70.8 billion yuan of short-term fixed-rate financing bills was issued based on the Shibor, accounting for about 25.3 percent of the issuance of all short-term fixed-rate financing bills. Furthermore, seven floating-rate bonds based on the Shibor were issued, with a total issuance volume of 66.5 billion yuan.

Bond issuances grew significantly. In Q1 2011, a total of 1.58 trillion yuan (excluding central bank bills) of RMB bonds was issued on the primary market, up 71.2 percent year on year. In particular, policy financial bonds, corporate bonds, short-term financing bills, and medium-term notes grew notably by 118.6 percent, 98.4 percent, 74.7 percent, and 60.2 percent respectively. In the meantime, 1.7 billion yuan of collective bills and 91 billion yuan of super and short-term commercial paper (SCP) were issued respectively. In terms of the maturity structure, the issuance of bonds with a maturity of less than 5 years accounted for 70.3 percent, up 4.9 percentage points year on year. At end-March, a total of 20.1 trillion yuan of bonds was deposited with the China Government Securities Depository Trust and Clearing Co., Ltd.

Table 6: Issuance of bonds, Q1 2011

Type of bonds	Issuances (100 million yuan)	Year-on-year growth (%)
Government securities①	3260	41.7
Policy financial bonds	6098	118.6
Bank subordinate bonds and hybrid bonds	175	-47.3
Bank ordinary bonds	20	-
Enterprise bonds②	6205	59.6
Of which: Short-term financial bills	2832	74.7
Medium-term notes	1841	60.2
Corporate bonds	403	98.4

Notes: ①Including municipal bonds issued by the Ministry of Finance on behalf of local governments; ②Including enterprise bonds, super and short-term commercial paper, short-term financing bills, medium-term notes, collective bills of SMEs, corporate bonds, and bonds with detachable warrants.

Source: State Treasury Bureau of the People's Bank of China, China Government Securities Depository Trust and Clearing Co., Ltd.

3. Interest rates on the bill market remained at an elevated level, and bill financing decreased on a continual basis

Affected by a number of factors such as the interest rates on the money market and the changed supply of and demand for bills, in Q1 2011 bill market interest rates first rose and then became subdued, but still remained at an elevated level. Outstanding bill financing continued to decline and transactions on the bill market were generally brisk. In Q1, commercial drafts issued by enterprises totaled 3.6 trillion yuan, representing year-on-year growth of 31.7 percent; cumulative discounted bills amounted to 6.9 trillion yuan, representing year-on-year growth of 12.8 percent. At end-March, the total value of outstanding undue commercial drafts increased 33.6 percent year on year to 5.9 trillion yuan; outstanding discounted bills registered 1.2 trillion yuan, down 29.7 percent year on year. Since 2011, financial institutions continued to strengthen credit asset structural adjustments and to decrease the scale of bill financing so as to meet the demand for ordinary loans, and outstanding discounted bills fell by 262.2 billion yuan from the beginning of the year. At end-March, the share of outstanding bill financing to outstanding loans was 2.5 percent, down nearly 2 percentage points year on year.

4. Stock indices increased slightly and the stock markets continued to trade briskly

The stock indices increased slightly. At end-March, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index increased 4.2 percent and 0.8 percent respectively from the end of the previous year to close at 2928 points and 12563 points. The average P/E ratio on the A-share market of the Shanghai Stock Exchange increased from 21.6 times at end-2010 to 22.8 times at end-March 2011; the average P/E ratio on the A-share market of the Shenzhen Stock Exchange declined from 45.3 times to 35.9 times.

Trading on the stock markets remained buoyant. In Q1 2011, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 13.51 trillion yuan, an increase of 16.5 percent year on year, and the daily turnover averaged 232.9 billion yuan, 32.3 billion yuan more than that during the same period of the previous year. At end-March, market capitalization increased 7.7 percent from the end of the previous year to 20.78 trillion yuan.

Financing on the stock markets declined somewhat. According to preliminary statistics, a total of 171.5 billion yuan was raised in Q1 2011 by non-financial enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, additional offerings, right issuances, and warrant exercises, 13.1 billion yuan less than that during the same period of the previous year.

5. Total assets of the insurance industry maintained fairly rapid growth

In Q1 2011, the total premium income of the insurance industry amounted to 461.7 billion yuan;[2] and total claim and premium payments increased 33.9 percent year on year to 98 billion yuan. In particular, total claim and benefit payments of the property-insurance sector increased 17.9 percent, whereas those of the life-insurance sector increased 49.8 percent.

[2]Because the CIRC adjusted the statistics on premium income in the insurance industry in 2011, the indicator cannot be compared with the previous year.

Total assets in the insurance industry maintained fairly rapid growth. At end-March 2011, total assets in the insurance industry posted 5.4 trillion yuan, an increase of 25.9 percent year on year, up 0.7 percentage points from the end of the previous year. Among this total, bank deposits increased 40.2 percent, up 7.5 percentage points and investment-type assets increased 21.4 percent, down 4.2 percentage points.

Table 7: Use of insurance funds, end-March 2011

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-March 2011	End-March 2010	End-March 2011	End-March2010
Total assets	54064	42929	100.0	100.0
Of which：Bank deposits	16257	11595	30.1	27.0
Investment	33899	27943	62.7	65.1

Source: China Insurance Regulatory Commission

6. The foreign exchange market traded briskly

The volume of forward and “currency pairs” transactions increased rapidly. In Q1 2011, the turnover of spot RMB foreign exchange transactions totaled US$813.3 billion, representing an increase of 5.5 percent year on year; the turnover of RMB foreign exchange swap transactions totaled US$337.7 billion, representing an increase of 18.5 percent year on year; among this total, overnight RMB/US dollar swap transactions amounted to US$186.1 billion, accounting for 55.1 percent of all swap transactions; the turnover on the RMB foreign exchange forward market totaled US$59.5 billion, an increase of 1855 percent year on year. In Q1 2011, the turnover of foreign currency pairs amounted to US$20.9 billion, an increase of 68.0 percent year on year. In particular, the US$/HKD pairs accounted for the lion’s share, or 49.9 percent, down 14.2 percentage points from the same period of the previous year. The number of participants on the foreign exchange market expanded further. In Q1 2011, one new member was accepted on the spot market, two new members were accepted on the foreign exchange swap market, and one enterprise group was permitted to trade on the interbank foreign exchange market.

7. The gold market operated stably

The price of gold first declined and then increased, keeping pace with the movement of gold prices on the international market. The price of gold on the Shanghai Gold Exchange saw a slight decline in January, and then rose continuously in February and March. The price of gold on the domestic market has continued to be higher than that on the international market, but the difference has gradually narrowed. The highest gold price on the domestic market was 305.3 yuan per gram, and the lowest gold price was 281.2 yuan per gram. At end-March, the price of gold was 302.1 yuan per gram, up 0.07 percent from the beginning of the year.

The Shanghai Gold Exchange operated stably. In Q1 2011, a total of 1,424.6 tons of gold was traded on the Shanghai Gold Exchange, a decrease of 0.9 percent year on year; total turnover posted 421.44 billion yuan, an increase of 19.7 percent year on year. The trading volume of silver was 40,276.0 tons, an increase of 488.1 percent year on year; total turnover amounted to 285.5 billion yuan, an increase of 948.1 percent. The trading volume of platinum increased 19.8 percent year on year to 15.7

tons and the total turnover rose 31.5 percent year on year to 6.13 billion yuan.

II. Institutional building in the financial market

1. Promoting the development of the foreign exchange market, and timely launching RMB-FOREX options trading

On April 1 2011, RMB-FOREX options trading was officially launched on the interbank foreign exchange market. Options trading is based on the principle of real demand, and will provide more tools for market participants to hedge exchange rate risks. Since the reform of the RMB exchange rate regime in July 2005, a number of RMB/foreign exchange derivatives were launched on the interbank foreign exchange market, such as forwards, foreign exchange swaps, and currency swaps, and the launching of RMB-FOREX options trading indicates that the Chinese foreign exchange market has offered a complete range of foreign exchange derivatives, and has laid a foundation for further development and innovation in the market.

2. Rules of the futures market was further improved, and new progress was made in product innovation

On January 17, the Supreme People's Court issued a specific regulation on issues concerning execution under the two-step settlement system arrangement and the three categories of guarantee fund system on the futures market. Approved by the CSRC, on March 24 the lead futures contract was officially launched on the Shanghai Futures Exchange, which further enriched the varieties of commodities trading in China and improved the pricing mechanism of relevant products.

3. Amending stock market trading settlement rules and clarifying the standard for mergers and acquisitions of public companies

On January 13, the China Government Securities Depository Trust and Clearing Corporation comprehensively amended the *Administrative Measures on the Registration and Settlement Business of the Pilot Securities Margin Trading Scheme*, and realized compliance of transfers of the remaining funds after the margin trading with the third party depository requirement. On January 17, the Shenzhen Stock Exchange amended its *Trading Rule*s, strengthening supervision over market transaction risks. On February 23, the CSRC issued the *Opinions on Listed Companies with Serious Financial Problems* and four other judicial interpretations on mergers and acquisitions, further improving the standards and transparency of mergers and acquisitions by listed companies.

4. Improving supervision of bancassurance business and solvency and upgrading the quality of insurance services

In order to further standardize the bancassurance market, in March the CIRC and the CBRC jointly issued the *Guidelines on Supervision of Bancassurance Business*, so as to maintain a stable bank-insurance company cooperative relationship, prevent and crack down on misleading sales, pre-empt risks of commercial bribery, delineate the responsibility of insurance companies and commercial banks, protect the legitimate rights and interests of consumers, and promote the shift in the development mode of the bancassurance business. In order to further improve supervision of the solvency of insurance companies, the CIRC issued relevant regulations specifying that the dynamic solvency test of insurance companies should be reviewed by third parties. In addition, the CIRC also issued notices stipulating that a reporting system of services commitments by insurance companies be put in place, requiring insurance companies to deliver their services commitments, so as to upgrade the quality of insurance services and to protect the interests of the insured.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q1 2011, the global recovery broadly continued but at two speeds, with increased uncertainties and unstable factors caused by the political unrest in West Asia and North Africa, the extreme weather conditions, the Tohoku earthquake in Japan, the spike in commodity prices, especially food and oil, and the volatile financial market. The U.S. economy grew moderately, with a gradually declining unemployment rate. But the U.S. housing market remained depressed and both the fiscal deficit and the trade deficit presented major challenges. In some European countries, sovereign debt risks still existed but the ECB had already embarked on a tightening monetary policy amid upward inflationary pressures. The earthquake in Japan and the resulting tsunami and nuclear crisis cast a shadow on the recovery of Japan and even the world. The emerging market economies experienced robust demand but in order to contain large cross-border capital flows and risks of overheating, some economies initiated a tightening of macro policy. In its April 2011 *World Economic Outlook*, the IMF projected growth for the United States, the euro area, Japan, and the emerging and developing economies will be 2.8 percent, 1.6 percent, 1.4 percent, and 6.5 percent respectively throughout 2011.

