China Monetary Policy Report
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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the first half of 2011 the Chinese economy was moving gradually from policy-stimulus-driven to endogenous growth, in line with the direction intended by macroeconomic management. Consumer demand remained stable, fixed asset investment increased rapidly, imports and exports grew in a stable and relatively brisk manner, agricultural production performed well, industrial enterprises achieved fairly good profitability, and household income grew, but expectations of domestic inflation remained strong and the basis for price stability was still not solid. In the first half of 2011, the Gross Domestic Product (GDP) registered 20.4 trillion yuan, up 9.6 percent year on year. The Consumer Price Index (CPI) rose by 5.4 percent year on year.

Since the beginning of 2011, the PBC, in accordance with the overall arrangements of the State Council, took inflation control as the top priority of macroeconomic management, implemented a prudent monetary policy, and employed a mix of price-based and quantitative monetary instruments, as well as macro-prudential tools. The reserve requirement ratio was increased six times by 3 percentage points cumulatively, and the benchmark deposit and loan interest rates were raised 3 times. In addition, the PBC conducted open market operations in a flexible way and adopted a dynamic mechanism for differentiated reserve requirement ratios to be adjusted on a continuous and case-by-case basis. Efforts were made to strengthen liquidity management, guide the growth of money and credit to return to a normal level, maintain a reasonable scale of all-system financing aggregate, and guide financial institutions to optimize their credit structure.

Due to the impacts of several macroeconomic management measures, the growth of money and credit continued to return to their normal level. At the end of June 2011, broad money supply M2 recorded 78.1 trillion yuan, up 15.9 percent year on year, a deceleration of 0.7 percentage points from the end of March 2011. Outstanding RMB loans grew 16.9 percent year on year, a deceleration of 1 percentage point from the end of March 2011 and 4.17 trillion yuan more than that at the beginning of 2011, a deceleration of 449.7 billion yuan year on year. In the first half of 2011, all-system financing aggregate posted 7.76 trillion yuan and the share of direct financing rose remarkably. The lending rates of financial institutions continued to move up. In June 2011, the weighted average lending rate offered to non-financial enterprises and other sectors reached 7.29 percent, up 0.38 percentage points from that in March. At end-June 2011 the central parity of the RMB against the US dollar was 6.4716 yuan, up 2.33 percent over end-2010.

Looking forward, the PBC will follow the theme of sustainable development, facilitate the transformation of economic growth pattern, earnestly implement a prudent monetary policy in accordance with the overall arrangements of the State Council, continue to regard price control as the top priority of macroeconomic management, and maintain its basic policy stance. Efforts will be made to strengthen monitoring and analysis of the economic situation at home and abroad, properly manage the pace and intensity of macroeconomic management, make macroeconomic management policies well-targeted, more flexible, and more forward-looking, maintain the effectiveness of the macroeconomic measures that were adopted during the previous stage, make good assessments of current and anticipated outcomes of the policy measures, and properly handle the relationship among preserving stable and fairly rapid economic growth, adjusting the economic structure, and managing inflation expectations.

In view of the economic and financial developments and the flow of foreign exchange funds, a combination of multiple policy tools will be used to keep the all-system financing aggregates at a proper volume, including interest rates, exchange rates, open market operations, the required reserve ratio, and macro-prudential measures. Measures will be taken to optimize the credit structure, improve financial services, and enhance credit support to facilitate economic structural adjustments, in particular to the agricultural sector and small enterprises. The differentiated mortgage credit policy will continue and loans will be promptly disbursed to qualified welfare housing projects to promote the healthy development of the real estate market. Efforts will be made to strengthen systemic risk prevention. Risk management of lending to local government financing platforms, off-balance sheet assets, and real estate financing will be enhanced. Effective measures will be adopted to enhance monitoring and management of cross-border capital flows. The market-based interest rate reform and the RMB exchange rate regime reform will be advanced. The PBC will continue to deepen the reform of financial institutions to enable financial markets to play a fundamental role in resource allocations. Direct financing channels will be expanded. Efforts will be made to support innovations in financial products that will enable the financial market to serve the real economy.