1. Economic developments in the major economies

The U.S. economy continued to rebound but at a moderate speed. The housing market remained lackluster and the problem of a double deficit did not see significant improvement. GDP growth registered 1.8 percent in Q1 (the seasonally adjusted annualized rate), lower than market expectations. Due to the fiscal stimulus and quantitative easing, the unemployment rate moved downward for four consecutive months to 8.8 percent in March 2011. The labor market added only a few new jobs because the number of job-seekers was falling. Consumption continued to change for the better, with retail sales edging up for nine consecutive months, driven mainly by the wealth effect from the stock market rally.

Boosted by the National Export Initiatives, exports reached a record high of US$167.5 billion in January. But downside risks still existed. Due to rising energy and food prices, in March the CPI climbed by 2.7 percent year on year, the largest surge since December 2009. It is possible that commodity price hikes will weigh on future economic growth. The housing market continued to be gloomy, and the large inventory provided ample room for a further decline in prices. Trade conditions and the fiscal deficit were not optimistic, reflected in the historical high federal deficit of US$222.5 billion in February, which in March squeezed downward a bit to US$188 billion. On April 18, Standard & Poor’s lowered its outlook for the U.S. credit rating from “stable” to “negative,” but the credit rating remained unchanged at AAA.

Table 8: Macroeconomic and financial indices of the major economies

country	Index	2010 Q1			2010 Q2			2010 Q3			2010 Q4			2011 Q1		
		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar
United States	Real GDP Growth Rate (annualized quarterly rate, MOM, %)	3.7			1.7			2.5			3.1			1.8（beginning number）		
	Unemployment Rate (%)	9.7	9.7	9.7	9.9	9.7	9.5	9.5	9.6	9.6	9.6	9.8	9.4	9.0	8.9	8.8
	CPI (YOY, %)	2.6	2.1	2.3	2.2	2.0	1.1	1.2	1.1	1.1	1.2	1.1	1.5	1.6	2.1	2.7
	DJ Industrial Average (closing number)	10067	10325	10857	11009	10137	9774	10466	10015	10788	11118	11006	11578	11892	12226	12320
	NASDAQ(closing number)	2147	2238	2398	2467	2257	2109	2255	2114	2369	2507	2498	2653	2700	2782	2781
Euro Area	Real GDP Growth Rate (quarterly YOY, %)	0.6			1.7			1.9			2.0					
	Unemployment Rate (%)	9.9	10.0	10.0	10.1	10.0	10.0	10.0	10.1	10.0	10.1	10.1	10.0	10.0	9.9	9.9
	HICP (YOY, %)	1.0	0.9	1.4	1.5	1.6	1.4	1.7	1.6	1.8	1.9	1.9	2.2	2.3	2.4	2.7
	EURO STOXX 50(closing number)	2479	2470	2629	2541	2397	2360	2476	2450	2482	2543	2478	2601	2654	2713	2583
Japan	Real GDP Growth Rate (annualized quarterly rate, MOM, %)	5.0			1.5			4.5			-1.3					
	Unemployment Rate (%)	4.9	4.9	5.0	5.1	5.2	5.3	5.2	5.1	5.0	5.1	5.1	4.9	4.9	4.6	4.6
	CPI(YOY,%)	-1.3	-1.1	-1.1	-1.2	-0.9	-0.7	-0.9	-0.9	-0.6	0.2	0.1	0.0	0.0	0.0	0.0
	NIKKEI225(closing number)	10198	10126	11090	11057	9768	9383	9537	8824	9369	9202	9937	10229	10238	10624	9755

Source: Statistical Bureaus and Central Banks of the Relevant Economies

Despite sovereign debt risks and rising inflationary pressures, there were fewer economic activities in the euro area than expected but there was substantial variation across the member states. Growth was robust in Germany and moderate in France and Italy. But countries such as Spain, Greece, Portugal, and Ireland were besieged by debt crises and their sovereign ratings were downgraded in March, resulting in tensions in their financing conditions. Portugal became the third euro area country, after Greece and Ireland, to seek a bailout from the EU. Meanwhile, ballooning energy and food prices added to inflationary pressures in the euro area. In March, the HICP picked up by 2.7 percent year on year, reaching its highest level since October 2008 and exceeding the 2 percent target set by the ECB for four consecutive months.

The earthquake, tsunami, and nuclear crisis posed serious challenges to the recovery of Japan, and raised concerns about Japan's public debt. On March 11, a large magnitude earthquake hit off the east coast of Japan, triggering a tsunami and a nuclear accident. The disaster caused major disruptions in the infrastructure, the global automobile industry, and the electronic industrial chain, which could ripple throughout the Japanese economy and even hamper the global recovery. Japan's public debt is now roughly twice the size of its GDP, the highest among the advanced economies. Huge fiscal expenditures for reconstruction will further weigh down on the public debt conditions. Although the unemployment rate was drifting lower, further observations are needed to better understand whether this trend will continue after the earthquake. Deflation continued to be a grave problem, as evidenced by the fact that in March the core CPI had been falling for 25 consecutive months.

Box 3: Sovereign Debt Challenges in the Advanced Economies

Since the onset of the financial crisis in 2008, sovereign debt crises have erupted in countries such as Iceland, Dubai, Greece, and Ireland due to bursting of the housing bubbles, the increasing bad banking loans, and the deteriorating fiscal conditions. The financial markets suffered a significant bout of volatility and the outlook for global recovery was not optimistic.

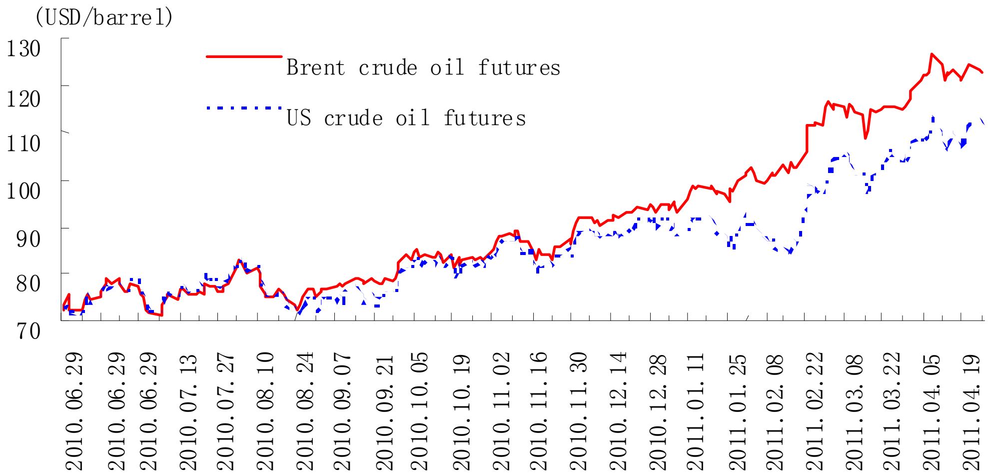
In general, some advanced economies already had problems of over-consumption and heavy debt burdens prior to the crisis. In addition, the large financial bailout plans and stimulus measures during the financial crisis, while contributing to the economic recovery, also transferred private debt to the public sector. According to the IMF, the share of the debt outstanding and the fiscal deficit in GDP in the U.S., Japan, the euro area, and the U.K. in 2010 was much higher than prior to the crisis and higher than that in the emerging market economies such as China, India, Brazil, and Russia. Compared with the Latin American debt crisis in the early 1980s and the Mexican and Russian debt crises in the 1990s, this round of sovereign debt crises in the advanced economies, evidenced in the unsustainability of the fiscal deficit and government debt have deeper root causes. First, aging population in the advanced economies has necessitated high level of welfare expenditures, which weighed heavily on public finance. The opposition of interest groups and political concerns has made it difficult to push forward with structural reforms. Meanwhile, because of the advantages of reserve currencies, those economies had little momentum to control their over-borrowing. Second, the traditional industries of the advanced economies by and large have lost their competitiveness and the financial crisis dealt these industries another significant blow. The sluggish post-crisis recovery has left a gap between slow fiscal income growth and huge crisis-related fiscal expenditures. Furthermore, factors such as persistent lack of fiscal restraints in some euro area member states, America's huge foreign expenditures, and Japan's fiscal costs for taming its deflation also all contributed to the accumulation of sovereign debt.

The credit ratings of some advanced economies were downgraded, revealing the risks of high public debt. According to the estimation of the IMF, the average fiscal deficit of G7 in 2011 would be 7 percent of GDP and the average indebtedness would be 113 percent of GDP. Among these countries, Japan's public debt would soar to an estimated 234 percent of GDP. The three international rating companies in succession downgraded the sovereign ratings of some euro area countries, including Spain, Portugal, Greece, and Ireland. On April 6, the Portuguese government decided to turn to the European Union for a bailout, becoming the third euro area country after Greece and Ireland to ask for external support. Although the European Union had already intensified fiscal austerity, facilitated the establishment of the ESM, and expended the funding sources of the EFSF, rating companies like Moody's did not rule out the possibility of downgrading euro area countries. Debt conditions in other developed countries were also gloomy. In 2011, Standard & Poor's and Moody's cut Japan's credit and outlook rating. Moody's warned against U.S. and U.K. sovereign risks. On April 18, Standard & Poor's lowered its outlook for the U.S.'s credit rating from "stable" to "negative." Given the size of the advanced economies and the weight of their financial market, should a crisis break out there, that would have a more profound influence on the global economy and financial stability.