Contents

Part 1 Monetary and Credit Performance 1

I. The growth of money supply generally declined..1

II. Deposit growth of financial institutions slowed down 1

III. Loan growth of financial institutions returned to a normal level 2

IV. All-system financing aggregate remained at an appropriate level, with direct financing accounting for a larger share 4

V. Lending rates of financial institutions continued to rise 6

VI. The flexibility of the RMB exchange rate rose significantly 9

Part 2 Monetary Policy Operations..10

I. Timely and well-managed open market operations 10

II. The reserve requirement ratio was increased on six occasions and a mechanism to adjust the differentiated reserve requirement on a continuous and case-by-case basis was adopted 11

III. Benchmark deposit and lending rates increase 11

IV. Strengthened window guidance and credit policy guidance...12

V. Progress in the cross-border use of RMB 12

VI. Improvement in the RMB exchange rate regime 13

VII. Progress in the reform of financial institutions...14

VIII. Deepened reform of foreign exchange administration 15

Part 3 Financial Market Analysis..17

I. Financial market analysis 17

II. Institutional building in the financial market 24

Part 4 Macroeconomic Analysis 27

I. Global economic and financial developments 27

II. Analysis of China's macroeconomic performance...34

Part 5 Monetary Policy Stance for the Next Period.................................48

I. Outlook for the Chinese economy 48

II. Monetary policy during the next stage 49

Boxes:

Box 1 An overview of wealth management products issued by commercial banks..................5
Box 2 Cross-country comparison of interest rate liberalization...8
Box 3 SME operations and access to financing..38

Tables:

Table 1 RMB loans of financial institutions in the first half of 2011..3
Table 2 Shares of loans with rates floating at various ranges of the benchmark in the first half of 2011 7
Table 3 Average interest rates of large-value deposits and loans denominated in US dollars in the first half of 2011..7
Table 4 Fund flows among financial institutions in the first half of 2011..............................17
Table 5 Transactions of interest-rate derivatives in the first half of 2011 18
Table 6 Issuances of bonds in the first half of 2011 21
Table 7 Use of insurance funds, end-June 2011 23
Table 8 Macroeconomic and financial indices of the major economies..................................28

Figures:

Figure 1 Monthly RMB settlement of cross-border trade 13
Figure 2 Yield curves of government securities on the interbank market 20
Figure 3 Trends in crude oil prices...30
Figure 4 Movements of exchange rates of the major currencies...31
Figure 5 Movements in the yields of the major treasuries 32
Figure 6 Movements of the major stock indices 32
Figure 7 Continued rapid growth of GDP 35
Figure 8 Fixed-asset investments grew relatively rapidly...36
Figure 9 Y-o-y growth of imports and exports decelerated, the trade surplus reemerged.......37
Figure 10 Quarter-on-quarter CPI in Q2 2011 was notably higher than the historical average 41

Part 1 Monetary and Credit Performance

In the first half of 2011 China's economy and financial system performed soundly. The growth of money and credit supply moved toward a normal level as a result of implementation of the prudent monetary policy.

I. The growth of money supply generally declined

At end-June 2011, outstanding M2 registered 78.1 trillion yuan, up 15.9 percent year on year, decelerating 0.7 and 3.8 percentage points over end-March 2011 and end-2010 respectively. Outstanding M1 stood at 27.5 trillion yuan, an increase of 13.1 percent year on year, decelerating 1.9 and 8.1 percentage points over end-March 2011 and end-2010 respectively. Currency in circulation M0 totaled 4.4 trillion yuan, up 14.4 percent year on year, decelerating 0.4 and 2.3 percentage points over end-March 2011 and end-2010 respectively. In the first half of 2011, net cash withdrawals posted 11 billion yuan, 76.6 billion more year on year.

In general, with the adoption of a mix of monetary policy tools, including open market operations, the reserve requirement ratio, and interest rates, and macro-prudential tools, aggregate money growth declined steadily in line with the anticipation of macroeconomic management. At the end of May, the growth of M2 and M1 had declined by 4.6 and 8.5 percentage points respectively over end-2010. In June, the growth of money supply rebounded. M2 and M1 growth accelerated by 0.8 and 0.4 percentage points respectively over the previous month, signaling pressures for management of money aggregate.