Sovereign debt risks bring huge uncertainties to the world recovery. On the one hand, European debt crisis has caused large fluctuations in global stock markets, foreign exchange markets, and bond markets, thus increasing systemic risks especially during the period when market confidence is fragile. On the other hand, fiscal consolidation measures taken by the various countries could overlap, exacerbating the economic slack in the euro area countries and dampening the rebound in global demand. The heavy debt burden in the U.S. and Japan could reduce their potential outputs and add to medium- and long-term inflationary and currency depreciation pressures. Though 95 percent of Japan's public debt is financed domestically and the U.S. issues reserve currency and has cutting-edge financial markets, thus eliminating the possibility of a short-term sovereign crisis in the two countries, rising debt levels in the U.S. and Japan could undermine market confidence, increase government financing costs and real interest rates, and reduce potential output. IMF studies show that each 10-percentage-point increase in the debt ratio slows annual real economic growth by about 0.15 percentage points. In addition, worsening fiscal conditions might weaken the willingness of investors at home and abroad to hold government treasuries, leaving central banks to be the final bill-payer for government debts. Monetization of the fiscal deficit would jeopardize central banks' efforts to reach the inflation targets. Generally, it is very difficult to fundamentally improve sovereign debt conditions in the advanced economies. In the U.S., the extension of tax cuts makes fiscal adjustments more difficult. In addition, a further fiscal stimulus is justified in some euro area countries because of the still fragile banking system, which could aggravate those countries' debt conditions, especially against the backdrop of an interest-rate increase by the ECB. In Japan, the huge capital demand for reconstruction in the aftermath of the earthquake is expected to have an adverse impact on Japan's public debt stance. The major advanced economies are caught in a dilemma between boosting economic growth and enhancing fiscal consolidation. If the major advanced economies fail to implement fiscal austerity measures and commit to structural reforms, sovereign debt risks will evolve into a major challenge to a global recovery.

The emerging market economies were challenged by large cross-border capital flows and economic overheating. The political upheavals in West Asia and North Africa might endanger the region and even global economic stability. Due to robust domestic demand and the rebound of external demand, growth of the major emerging market economies gradually went back on track. However, in the face of mounting inflationary pressures and large cross-border capital flows, some emerging market economies took the initiative to tighten the macro economy, which might slow the pace of growth. Political unrest in West Asia and North Africa might threaten the global recovery. Market panic and risk aversion caused by the political upheavals in Tunisia, Egypt, and Libya sparked a round of oil and gold price hikes.

Figure 3: Trends in Crude Oil Prices

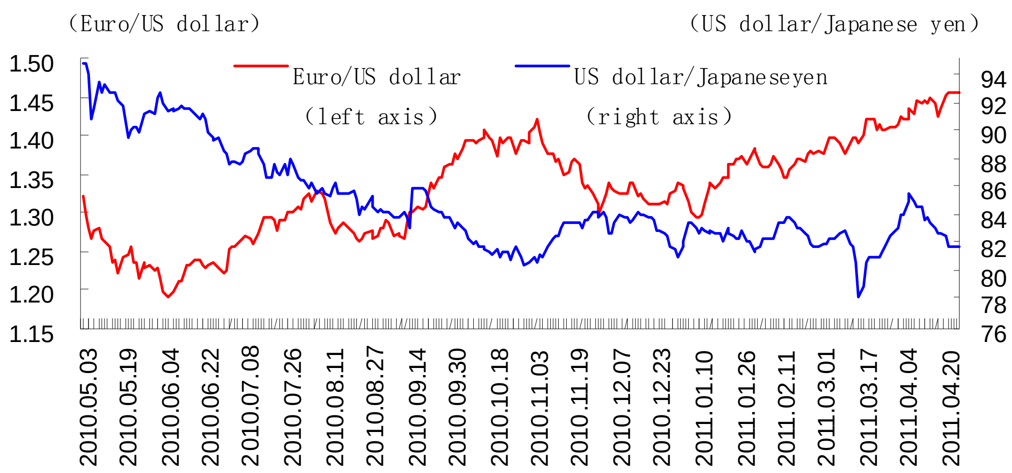


Source：Reuters

2. Global financial market development

The exchange rates of the major currencies fluctuated within a large band. The euro weakened against the US dollar but later recouped its losses. The euro dropped rapidly against the US dollar at the beginning of the year due to concerns about the euro area debt problems, but turned upwards later in the year after the announcement by China, Japan, and Russia of support and against the background of rising inflationary pressures and expectations of an interest-rate increase in the euro area. On March 31, the exchange rate of the euro against the US dollar closed at 1.4159, up by 5.85 percent from the beginning of the year. Immediately after the Japanese earthquake and tsunami, Japanese insurance companies and other enterprises repatriated funds from foreign assets all at once to pay for reconstruction and insurance claims. At the same time, speculators took the opportunity to buy Japanese yen in large amounts. On March 17, the Japanese yen reached 76.25 yen per US dollar, the highest level since World War II. To prevent the yen from soaring too rapidly, after a conference call on March 18, the G7 pledged to jointly intervene to stabilize the foreign exchange market. With this news, the yen retreated by more than 3 percent within the day. On March 31, the exchange rate of the Japanese yen against the US dollar closed at 83.20 yen per US dollar, down by 2.46 percent from the beginning of the year.

Figure 4: Movements in the Exchange Rates between the Major Currencies

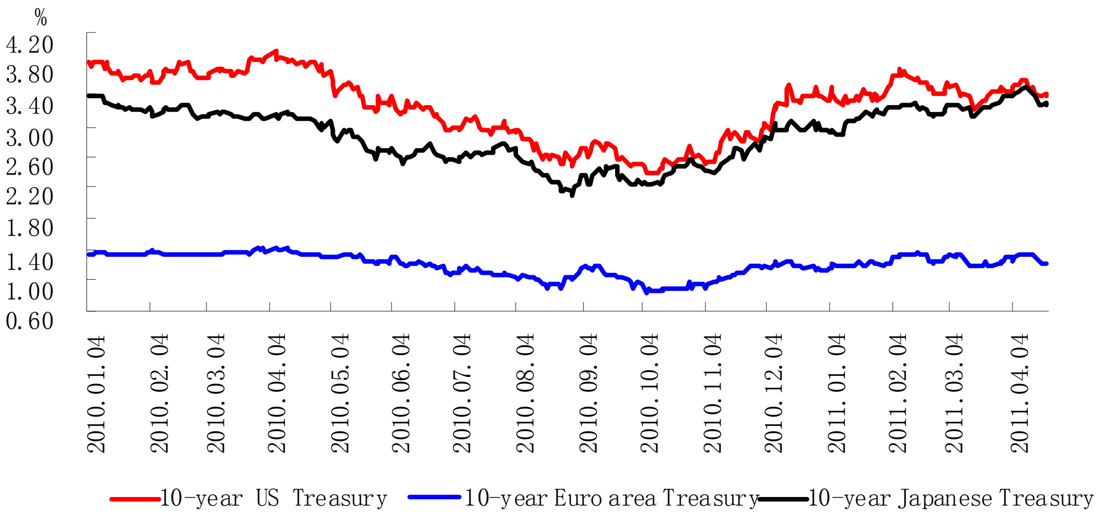


Source: Reuters

The US dollar Libor fluctuated at a low level. In 2011 the U.S. Fed continued to implement quantitative easing, which contributed to the slight swing of the US dollar at a low level. On March 31, the 1-year Libor read at 0.78 percent, almost the same as that at the beginning of the year. Influenced by the euro area sovereign debt crisis and expectations of an interest rate increase by the ECB, the Euribor squeezed up. On March 31, the 1-year Euribor reached 2.0 percent, up by 0.50 percentage points compared to the beginning of the year.

The yields of securities in the major countries fluctuated within a narrow range. The good performance of the U.S. stock market attracted capital flows from the securities markets. Meanwhile, despite factors such as divergent opinions about government spending cuts in the U.S. Congress, Moody's warning of the potential downgrading of the AAA sovereign rating of the U.S., yields of U.S. government securities climbed up from January until the beginning of February. However, due to the social unrest in West Asia and North Africa, and the risk aversion resulting from the Japanese earthquake, yields began to drift lower. The buildup of inflationary pressures in the euro area heightened market expectations of an interest-rate increase, which boosted yields of securities in the euro area. Despite Standard & Poor's and Moody's cut in Japan's sovereign rating, the repatriation of capital from abroad and stock market returns from the overseas bond market kept the yields of Japanese government securities almost unchanged. On March 31, yields of 10-year treasury bonds in the U.S., euro area, and Japan closed at 3.47 percent, 3.36 percent, and 1.25 percent respectively, up by 11, 39, and 13 basis points from the end of the previous year.

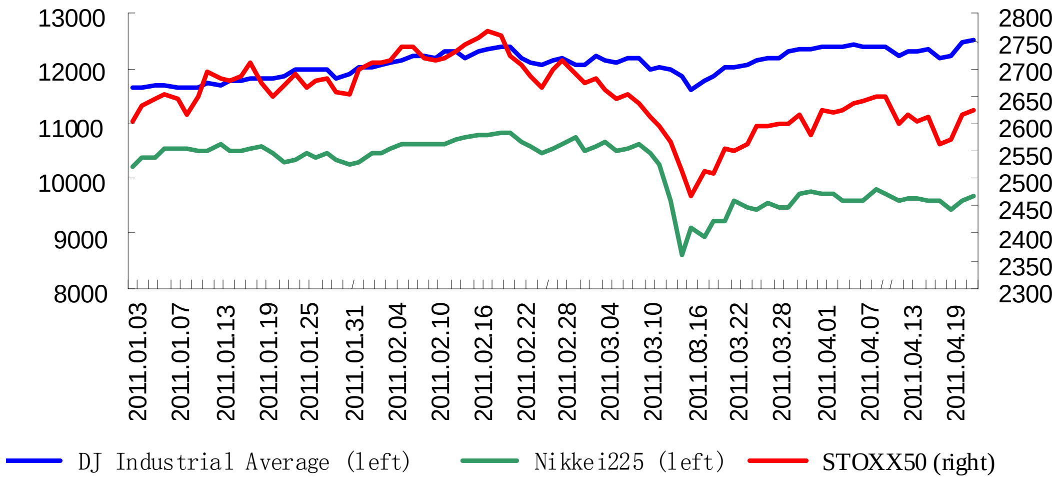
Figure 5: Movements in the Yields of the Major Treasuries



Source: Reuters

Social tensions in West Asia and North Africa put a drag on stock markets in the U.S. and euro area. The earthquake and tsunami caused an avalanche in the Japanese stock market. At the beginning of the year, stock markets in the major advanced economies continued the upward momentum that had begun in Q4 of 2010. But hit hard by unexpected incidents such as the political upheaval in West Asia and North Africa and the Japanese earthquake, the major stock indices experienced a freefall. On March 31, the Dow Jones Industrial Average and the NASDAQ closed at 12,320 and 2,781, up by 6.4 percent and 4.8 percent from the beginning of the year; the STOXX5 was 2,583, down 0.7 percent from the beginning of the year. After the massive earthquake hit Japan on March 11, the Nikkei 255 fell by an accumulated 20 percent in just two days. And on March 15, it plunged by 14.2 percent. But later, the Bank of Japan flooded the financial market with liquidity, helping to stabilize the stock market. On March 31, the Nikkei 225 closed at 9,755, down by 4.6 percent from the beginning of the year.