At the end of June, outstanding base money registered 20.3 trillion yuan, up 32.7 percent year on year and 2.1 trillion yuan more than at the beginning of the year. At end-June, the money multiplier stood at 3.84, which was 0.10 and 0.08 lower than at end-March 2011 and end-2010 respectively. At end-June, the excess reserve ratio of financial institutions stood at 0.8 percent, and the excess reserve ratio of rural credit cooperatives (RCCs) posted 2.9 percent.

II. Deposit growth of financial institutions slowed down

At end-June 2011, the outstanding deposits in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, the same hereinafter) stood at 80.3 trillion yuan, up 17.5 percent year on year. Such growth was 1.2 and 2.3 percentage points lower than the growth at end-March 2011 and end-2010 respectively. The value of outstanding deposits at end-June had risen by 7.5 trillion yuan over that at the beginning of 2011, a deceleration of 53.3 billion yuan year on year. Outstanding RMB deposits registered 78.6 trillion yuan, up 17.6 percent year on year, decelerating 1.4 and 2.6 percentage points over end-Q1 2011 and end-2010 respectively. Their total value was 7.3 trillion yuan more than that at the beginning of 2011, a deceleration of 184.6 billion yuan year on year. Outstanding deposits in foreign currency posted US$256.4 billion at end-Q2, an increase of 17.9 percent year on year, or US$30.7 billion over that at the beginning of 2011, which was US$24.6 billion more than the growth during the same period of the previous year.

Broken down by sectors, household deposits grew quite rapidly whereas deposits of non-financial institutions stabilized. At end-June, outstanding household deposits stood at 33.4 trillion yuan, up 17.0 percent year on year, accelerating 0.9 percentage points over end-March and 0.5 percentage points over end-2010. This was also 3.3 trillion yuan more than that at the beginning of 2011, an acceleration of 554.7 billion yuan year on year. Outstanding RMB deposits of non-financial institutions totaled 29.4 trillion yuan, up 14.8 percent year on year, decelerating 1.8 and 6.7 percentage points over end-March and end-2010 respectively. Their total value was 1.6 trillion yuan more than that at the beginning of 2011, a deceleration of 1.3 trillion yuan year on year. Among this total, the growth of RMB deposits of non-financial institutions recovered 0.5 and 0.3 percentage points over May and April respectively, indicating stable growth. The growth of deposits and good corporate sales facilitated rapid growth of bankers' acceptances and brought about strong solvency and sound financial status in the corporate sector. In the first half of 2011, a total of 7.2 trillion yuan of bankers' acceptances were drafted, which was 1.9 trillion yuan more than that in the first half of 2010. The PBC business survey of 5,000 enterprises showed that the receivables turnover ratio of enterprises stood at 70 percent, up 1.1 percentage points year on year. The solvency and liquidity ratio of the corporate sector rose 0.7 and 2.0 percentage points respectively year on year, both hitting record highs since 2000. At end-June, outstanding fiscal deposits reached 3.6 trillion yuan, up 12.8 percent year on year and 974.8 billion yuan more than that at the beginning of 2011, an acceleration of 10.3 billion yuan year on year.

III. Loan growth of financial institutions returned to a normal level

At end-June outstanding loans in domestic and foreign currencies of all financial institutions reached 54.7 trillion yuan, up 16.8 percent year on year, decelerating 0.8 and 2.9 percentage points over end-March and end-2010 respectively and 4.4 trillion yuan more than the beginning of 2011, a deceleration of 388.8 billion yuan.

The growth of RMB loans continued to slow down. At end-June, outstanding RMB loans stood at 51.4 trillion yuan, up 16.9 percent year on year, decelerating by 1.0 and 3.0 percentage points respectively over end-March and end-2010 and 4.17 trillion yuan more than the beginning of 2011, a deceleration of 449.7 billion yuan. Among this total, new loans in June registered 633.9 billion yuan, 20.7 billion yuan more year on year. At present, credit demand is still robust. The strong local investment impulse added pressures to management of credit extensions. Broken down by sectors, loan growth in the household sector slowed down gradually, and that in non-financial institutions and other sectors remained relatively stable. At end-June, outstanding household loans increased 24.8 percent year on year, decelerating 3.5 and 12.8 percentage points respectively over end-March and end-2010 and 1.5 trillion yuan more than that at the beginning of 2011, a deceleration of 288.3 billion yuan. Among this total, the growth of home mortgage loans slowed down. Home mortgage loans grew by 487.7 billion yuan over the beginning of 2011, marking a deceleration of 382.8 billion yuan. Loans to non-financial institutions and other sectors increased by 14.1 percent year on year, 0.5 and 1.2 percentage points lower than end-March and end-2010 respectively, or 2.7 trillion yuan more than that at the beginning of 2011, decelerating by 188.5 billion yuan. Broken down by maturities, medium- and long-term loans grew 1.4 trillion yuan over the beginning of the year, a deceleration of 1.3 trillion yuan year on year. Bill financing was 142.2 billion yuan less than that at the beginning of 2011, or 510.9 billion yuan less than the decrease during the same period of the last year. Broken down by institutions, loan growth of Chinese-funded large-sized national banks decelerated significantly, whereas loan growth of national small- and medium-sized banks accelerated.

The growth of foreign currency-denominated loans rebounded. At end-June, outstanding foreign currency loans of financial institutions reached US$501.8 billion, up 22.2 percent year on year, accelerating 5.0 and 2.7 percentage points over end-March and end-2010 respectively, or US$51.3 billion more than that at the beginning of 2011, an acceleration of US$19.3 billion. Import and export financing increased by US$20.7 billion, marking an acceleration of US$8.4 billion. Overseas loans and medium- and long-term loans climbed by US$16.7 billion, an acceleration of US$8.1 billion.

Table 1 RMB loans of financial institutions in the first half of 2011

	First half of 2011		First half of 2010	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	20243	-4039	24282	-17180
Chinese-funded Small and Medium Banks Operating Nationwide②	13636	994	12643	-8962
Chinese-funded Small and Medium Local Banks③	2567	-233	2801	-1713
Rural Cooperative Financial Institutions④	7031	-571	7602	143
Foreign-funded Financial Institutions	284	-491	775	1101

Unit: 100 million yuan

Note: 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 amount of total 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 of 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: People's Bank of China

IV. All-system financing aggregate remained at an appropriate level, with direct financing accounting for a larger share

It is estimated that in the first half of 2011, all-system financing aggregates registered 7.76 trillion yuan, down 384.7 billion yuan compared with the same period of the previous year. Among this total, new RMB loans posted 4.17 trillion yuan, a reduction of 449.7 billion yuan. Foreign-currency denominated loans registered the equivalent of 336.1 billion yuan, an increase of 117.9 billion yuan year on year. New entrusted loans reached 702.8 billion yuan, up 382.9 billion yuan year on year. Trust loans increased by 91.3 billion yuan, an increase of 510.2 billion yuan. Bankers' acceptances grew 1.33 trillion yuan, decelerating by 44.1 billion yuan. Net financing through corporate bonds registered 658.8 billion yuan, accelerating by 9 billion yuan. A total of 267.7 billion yuan was raised by domestic non-financial institutions via the stock market, up 27.4 billion yuan year on year.