Figure 6: Movements of the Major Stock Indices



Source: Reuters

3. The development of the housing market in the major economies

The U.S. housing market remained in the doldrums. According to the U.S. Department of Commerce, new home sales in February declined by 28 percent year on year and new home prices plummeted to their lowest level since December 2003. The Case-Shiller Home Price Indices published by Standard & Poor's showed that in January 2011, home prices in twenty metropolitan regions of the U.S. had slid by 1.0 percent month on month to almost the same level as that in 2003.

The European housing market experienced a moderate rebound. In January, the U.K. Halifax picked up by 0.8 percent month on month. Demand for both residential and commercial real estate, as well as for rentals, in German metropolitan areas including Berlin and Frankfurt was promoted by the strong economic performance. Due to low lending rates and robust market demand, the start of new homes rocketed. But sluggish economic activities and the shadow of the debt crisis kept housing prices in the peripheral countries of the euro zone flat and low.

There were signs of stabilization in the Japanese housing market. In January, orders received for construction by the big 50 construction companies rose by 19.5 percent year on year. Promoted by government subsidies and tax reductions for energy-saving homes, the start of new building picked up by 10.1 percent year on year in February, registering the ninth successive positive monthly reading. After the earthquake and the tsunami, demands of refugees drove up housing prices in Tokyo and its peripheral areas and it is estimated that the demand gap will continue to push up housing prices before completion of reconstruction.

4. The monetary policies of the major economies

The monetary policies of the various economies diverged remarkably. The U.S. Fed implemented the QE2 as planned. The Bank of Japan went all out to flood the market with liquidity to fight the shocks caused by the earthquake and tsunami. The ECB raised its benchmark interest rate for the first time in the past three years. Further, a number of central banks in the emerging market economies took measures, such as boosting interest rates and the reserve requirement ratio, to counter the ballooning inflationary pressures and large capital inflows. The Bank of Canada and the Reserve Bank of Australia kept their benchmark interest rates unchanged while the Reserve Bank of New Zealand, against the background of the New Zealand earthquake, announced it would cut its interest rate.

The U.S. Fed continued to maintain the target range for the federal funds rate at 0 to 0.25 percent and to implement the QE2. Since the economic recovery had firmed and inflation had picked up, there were different opinions within the Fed as to whether to retain the quantitative easing monetary policy. On April 27, the Federal Open Market Committee announced it would continue expanding its holdings of securities and would complete the second round of asset purchases by the end of June.

The ECB raised its benchmark interest rates for the first time in the past three years to restrain inflationary pressures. On March 3, the ECB revised upward its forecast for inflation by 50 basis points to 2.3 percent. On April 7, the ECB decided to increase interest rates on the main refinancing operations, the marginal lending facility, and the deposit facility, each by 0.25 percentage points, to 1.25 percent, 2 percent, and 0.5 percent respectively. This was the first boost in interest rates in three years.

Though the inflation rate moved upward, because of concern about the sluggish domestic economy, the Bank of England decided to maintain the official bank rate at 0.5 percent and to keep the stock of asset purchases unchanged at ￡200 billion.

The Bank of Japan continued to keep the uncollateralized overnight call rate at about 0 to 0.1 percent and tried to gauge the effects of the earthquake and tsunami by injecting a large amount of liquidity into the financial market. To ease the market panic due to the earthquake and tsunami, on several occasions the Bank of Japan injected an enormous amount of liquidity into the market. By March 22, the total amount of injected cash reached 40 trillion yen, accounting for about 20 percent of the balance sheet of the Bank of Japan. In addition, the Bank of Japan also expanded the amount of the Asset Purchase Program by about 5 trillion yen and provided a new trillion yen lending program, offering cheap one-year loans to financial institutions in the disaster-hit areas.

Some economies experienced a strong rebound and some economies facing increasing inflationary pressures had already entered a period of interest rate increases. In Q1, India, Brazil, Russia, South Korea, Thailand, Indonesia, Vietnam, Philippines, Sweden, Poland, Hungary, Peru, and Israel increased their benchmark rates to restrain inflation. Moreover, in order to prevent international short-term capital inflows attracted by the higher interest rate spread, the Central Bank of Turkey, while cutting its benchmark interest rate, increased its reserve requirement ratio.

5. World economic outlook

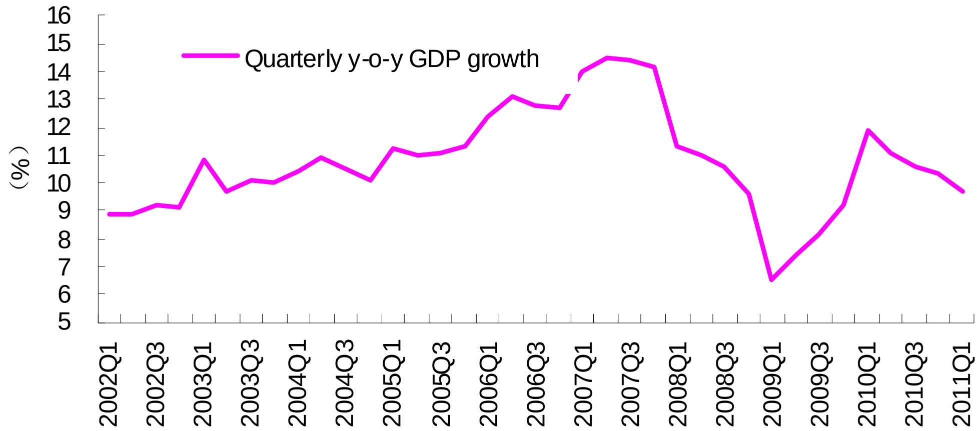
Currently, the global recovery has gradually strengthened, with private demand as the major driver, and the inherent strength of economic growth has been enhanced. However, the geopolitical risks, the large natural disasters that occurred in succession, and the soaring commodity prices are all factors affecting economic growth. The global economy and financial market are still prone to shocks.

Within the predictable future, the double-speed recovery is expected to continue. Growth and unemployment problems will linger on for a while in the advanced economies, whereas the emerging market economies will face the risks of overheating and cross-border capital flows. According to the World Economic Outlook Projections published by the IMF in April, in 2011 the growth rates of the advanced and emerging and developing economies will be 2.4 percent and 6.5 percent respectively. The inflation rates in the advanced and emerging and developing economies are projected to increase from the 1.6 percent and 2.2 percent in 2010 to 6.2 percent and 6.9 percent respectively in 2011. Inflation will be a common challenge to all countries.

II. Analysis of China's macroeconomic performance

In the first quarter of 2011, China's economy made a good start and developed in the direction as intended by the macroeconomic management policies. Consumption demand stabilized, fixed-asset investments and imports and exports grew rapidly, agricultural production performed well, the profitability of industrial enterprises improved, and household income grew, but prices rose rather quickly. In the first quarter of 2011, the Gross Domestic Product (GDP) registered RMB 9.6 trillion, up 9.7 percent year on year and a deceleration of 2.2 percentage points from the same period of the previous year. The Consumer Price Index (CPI) was up 5.0 percent year on year, an acceleration of 2.8 percentage points from the previous year. The trade deficit posted US$10.2 billion, the first quarterly deficit since 2005.

Figure 7: The GDP Continues Growing Rapidly

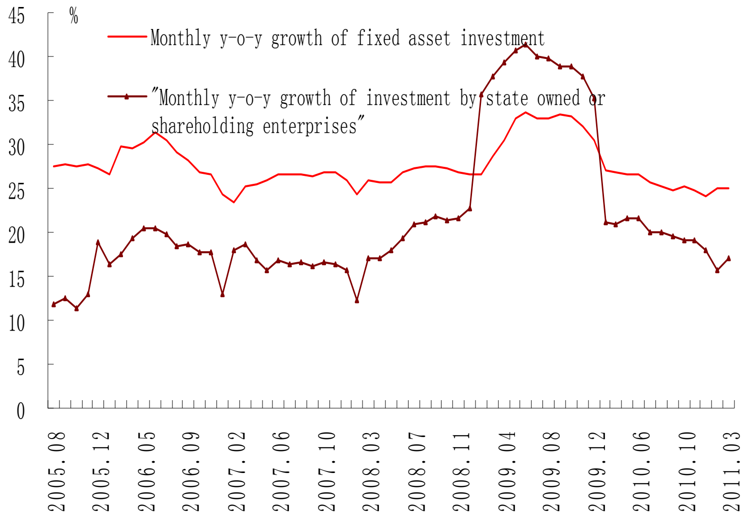


Source: National Bureau of Statistics

1. Consumption demand stabilized, investment growth was rapid, and external trade posted a quarterly deficit

Supported by the income gains of urban and rural residents, domestic consumption remained stable. In the first quarter of 2011, the per capita disposable income of urban households posted 5,963 yuan, representing year-on-year growth of 12.3 percent and real growth of 7.1 percent. The per capita cash income of rural households registered 2,187 yuan, up 20.6 percent or 14.3 percent in real terms. The PBC survey on urban depositors in the fourth quarter shows that the income index of residents in the period under review posted 54.5 percent, up 3.4 percentage points from the previous quarter. In the first quarter, retail sales of consumer goods totaled 4.3 trillion yuan, representing a year-on-year increase of 16.3 percent, or 11.6 percent in real terms. Broken down by urban and rural areas, consumption in the urban areas outpaced that in the rural areas, and the growth gap remained basically stable. In the first quarter, retail sales in the urban areas registered 3.7 trillion yuan, up 16.4 percent year on year, whereas retail sales in the rural areas posted 567.4 billion yuan, up 15.8 percent year on year.