The financing structure was characterized by the following: First, RMB loans accounted for a smaller share of the total, whereas other forms of financing rose significantly, both in absolute value and as a percentage of the total. In the first half of 2011, new RMB loans accounted for 53.7 percent of the all-system financing aggregates, decelerating 3.2 percentage points. Financing other than RMB loans stood at 3.59 trillion yuan, accelerating by 64.9 billion yuan. Second, foreign currency-denominated loans held a much larger share. In the first half of the year, the share of new foreign currency-denominated loans was 4.3 percent of the all-system financing aggregates, up 2.0 percentage points year on year. Third, off-balance sheet financing of financial institutions for the real economy declined. In the first two quarters of 2011, financial institutions newly financed 2.12 trillion yuan through off-balance sheet channels, such as entrusted loans, trust loans, and bankers' acceptances, accounting for 27.3 percent in the all-system financing aggregates, a deceleration of 0.9 percentage points year on year. Specifically, the shares of new entrusted loans, bankers' acceptances, and trust loans of the all-system financing aggregate were 9.1 percent, 17.1 percent, and 1.2 percent respectively, indicating an acceleration of 5.1 percentage points, an acceleration of 0.2 percentage points, and a deceleration of 6.2 percentage points respectively year on year. Fourth, non-banking financial institutions played a more important role in supporting the real economy. From January through June, compensation payments by insurance companies and new loans extended by micro credit companies and loan companies totaled 196 billion yuan, marking a significant acceleration. Fifth, direct financing became more important. In the first half of the year, a total of 926.5 billion yuan was raised by enterprises through corporate bonds and domestic stocks, accounting for 11.9 percent of the all-system financing aggregates, hitting a record high and also accelerating 1.0 percentage points year on year. Among this total, the share of net financing via corporate bonds and via the domestic stock market stood at 8.5 percent and 3.4 percent respectively of the all-system financing aggregates, each accelerating by 0.5 percentage points.

Box 1 An overview of wealth management products issued by commercial banks

Wealth management products are investment and fund management programs sold and operated by banks. Banks may design and operate such products independently or jointly with trust companies and securities companies. At present, there is a wide range of wealth management products on the market. Based on their differences in contract content, the application of accounting standards, and different risk-sharing and identification rules for external audits, they fall into two categories, namely balance sheet and off-balance sheet wealth management products. Wealth management products on the balance sheets of banks are covered by money and credit statistics. Off-balance sheet wealth management funds going into the real economic sector are also counted as part of the all-system financing aggregates, which is a new statistical measure adopted by the PBC at the beginning of 2011 to adapt to the rapid development of the financial market and the diversification of financing sources.

Banks usually set an expected return rate of wealth management products by deducting the relevant expenses (such as commissions, sales expenses, and so forth) from the expected yields of the investment funds they manage, in line with the profitability request. The investment portfolios of wealth management funds usually cover market-priced securities, bonds, trust products, and so on. The return varies with the market movements. Investors are exposed to risks when investing in wealth management products, just like other investments, and different wealth management products have different risk-return features. Some are capital-guaranteed wealth management products, whereby they are the banks' proprietary business and there are fewer risks for clients. Some are non-capital guaranteed wealth management products, which are fee-based businesses run by the banks as agents for the clients. The risks of such products are fully shouldered by the investors. Before purchase, an investor should go through the relevant contracts and notices very carefully to understand the potential risks, evaluate the risks and returns, and make prudent decisions based on his risk tolerance. The transaction volume over a period of time or the outstanding balance at a point in time is used in financial statistics, and it is common practice to use the outstanding balance as the measure of the stock, and the change in the outstanding balance as the measure of the growth of the financial business during a certain period. Most wealth management products have short maturities, and new products are issued upon the maturity of old products. Therefore, the transaction volume is much larger than the outstanding balance and also much larger than the growth of the outstanding balance. In the first half of 2011, the cumulative transaction volume of the wealth management products was quite large, whereas the volume of products with 3 month or shorter maturities accounted for nearly 80 percent of the volume of the total issuance. At end-June, the outstanding balance stood at 3.57 trillion yuan, equivalent to 4.5 percent of the outstanding balance of deposits (78.6 trillion yuan) during the same period, and an increase of over 800 billion yuan over end-2010. A large part of the funds went to securities, stocks, and other capital markets, promoting direct financing. Wealth management is an important fee-based business for banks. Its development mirrors the diversification and expansion of investment products on the financial market. Meanwhile, some financial institutions issue wealth management products on a massive scale merely to meet regulatory requirements, aggravating fluctuations in market liquidity. Their operational practices still need to be improved. The central bank and other relevant regulators have always attached great importance to improving the regulation and transparency for the issuance, sales, and investment of wealth management products, improving investors' risk awareness, and clarifying rights and responsibilities of issuers, investment receivers, and investors. In the next stage, efforts will be made to guide financial institutions to further disclose information, enhance product transparency, and honor obligations as defined in the contracts, thus enabling financial institutions to provide quality services. Financial institutions will also be guided to improve risk management and to manage their portfolios and maturity structure so as to ensure sound operations.

V. Lending rates of financial institutions continued to rise

Lending rates offered to non-financial institutions and other sectors continued to increase in the first half of 2011. In June, the weighted average lending rate was 7.29 percent, up 0.38 percentage points over March. The weighted average interest rate of loans registered at 7.36 percent, up 0.26 percentage points over March, and the weighted average bill financing rate posted 6.98 percent, up 0.72 percentage points over March. The weighted average residential mortgage rate rose steadily, standing at 6.83 percent in June, up 0.66 percentage points over March.

Loans with interest rates lower than or flat with the benchmark accounted for a smaller share of the total whereas those with interest rates higher than the benchmark increased as a percentage of the total. In June, the share of loans with interest rates lower than or at the benchmark stood at 9.94 percent and 28.91 percent respectively, down 4.02 percentage points and 1.31 percentage points respectively over March. Loans with interest rates higher than the benchmark accounted for 61.15 percent of the total, up 5.33 percentage points over March.

Table 2 Shares of loans with rates floating at various ranges of the benchmark in the first half 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
April	12.54	28.43	59.04	18.72	20.56	7.39	9.14	3.22
May	11.18	27.96	60.87	20.81	21.34	7.29	8.69	2.74
June	9.94	28.91	61.15	20.56	22.70	7.22	8.08	2.60

Source: The People's Bank of China

Foreign currency deposit rates generally went up and lending rates continued to grow due to changes in the supply and demand for funds. In June, the weighted average interest rate of large-value US dollar deposits with a maturity of less than 3 months stood at 2.79 percent, up 0.48 percentage points over March. The weighted average US dollar lending rate for less than 3 months and 3 (inclusive)-6 month maturity posted 3.16 percent and 3.46 percent respectively, up 0.12 percentage points and 0.20 percentage points over March.

Table 3 Average interest rates of large-value deposits and loans denominated in US dollars in the first half of 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
April	0.28	2.61	2.58	2.96	4.19	5.20	3.02	3.25	3.57	3.41	3.16
May	0.29	2.63	3.14	3.38	3.60	5.58	3.12	3.44	3.68	3.54	3.60
June	0.26	2.79	2.80	2.66	1.48	3.22	3.16	3.46	3.73	3.78	3.46

Source: The People's Bank of China.

Box 2 Cross-country comparison of interest rate liberalization

The interest rate, which is the price of funds, plays a fundamental role in resource allocation. Interest rate liberalization gradually allows the interest rate to be decided by market forces, thus optimizing fund distribution. Progress in interest rate deregulation around the world is closely related to the development of the financial market and improvements in the institutional infrastructure, such as relevant rules, regulations, mechanisms, and systems.

In the 1970s, with the rapid development of money market funds and the diversification of financial products, brisk trading on the market laid the foundation for a relaxation of interest rate regulation. Against this background, the US phased out regulation over interest rates of large-value negotiable deposit certificates. In the 1980s, with the passage of the *Depository Institution Deregulation and Monetary Control Act*, the US began to liberalize deposit and lending rates. The Act aimed to remove controls over deposit rates, announced the creation of the Depository Institution Deregulation Committee, and sought to deregulate gradually. From then on, innovations in financial market instruments and products continued and regulation over deposit and lending rates was fully lifted. By 1986, interest rates in the US were basically liberalized, and the Federal Reserve started to guide market interest rates via discount rates and open market operations. After deregulation, the number of collapsed banks went up in the US, but financial stability was not impacted due to the sound market infrastructure and the deposit insurance system that were in place.