Figure 8: Fixed-asset Investments Continue their Rapid Growth

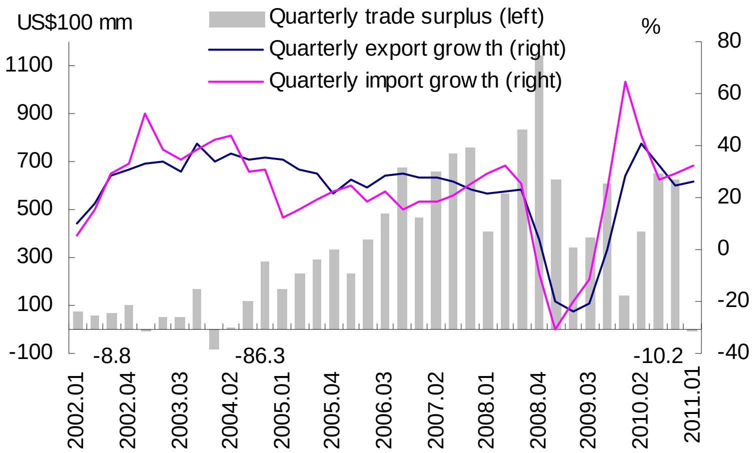


Source: National Bureau of Statistics

The growth of fixed-asset investments remained rapid, with the growth in central and western China outpacing that in the east. In the first quarter, completed fixed-asset investments (excluding investments by rural households) totaled 3.9 trillion yuan,[3] up 25 percent year on year. Among this total, investments by state-owned and state-holding enterprises registered 1.4 trillion yuan, up 17.0 percent year on year. Broken down by regions, growth of fixed-asset investments in the eastern, central, and western regions registered 21.6 percent, 31.3 percent, and 26.5 percent respectively, with the central and western regions obviously outpacing the eastern region. Broken down by industries, fixed-asset investments in the primary, secondary, and tertiary industries grew 10.8 percent, 24.8 percent, and 25.6 percent respectively, and growth in the secondary and tertiary industries remained rapid. In the first quarter, the total planned investment in projects under construction in urban areas grew by 19.1 percent year on year to 33.6 trillion yuan, a deceleration of 11.3 percentage points from the same period of the previous year. The total investment in new projects in urban areas dropped 12.7 percent year on year to 2.95 trillion yuan.

[3] From 2011, fixed-asset investment data will include project investments by operational and non-operational rural entities, and the threshold will be adjusted to 5 million yuan of the total volume of planned investment. Based on data now released by the NBS, the data before 2010 in Figure 8 are based on the previous statistical scope for fixed- asset investments in urban areas. Because the completed investment volume of projects below the 5 million yuan threshold as a ratio of the total is very small, the completed volume of projects at or above 5 million yuan can relatively accurately reflect the growth and structure of investments, and the change will not influence judgments about overall trends in investment development, so the difference between the two is small.

Figure 9: Imports and Exports Grow Rapidly, Posting a Trade Deficit



Source: The People's Bank of China, the General Administration of Customs

The volume of imports and exports grew rapidly, registering a quarterly trade deficit. In the first quarter, imports and exports totaled US$800.3 billion, up 29.5 percent year on year. Specifically, exports posted US$399.6 billion, up 26.5 percent year on year; imports registered US$400.7 billion, up 32.6 percent year on year. The strong growth of imports resulted in a trade deficit of US$1.02 billion, the third quarterly deficit since 2000, following the deficit of US$970 million in the first quarter of 2003 and the deficit of US$8.61 billion in the first quarter of 2004. The trade deficit was a result of the rapid growth in both imports and exports, with the growth of imports 6.1 percentage points faster than that of exports. The rapid import growth was due to strong domestic demand and rising import prices. In the first quarter, China's trade surplus with the U.S. and the EU stood at US$34.55 billion and US$29.48 billion respectively, and China's trade deficit with South Korea, Japan, and the ASEAN countries posted US$17.77 billion, US$15 billion, and US$6.59 billion respectively. In the first quarter, actually utilized foreign investment reached US$30.34 billion, up 29.4 percent and an acceleration of 21.8 percentage points from the same period of the previous year.

2. Agricultural production performed well, and industrial production remained stable

In the first quarter, the added value of the primary, secondary, and tertiary industries reached 598 billion yuan, 4.7 trillion yuan, and 4.4 trillion yuan respectively, up 3.5 percent, 11.1 percent, and 9.1 percent. The share of the three industries in GDP was 6.2 percent, 48.6 percent, and 45.2 percent respectively.

The area of planted grain increased modestly and the output of animal husbandry registered stable growth. The survey of over 70,000 farmers indicates that the total area of planted grain in 2011 will reach 110.28 million hectares, 400,000 hectares more than that in the previous year. In the first quarter, the total output of meat (including pork, beef, mutton, and poultry) posted 21.42 million tons, up 1.8 percent

year on year.
Industrial production posted stable growth and corporate profitability continue to rise. In the first quarter, the added value of statistically large enterprises grew 14.4 percent[4] year on year. Production and sales of industrial products were well connected, and 97.7 percent of manufactured goods were sold, up 0.1 percentage point from the same period of the previous year. Corporate profitability continued to increase. In the first quarter, profits of statistically large enterprises posted 1065.9 billion yuan, up 32 percent year on year. The survey of 5,000 industrial enterprises conducted by the PBC in the first quarter reveals that the corporate business index dropped by 0.2 percentage points to 71.7 percent, after registering growth for seven successive quarters. Market demand remained generally stable, with the market demand index posting 63.5 percent, representing a deceleration of 1.8 percentage points from the previous quarter. Among the total, the domestic orders index stood at 56.9 percent, a deceleration of 0.9 percentage points from the previous quarter, but still considered a high level since the survey began. The export order index continued the declining trend from the previous quarter, and dropped by 0.8 percentage points to 51.5 percent. Inventories of finished products decreased from the previous quarter, and the inventory index posted 49.6 percent, a deceleration of 0.7 percentage points from the previous quarter and an acceleration of 0.5 percentage points from the same period of the previous year respectively. Corporate profitability remained stable, with the profitability index edging down by 2.9 percentage points from the previous quarter to 58.2 percent, an acceleration of 1.8 percentage points from the same period of the previous year.

3. Pressures on price hikes remained high

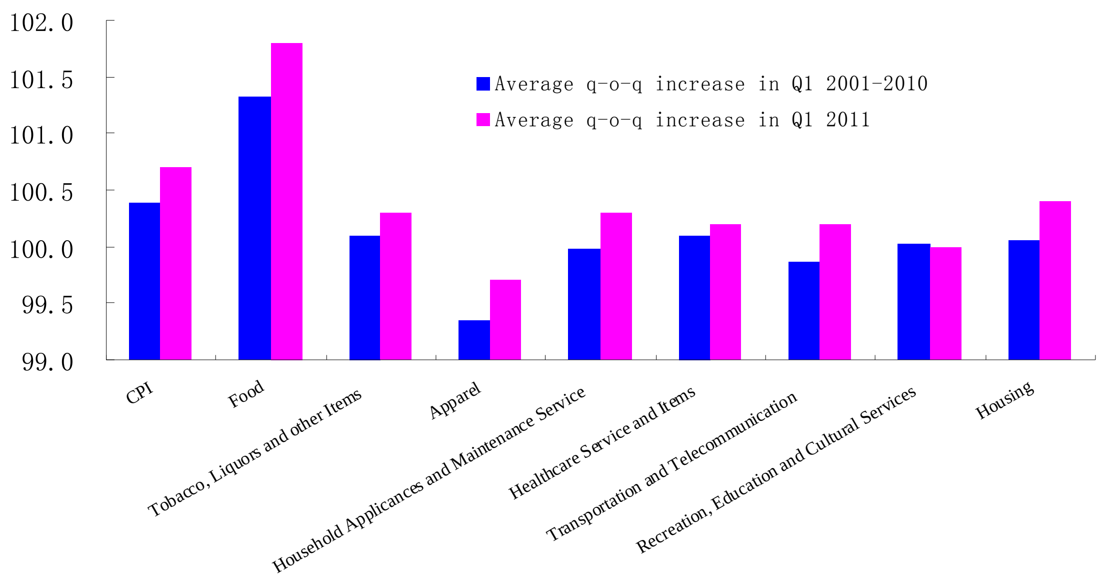
Affected by the continued loose monetary policies of the major economies and the gradual recovery of the world economy, commodities prices in the international market continued to rise, global inflationary expectations heightened, and imported inflationary pressures built up in China. At the same time, driven by domestic investment demand and rising costs of energy, resources, labor, land, and other factors, the general price level in China began to gradually climb up since the second quarter of 2009, and pressures on price hikes mounted notably in the latter half of 2010, in the fourth quarter in particular,.

The CPI continued to rise. In the first quarter, the CPI gained 5.0 percent year on year, an acceleration of 0.3 percentage points from the previous quarter. The monthly CPI was up 4.9 percent, 4.9 percent, and 5.4 percent respectively. Broken down by food and non-food items, food prices increased by 11.0 percent, an acceleration of 0.5 percentage points from the previous quarter, and non-food prices edged up by 2.5 percent, an acceleration of 0.6 percentage points from the previous quarter, revealing an accelerated growth rate. Six out of the seven categories of the non-food items registered positive growth (except for the category of transportation and communications, which dropped 0.1 percent year on year). Broken down by consumer

[4] Statistically large enterprises in and before the 2010 refer to those enterprises with income of over 5 million yuan from their main operating activities, and from 2011, the scope of statistics has changed to those industrial enterprises with income of over 20 million yuan from their main operating activities.

goods and services, the prices of consumer goods grew by 5.4 percent, up 0.1 percentage points from the previous quarter, and the prices of services were up 4.2 percent, an obvious acceleration of 1.6 percentage points from the previous quarter. In terms of the base period factor and the new price-rising factor, in the three months of the first quarter, the base period factor was up 4.0 percent, 2.7 percent, and 3.4 percent respectively, averaging 3.4 percent, whereas the new price-rising factor gained 0.9 percent, 2.2 percent, and 2.2 percent, averaging 1.7 percent. In terms of quarter-on-quarter data, except for the category of entertainment, education, and cultural products and services whose average quarter-on-quarter increase in the first quarter was at par with the average historical level, the CPI and price increases of the other categories all rose quarter on quarter above the historical average level.

Figure 10: Quarter-on-Quarter CPI in Q1 2011 versus Historical Average Level



Source: National Bureau of Statistics and Calculations by the People's Bank of China Staff

Producer prices grew rapidly. In the first quarter, ex-factory producer prices[5] of industrial products gained 7.1 percent year on year, an acceleration of 1.4 percentage points from the previous quarter. The monthly price hike was 6.6 percent, 7.2 percent, and 7.3 percent respectively year on year. The producer purchase prices increased by 10.2 percent year on year, representing an acceleration of 1.1 percentage points from the previous quarter, and the increase in the three months posted 9.7 percent, 10.4 percent, and 10.5 percent respectively year on year. In the first quarter, the Corporate Goods Price Index (CGPI) grew 8.7 percent, an acceleration of 0.6 percentage points from the previous quarter, registering the second quarterly increase in succession. Broken down by the application of goods in the CGPI basket, the prices of investment goods and consumer goods rose 8.1 percent and 9.8 percent respectively. Broken

[5] The National Bureau of Statistics began using a new method for PPI statistics beginning in January 2011. "Ex-factory prices of industrial products" and "the purchase prices of raw materials, fuel, and power" were renamed "ex-factory producer prices" and "producer purchase prices" respectively.

down by categories within the basket of the CGPI, the prices of agricultural products, mineral products, coal, oil, and electricity, and processed products were up 19.3 percent, 14.1 percent, 7 percent, and 6.4 percent respectively. In the first quarter, the producer prices of agricultural products (the prices at which farmers sell their products) climbed by 15.6 percent, 8.7 percentage points higher than the increase in prices of agricultural capital goods during the same period, thus being conducive to increasing farmer incomes.

The import price hike was rapid. In the three months of the first quarter, import prices went up by 11.7 percent, 16.6 percent, and 15.5 percent respectively, averaging 14.6 percent. Export prices grew by 11.0 percent, 11.4 percent, and 7.5 percent respectively in the three months, averaging 10.0 percent. The faster import price hike was mainly due to the continuously rising commodity prices in the international market. In the first quarter, the average price of crude oil futures trading on the New York Mercantile Exchange grew 11.8 percent quarter on quarter, or 12.0 percent year on year. The average spot prices of copper on the London Metal Exchange were up by 21.2 percent quarter on quarter, or 37.7 percent year on year. The average prices of copper and aluminum trading on the London Metal Exchange posted quarter-by-quarter growth of 6.1 percent and 11.4 percent respectively, or 33.2 percent and 15.6 percent year on year. The National Development and Reform Commission twice raised the prices of oil products according to the existing oil product-pricing mechanism and in view of the changes in oil prices on the international market. Starting from February 20, the prices of petrol and diesel were increased by 350 yuan per ton, and starting from April 7, by 500 yuan per ton and 400 yuan per ton respectively.

Box 4: Commodity Prices

A commodity usually refers to standardized materials sold or purchased in bulk and used for production and consumption, including three major categories: first, gold, crude oil, and other commodities with metal properties with strong value preservation function; second, raw materials such as non-ferrous and ferrous metals; third, agricultural products including soy beans, sugar, wheat, cotton, and rubber. At present, the prices of most commodities are determined by major international futures markets. For example, the West Texas Intermediate (WTI) futures price is an important reference for the crude oil price on the international market. Major indices measuring the price changes of commodities include Reuters CRB Index, the Standard & Poor’s Goldman Sachs Commodity Index (S&P GSCI), and the IMF Commodity Index. These indices usually include futures prices or stock prices of commodities sensitive to the economy, and their weights are dynamically adjusted according to trading or producing volumes of these commodities, so they can reflect the general changes in commodity prices on the international market in a timely manner.

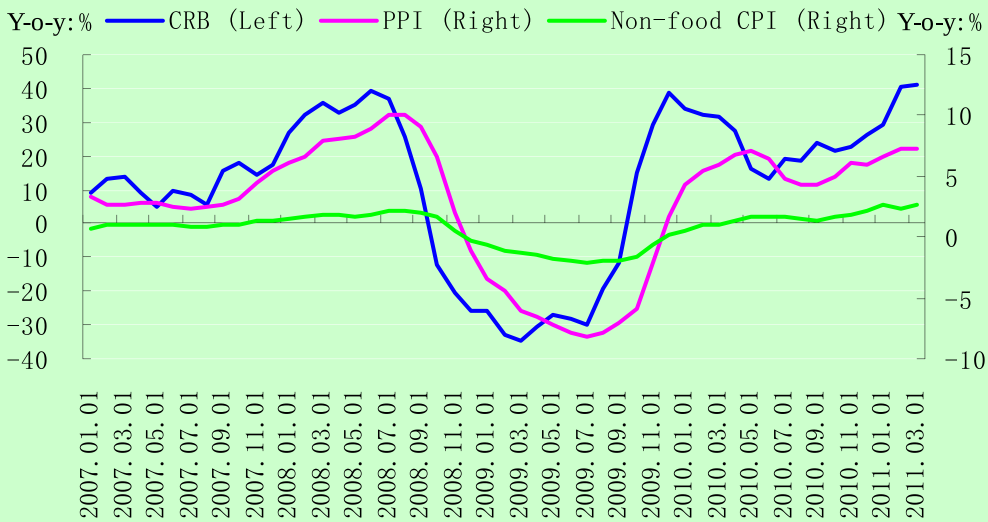
Factors that influence changes in commodity prices are rather complex, and can be roughly divided into three categories: First, supply factors in the real economy. As most commodities are non-renewable energy and raw materials of a resource nature, whose supply is rather rigid, the more robust the growth of the real economy, the larger the demand for energy and raw materials, and, as a result, the stronger the dynamics pushing up the prices. The second category is financial factors, i.e., liquidity, US dollar exchange-rate changes, and speculation activities. Generally, the more liquidity there is in the market and the more active speculation there is, the more rapidly the prices of commodities will increase. In addition, as commodities are priced in US dollars, a dollar appreciation will lead to a price decrease of commodities, and vice versa. The third group of factors is short-term factors, such as unexpected events, the climate, and geopolitical issues that will heighten short-term fluctuations of commodity prices by influencing expectations.

The volatility of commodity prices influences domestic prices mainly through their effects on import prices and expectations, and the degree of their influence is mainly determined by three factors: first, the dependency on the imported commodities; second, supply and demand of consumer products in the domestic market; third, resource utilization efficiency. In terms of import dependency, China's dependency on imported crude oil, iron ore, copper, and other energies and metals exceeds 50 percent, and a price hike in these commodities will greatly influence the PPI and the prices of industrial finished products (non-food items) that mainly rely on the input of energy and raw materials. Conversely, the import dependency of agricultural products is relatively low, so grain price fluctuations have a relatively small effect on domestic food prices. In terms of supply and demand in the domestic consumer goods market, there is either an oversupply or a balanced supply and demand of most industrial finished products, so the influence of the prices of commodities in the international market on the CPI is generally smaller than their effect on the PPI. In terms of resource utilization efficiency, in 2009 per unit of GDP energy consumption in China was 2.78 times that of the world average, and electricity consumption was 3.5 times that of the OECD countries. Therefore, the influence of price hikes of commodities in the international market on China's price levels is greater than that on developed countries that utilize resources more efficiently. In contrast, Japan's resource utilization efficiency is high. As a result, although Japan imports most energy and raw materials, substantial price hikes of imported commodities have only a small influence on Japanese domestic prices.

In recent years, with the rapid economic development and increasing dependency on imported commodities, price movements of commodities in the international market have had a greater influence on domestic prices. After the international financial crisis, commodity prices experienced drastic fluctuations, first plummeting and then increasing rapidly. Movements of China's domestic PPI and the non-food CPI are generally in line with the CRB movements. Since the beginning of 2011, impacted by the recovery of the global economy, the loose monetary policies of the major economies, and the geopolitical conflicts, the prices of crude oil and other commodities rose rapidly, heightening the pressures on domestic prices.

To deal with the impact of price fluctuations of commodities in the international market, we need to improve the reserve system of important energy and raw material items, guarantee supply security by exploring international and domestic resource markets through various channels, accelerate strategic adjustment of the economic structure and the shift in the development pattern, improve the efficiency of resource utilization, accelerate the reform of the resource-pricing mechanism, and reduce the demands of economic development for resources, thus fundamentally strengthening the ability to mitigate the impact of price volatility of international commodity prices.

Figure 11: CRB Futures Price Index and PPI, Non-food CPI in China



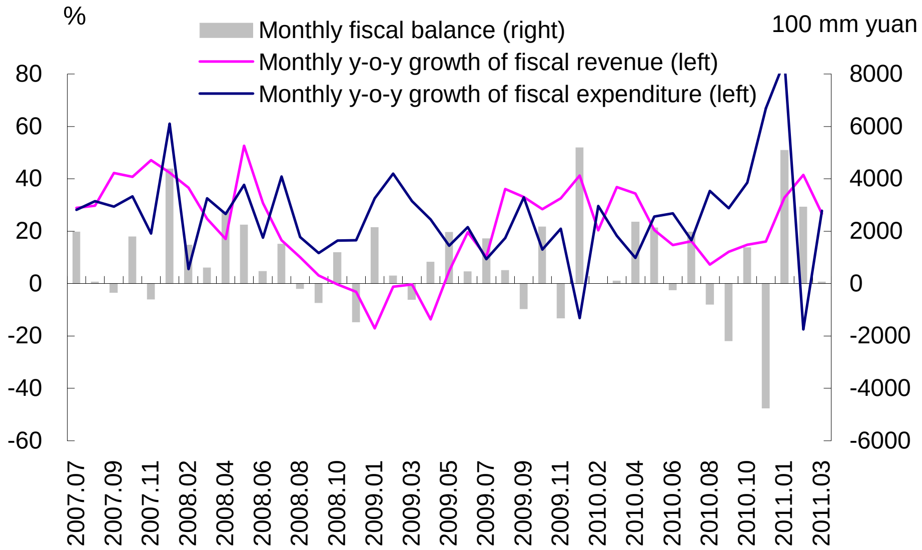
Source: WIND; Calculation by the People's Bank of China Staff

The GDP deflator continued to rise. The GDP in the first quarter registered 9.6 trillion yuan, up 9.7 percent year on year in real terms. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 7.2 percent, up 2.4 and 1.4 percentage points respectively from the same period of the previous year.

4. Fiscal revenue maintained rapid growth, and growth of fiscal expenditures for medical services, social security, and employment accelerated

In the first quarter, fiscal revenue (excluding debt income) surged by 33.1 percent year on year to 2.6 trillion yuan, representing a deceleration of 0.9 percentage points, whereas fiscal expenditures registered 1.8 trillion yuan, up 26 percent year on year and an acceleration of 14.1 percentage points from the same period of the previous year. As a result, revenue was 807.2 billion yuan more than expenditures, representing an increase of 277.5 billion yuan from the same period of the previous year.

Figure 12: Monthly Year-on-Year Growth of Fiscal Revenue and Expenditures and the Fiscal Balance



Source: Ministry of Finance, the People's Bank of China

As for the structure of fiscal revenue, tax revenue in the first quarter posted 2.34 trillion yuan, up 32.4 percent year on year, representing a deceleration of 3.5 percentage points from the same period of the previous year. In particular, domestic VAT, business tax, and consumption tax revenue were up 23.2 percent, 26.3 percent, and 21.5 percent year on year respectively. Within the expenditure basket, the three largest items were social security and employment (283.24 billion yuan, or 15.7 percent of the total spending), education (259.33 billion yuan, or 14.4 percent of the total spending), and general public services (206.15 billion yuan, or 11.4 percent of the total spending). Among all items in the basket, expenditures on medical services, and social security and employment registered relatively rapid growth at 55.6 percent, and 44.5 percent year on year respectively.

5. The balance of payments continued to run a "dual surplus"

In 2010 China's balance of payments (BOP) continued to run a surplus in both the current account and the capital and financial account, and international reserves assets continued to rise. In particular, the current account grew by 17 percent year on year to US$305.4 billion, the capital and financial account surplus was up 25 percent to US$226 billion, and the international reserves assets grew by US$469.6 billion. In the first quarter of 2011, against the background of the complex and ever-changing macroeconomic conditions both at home and abroad, China's foreign exchange was generally in a position of net influx, with a rapid build-up of foreign exchange. As of end-March, foreign exchange reserves posted US$3044.7 billion, an increase of US$197.4 billion from end-2010. Due to the combined influence of economic fundamentals both at home and abroad, the interest spread, expected exchange gains, and other factors, it is expected that China will continue to have net inflows of foreign exchange in the coming three quarters.

The volume of external debt grew rapidly, and the share of short-term debt increased. As of end-2010, the stock of China's external debt stood at US$548.9 billion, up 28.1 percent from the end of 2009, an acceleration of 13.7 percentage points from the previous year. Among this total, the stock of registered external debt posted US$337.7 billion, up 26.5 percent from the end of 2010; short-term external debt posted US$375.7 billion, a year-on-year increase of 44.9 percent, accounting for 68.4 percent of the stock of external debt, and representing an acceleration of 8.0 percentage points from end-2010.

6. Sectoral analysis

Industrial profits grew rapidly. In the first quarter, among all 39 industrial sectors, 37 sectors reported year-on-year growth in profits, one industry experienced a year-on-year decline in profits, and one industry reported a decline in losses. Among the industries, the profits of the oil and natural gas exploration industry grew 33.1 percent year on year, the mining of ferrous metals industry experienced growth of 80.1 percent, and profits of the chemical fiber production industry doubled, but the oil processing, coking, and nuclear fuel processing industry declined by 17 percent. In the first quarter, crude coal output grew by 18.8 percent year on year to 840 million tons, power generation increased 13.4 percent to 1065.07 billion kilowatts hour, and the output of crude oil grew 6.7 percent to 51.356 million tons. In the first two months, a total of 5.21 tons of cargo were handled, up 13.2 percent year on year.

(1) The real estate sector

In the first quarter, with the implementation of a series of macroeconomic policies targeting the real estate sector, the real estate sector continued to stabilize, more cities reported a month-on-month decline in housing prices, and real estate loans issued by the major financial institutions decelerated.

Sales of commercial real estate decelerated from the same period of the previous year, but accelerated slightly compared to the annual figure in 2010. Growth in the sold floor area and sales value pulled back rapidly since end-2009, but went up after September 2010. In the first quarter of 2011, the sold floor area of commercial real estate was up 14.9 percent year on year to 176.43 million square meters, representing a deceleration of 20.9 percentage points from the same period of the previous year, but an acceleration of 4.8 percentage points from the annual figure in 2010. Sales of commercial real estate were up 27.3 percent year on year to 1015.2 billion yuan, representing a deceleration of 30.4 percentage points from the same period of the previous year but an acceleration of 9 percentage points from the annual figure in 2010. In particular, the sold area and the sales value of commercial residential housing accounted for 89.8 percent and 84.8 percent of the sold area and sales value of commercial housing respectively.

More cities reported a month-on-month decline in housing prices. The National Bureau of Statistics began using a new statistical system starting in 2011. In March, 12 out of 70 large- and medium-sized cities experienced a month-on-month drop in housing prices, 4 cities more than in February; 50 out of 70 cities reported a month-on-month increase in housing prices, 6 less than in February. About 16 cities reported a month-on-month decline in prices of pre-occupied housing, 12 more than in February; 44 cities reported a month-on-month increase, 6 less than in February.

Investment in real estate development continued to grow rapidly. Throughout 2010, the monthly growth of cumulative investment in real estate development was over 30 percent, but the growth decelerated slightly after May. In the first quarter, completed investment in real estate development totaled 884.6 billion yuan, up 34.1 percent year on year, representing a deceleration of 1 percentage point from the same period of the previous year, but an acceleration of 0.9 percentage points from 2010. In particular, completed investment in commercial residential housing reached 625.3 billion yuan, accounting for 70.7 percent of the total investment in real estate development. In the first quarter of 2011, the floor area of newly built housing increased by 23.4 percent year on year to 398 million square meters, representing a deceleration of 37.4 percentage points from the same period of the previous year and a deceleration of 17.3 percentage points from 2010.

The expansion of outstanding real estate loans decelerated. With the changes in the real estate market, growth of outstanding real estate loans moderated from May 2010. As of end-March 2011, the outstanding real estate loans of the major financial institutions reached 9.89 trillion yuan, up 21 percent year on year and a deceleration of 6.4 percentage points from end-2010. In particular, outstanding land development loans were up 18.6 percent year on year to 2.49 trillion yuan, representing a deceleration of 4.5 percentage points from end-2010, the fourth consecutive monthly decline . Outstanding mortgage loans posted year-on-year growth of 22.8 percent to 6.48 trillion yuan, representing a deceleration of 6.5 percentage points from end-2010, the eleventh consecutive month of decline. Outstanding housing development loans were up 12.5 percent year on year to 836.8 billion yuan, representing a deceleration of 12.2 percentage points from end-2010. In the first quarter, new real estate loans posted 509.5 billion yuan, a year-on-year decrease of 333.8 billion yuan. In particular, new loans in March reached 166.5 billion yuan, about 32.1 billion yuan less than that during the same period of the previous year.

In order to consolidate and expand the results of the price-containing measures, further improve regulation of the real estate market, gradually resolve the housing difficulties of urban dwellers, and promote stable and healthy development of the real estate market, the General Office of the State Council issued the *Notice of the General Office of the State Council on Issues Relating to Further Improvements in Real Estate Market Regulatio*n (Guo-Ban-Fa [2011] No. 1, hereinafter referred to as Guo-Ban-Fa No. 1 Document) on January 26, 2011, and local governments subsequently issued related measures. In order to carry out the principles laid out in the Guo-Ban-Fa No. 1 Document, and to improve the differentiated housing credit policies, the PBC issued the *Notice on Improving the Differentiated Mortgage Loan Policies* (PBC Document No. 66 [2011]) on March 18, clarifying the basic conditions, procedures, and regulatory requirements for different localities to carry out the differentiated mortgage lending policies, and urged financial institutions to strictly carry out the differentiated mortgage loan polices.

In view of the status quo in government-subsidized housing, the PBC worked with other relevant government agencies to establish and improve an institutional framework to render financial support for the building of government-subsidized housing; as a result, credit support by financial institutions to government-subsidized housing was continuously strengthened. At end-March 2011, outstanding loans extended by the major financial institutions to government-subsidized housing amounted to 227.43 billion yuan, and outstanding mortgage loans for the purchase of government-subsidized housing posted 25.102 billion yuan.

(2) The agricultural sector

The agricultural sector is a basic sector in the national economy. In recent years, according to the basic principles of industry supporting agriculture, urban areas supporting rural areas, and the policy of “giving more, taking less, and loosening control,” the Central Committee of the Communist Party of China (CPC) issued eight No.1 documents on *sannong* (agriculture, rural areas, and farmers) over eight consecutive years to continuously strengthen policy support; as a result, the agricultural sector and rural economy performed well and grew relatively rapidly. The overall capacity of agricultural production improved noticeably, and the supply of grain and other major agricultural products remained adequate. In 2010, total grain production was above 500 billion kilograms for the fourth consecutive year, marking the seventh year of an increase. Farmers’ income continued to grow and the sources of their income became more diversified. In 2010, the per capita net income of farmers posted 5919 yuan, up 10.9 percent in real terms, outpacing GDP growth. In particular, wage income accounted for 41.4 percent of the total income. More efforts were made to promote agricultural-related technology, and agricultural production became more machine-based. In 2010 science and technology contributed 52 percent to growth in the sector, in comparison to 48 percent in 2005. Crop varieties accounted for over 96 percent of the total crops. The combined use of machines in breeding, planting, and harvesting exceeded 50 percent for the first time in history. In recent years, the reform and innovation of financial institutions in the rural areas have been promoted on a continual basis, playing an important role in carrying out the national policies of supporting agriculture and farmers and in maintaining the momentum of economic and social development in the rural areas. As of end-November 2010, around 30 provinces had achieved full coverage of financial services in townships, and 10 provinces had achieved full coverage of financial institutions in townships. As of end-2010, outstanding agro-linked loans of all financial institutions reached 11.8

trillion yuan, including 2.3 trillion yuan to agriculture, forestry, animal husbandry, and fishery. The credit lending has effectively supported agricultural industrialization and promoted the modernization of the agricultural sector.

Despite the good performance in the agricultural sector and the sound economic development in the rural areas, in general the agricultural sector is still a weak link in the national economy, facing a lot of problems and challenges. First, the development pattern is still extensive, and the ability to mitigate natural disasters is not strong. The agricultural infrastructure is relatively backward, and the land output ratio, resource utilization ratio, and labor productivity are still low. According to the Ministry of Agriculture, medium- and low-yield land accounts for 70 percent of the arable land, effectively irrigated farmland only accounts for 50 percent of the total arable land, nearly two-thirds of the agricultural technology-promoting agencies are incapable of providing socialized services, and the status quo of "depending on Heaven for food" fundamentally has not been addressed. Second, it has become increasingly difficult to guarantee national food security and to supply the major agricultural products. Due to the backward production methods, agricultural growth mainly relies on resource inputs. In terms of resources, the arable land area decreased from 1.951 billion mu (1 mu=666.67 square meters) in 1996 to 1.826 billion mu in 2010, close to the alarm threshold of 1.8 billion mu. China is short of fresh water, and its geographical and seasonal distribution is uneven. Some localities extract underground water exceeding the prescribed volume, and water shortages have become a bottleneck constraining agricultural development in many regions. At the same time, demand for agricultural products has continued growing rather rapidly, highlighting the conflict between supply and demand of grain and other major agricultural products. Third, the costs of agricultural production have risen markedly and it has become more difficult to maintain price stability of grain and other major agricultural products. In recent years, with the agricultural labor force continuing to flow into the manufacturing industry, the construction industry, and other non-agricultural sectors, the supply of an agricultural labor force is inadequate, and labor costs in the agricultural sector are moving closer to those in the manufacturing sector. Affected by price factors for resource products both at home and abroad, the prices of fertilizers, animal feed, pesticides, seeds, agricultural machinery, and other capital goods for the agricultural sector have continued to grow. Fourth, with the further opening-up of the agricultural products market in China, prices of agricultural products in the domestic and international markets are increasingly interconnected, and fluctuations of food prices in the global market will influence the prices of grain and agricultural products in the home market, in particular the prices of soybeans and other agricultural products that depend on imports.

The agricultural sector is the key to stabilizing economic growth, containing inflation, and restructuring the economy. The Report on the Work of the Government reiterates that we need to strengthen the fundamental role of agriculture, prioritize efforts related to agriculture, rural areas, and farmers, promote agricultural modernization while deepening industrialization and urbanization, and consolidate and develop a good momentum in the rural areas. The PBC will work closely with other relevant departments to deepen the reform of the rural credit cooperatives, speed up the building of a multi-layered, diversified, and modestly competitive financial service system for the rural areas, push ahead with innovation in rural credit products and services, improve the rural financial market system, including credit, securities, and insurance, and put into better play the important role of financing to support the development of agriculture, rural areas, and farmers.

Part 5 Monetary Policy Stance in the Next Period

I. Outlook for the Chinese economy

At this current juncture, due to the mix of a series of policy measures, the momentum of steady and fairly rapid economic growth has been maintained. The world economy has generally maintained the momentum for recovery amidst fluctuations, and the external environment has generally improved. Local governments have strong investment incentives, room for consumption growth is vast, and urbanization can help bring down transaction costs, driving the labor force and other productive factors to flow to and concentrate in more efficient sectors, thus forming new growth points. In general, the dynamism for sustained economic growth remains strong. According to the business survey, bankers' survey, and urban depositors' survey conducted by the PBC in the first quarter of 2011, the major indices have remained stable and fairly high. The household income sentiment index was flat with the level in the previous quarter; the employment sentiment index improved to a record high since 2009; the market demand index and the domestic order index were up 1.7 percentage points and 2.0 percentage points respectively from the previous quarter; the export orders index increased for the first time since the second quarter of 2010, up 3.8 percentage points from the previous quarter. Financial institutions report a large volume of pipeline projects and enterprises have a strong demand for credit, so pressures for expansionary lending remain. Thus, aggregate credit must be managed well. At the same time, given the growing pressures of economic restructuring, weak innovative capabilities, stronger resource and environment constraints, and the arduous task of improving the people's livelihood, it is necessary to make greater efforts to achieve balanced and sustainable growth driven by endogenous factors. With the declining growth in the working-age population and the gradual shift in the economic development pattern, potential economic growth might slow down to some extent. More attention should be given to improving productive efficiency through economic restructuring and reform, enhancing independent innovative ability, improving the quality of economic growth, and creating more room for future economic growth.

With the economic growth momentum becoming more entrenched, the rapid price increases have become the most acute problem facing economic development. It should be noted that money and credit growth has continued to decline since the latter half of 2010, and the series of price management measures are still unfolding. Crop output increases, abundant inventories, and adequate supplies of industrial products will help contain further price hikes. However, against the backdrop of extended loose monetary conditions throughout the world, generally adequate liquidity, rapid fund flows into the emerging market economies, generally good economic performance, and rapid and sustained increases in the prices of commodities, inflationary pressures will build up worldwide. In addition, investments in China have expanded massively in order to deal with the international financial crisis, resulting in a large number of projects under construction and a rapid rebound of social demand. The combination of all these factors will push up inflationary expectations and increase pressures for price hikes. Meanwhile, due to the Balassa-Samuelson effect and the moderated growth of the working-age population, the increase in labor costs related to agricultural products and services might exceed their respective productivity growth, thus pushing up prices. At the same time, prices of resource products are yet to be rationalized. These factors are likely to systematically shore up the price levels. Macroeconomic policies need to prevent mutually reinforcing interactions between structural and entrenched price hikes and inflationary expectations, which will heighten inflationary pressures. The survey of urban depositors conducted by the PBC in the first quarter of 2011 shows that residents' expectations of further price hikes have weakened somewhat, which indicates that the effects of the macroeconomic policies are unfolding. However, in general, inflationary expectations remain at a high level. A large proportion of residents believe that current housing prices are too high, reaching the second highest level since the survey began in the first quarter of 2009.

II. Monetary policy in the next stage

Going forward, the PBC will make acceleration in the shift of the economic development pattern a priority, implement the prudent monetary policy, manage well the pace and intensity of macroeconomic management policies, maintain policy consistency and continuity, and make policy measures well-targeted, more flexible, and effective in line with the general arrangements of the State Council and the theme of scientific development. On the one hand, the PBC will manage well the relationship between controlling monetary aggregates and adjusting the economic structure. While satisfying reasonable demand for capital for the sake of economic development, the PBC will endeavor to eliminate monetary conditions that cause inflation and will focus on structural optimization, so as to better meet diversified investment and financing demands. On the other hand, the PBC will manage well the relationship between promoting economic growth and containing inflation. At the current juncture, the growth rate and employment rate are both within a reasonable range, so it is essential to stabilize price levels and manage well inflationary expectations, which is also the top priority of macroeconomic management. The intensity of management policies must be maintained at a necessary level, the achievements of the previous management policies should be consolidated and strengthened, and the good economic development momentum must be sustained.

First, measures will be adopted to continue to strengthen liquidity management and to keep the growth of money and credit at appropriate levels. The reserve requirement ratio is an instrument to deal with excess liquidity caused by flows of foreign exchange funds, whose intensity of use and room for further adjustment depend on a number of variable conditions; therefore, there is no absolute limit for its intensity of use and scope for adjustment. It is necessary to apply a mix of monetary policy instruments, including open market operations and the reserve requirement ratio, to properly arrange the mix and maturity structure of these instruments as well as the strength of operations, to strengthen liquidity management, to keep liquidity in the banking system at appropriate levels, to properly manage aggregate liquidity, and to maintain the reasonable growth of money and credit in line with the changing economic and financial situations and the flows of foreign exchange funds. The PBC will continue to use interest rates and other price-based management measures to adjust funding demands and will manage investment and savings behavior in accordance with the changing situations, so as to manage inflationary expectations. Efforts will also be made to monitor and adjust aggregate social financing and to keep the size and pace of financing at appropriate levels.

Second, the establishment of a macro-prudential policy framework will be promoted to supplement conventional monetary policy instruments. Management and adjustment of aggregate money, credit, and liquidity will be combined with stronger measures of macro-prudential regulation, and this combination will be properly adjusted in line with the changing macroeconomic situations and the soundness of the banking system. The PBC will continue to implement dynamic adjustment measures of differentiated reserve requirement ratios in order to guide and encourage financial institutions to perform soundly, to manage their lending, and to strengthen the resilience of financial institutions against shocks. It will enhance mitigation of systematic risks. The PBC will continue to strengthen management of risks associated with lending and off-the-balance-sheet assets of local financing platform companies and real estate financing.

Third, efforts will be made to guide financial institutions to improve the credit structure to strengthen financial support to the real economy. The PBC will guide financial institutions to manage well the pace of lending, to beef up innovation of financial products and services, and to increase support to priority areas and weak links. Financial institutions will be urged to improve support to strategic and emerging industries, energy conservation and environmental protection industries, modern service sectors, and projects of independent innovation in science and technology, strictly control lending to industries that consume excessive energy and pollute heavily and industries with excess capacity, and support development of a low-carbon economy, in accordance with the requirements of economic restructuring and the shift in the economic development pattern. More funds will be channeled to the rural areas, agricultural sector, farming households, and SMEs, and financial services will be provided to support job creation, students in need, and poverty reduction. Consumer credit services will be developed to boost domestic demand. Financial support will be continued to support balanced regional development. The differentiated mortgage credit policy will be implemented to promote the healthy development of real estate financing. The ratio of medium- and long-term loans versus short-term loans will be properly adjusted.

Fourth, the market-based interest rate reform and the RMB exchange rate regime will be advanced. Efforts will continue to develop benchmark interest rates on the money market (Shibor) and to improve the pricing capability of financial institutions, advance the market-based interest rate reform in a well-sequenced manner through various measures such as selecting financial institutions with strong discipline and gradually liberalizing prices of substitute financial products, according to the overall arrangements of the 12th Five-Year Plan. The PBC will, in accordance with the principle for reforming the RMB exchange rate regime in a self-initiated, controllable, and gradual manner, further improve the RMB exchange rate regime based on market supply and demand with reference to a basket of currencies, allow market demand and supply to play a fundamental role in the exchange rate regime, increase the flexibility of the RMB exchange rate, keep the exchange rate basically stable at an adaptive and equilibrium level, and promote a balance in the BOP accounts. The PBC will steadily promote the use of RMB in cross-border trade and investment activities and expand channels for RMB to flow in and out of China. Measures will be taken to deepen the reform of the foreign exchange management system and to stop the inflow of hot money through illegal channels.

Fifth, the PBC will continue to promote the healthy development of financial markets and to deepen the reform of financial institutions. Financial markets will play a fundamental role in resource allocations. Direct financing will be expanded. The role of financing instruments, such as stocks, bonds, and industrial funds, will be leveraged to improve the institutional framework and infrastructure in the financial market, so as to promote financial markets to support the development of the real economy. The opening-up of the interbank bond market will be actively and prudently advanced. The reform of financial institutions will be deepened to improve the delivery and quality of financial services so that they assume their social responsibilities. The reform of the Agricultural Bank of China will be promoted, and the reform of its Agricultural and Rural Business Division will be advanced to improve services for the agricultural sector, the rural areas, and farmers. The transformation of the China Development Bank into a commercial bank will be advanced. The reform of the Import and Export Bank of China and the China Export and Credit Insurance Corporation will be accelerated. Ex-ante studies on the reform of the Agricultural Development Bank of China will be conducted.