In Japan, the deregulation of interest rates took longer, as greater importance was attached to market development and improving the market system. In 1977, treasury bonds held by financial institutions became tradable on the market and the treasury yield curve took form. Later, the issuance rate of treasury bonds, the interbank offering rates, the interest rates of bills, and the issuance rates of negotiable certificates of deposit issued by commercial banks were deregulated. As the financial market developed, Japan gradually lowered the denomination requirement for the issuance of negotiable certificates of deposit and other market-priced financial products and expanded the scope of market participants, thereby steadily promoting the market-based reform of interest rate. The reform was completed in 1994.

The developing economies were latecomers in terms of financial market development compared with the advanced economies. The financial markets in the developing economies were characterized by weak foundations and poor pricing capability in financial institutions, highlighting the key importance of building a market system. In the 1970s, the Republic of Korea (ROK) enriched its financial market products by introducing negotiable certificates of deposit, repurchasing agreements for short-term bills, and so on. In 1981, the ROK liberalized the discount rate for commercial bills, marking a first step in the market reform of interest rates. In 1986, the rates of interbank offerings, corporate bonds, and certificates of deposit were deregulated respectively. In 1988, it was announced that regulation over the lending rates and the rates of deposits with maturities of two years or more was lifted, basically completing the liberalization of deposit and lending rates. In 1989, however, the government resumed "window guidance" to regulate interest rates in the face of an economic slowdown, aggravated inflation, and a surge in market rates. Based on a review of the previous round of deregulation, this process resumed in 1991. With a more sound market foundation and a detailed roadmap, interest rate deregulation was accomplished in 1997.

In 1974, the Chilean government began the reform to liberalize its economy, and by 1979 it had completed banking sector privatization, interest rate deregulation, and full convertibility of the capital account. As the fundamentals for interest rate liberalization actually did not exist, between 1976 and 1982 was a period of hyper-interest rates, with the average annual real interest rate as high as 32 percent. Many banks collapsed. The central bank had to resume regulation via simultaneously announcing guiding interest rates and restructuring the banks. It was not until the completion of the banking sector restructuring that the central bank stopped announcing guiding rates and started guiding market interest rates via open market operations.

Despite the different trajectories, interest rate liberalization progressed along with the supporting domestic reforms. With the improved pricing capability of financial institutions, stronger self-discipline of the market, and more diversified products, the central banks' policy rates have been more effectively transferred into market rates.

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. At end-June, the central parity of the RMB against the US dollar was 6.4716 yuan per US dollar, up 1511 basis points or 2.33 percent over end-2010. From the reform of the RMB exchange rate in July 2005 to end-June 2010, the RMB appreciated 27.89 percent against the US dollar. The BIS estimated that the nominal effective RMB exchange rate depreciated by 1.5 percent and the real effective exchange rate depreciated by 3.02 percent in the first half of 2011, and the nominal effective RMB exchange rate appreciated by 13.05 percent and the real effective exchange rate appreciated by 18.91 percent during the period from the exchange rate reform in 2005 to end-June 2011.

Part 2 Monetary Policy Operations

In line with the overall arrangements of the State Council, since the beginning of 2011 the PBC has focused on keeping the overall price level basically stable - the priority of China's macroeconomic management – and it has implemented a prudent monetary policy. By employing a mix of quantitative and price-based monetary policy tools as well as macro-prudential policy instruments, the PBC strengthened liquidity management, guided a steady normalization of money and credit supply, kept the all-system financing aggregate at a reasonable level, and encouraged financial institutions to improve their credit structures.

I. Timely and well-managed open market operations

The intensity and pace of open market operations were properly managed. Building on a sound analysis of liquidity supply and demand in the banking system, the PBC properly managed the intensity and pace of open market operations and helped keep the liquidity in the banking system stable. In the first six months of 2011, the PBC issued 921 billion yuan of central bank bills and conducted 1,360 billion yuan of repurchase operations on a cumulative basis. Outstanding central bank bills stood at about 2.4 trillion yuan at end-June.

The maturity structure of open market operations was improved. Leveraging on the role of open market operations to pre-adjust and fine-tune liquidity, the PBC focused on central bank bills with a maturity of less than one year as well as short-term repurchase operations, which were further supplemented by 3-year central bank bills. This improved the maturity structure of open market operations and allowed the banking system to address short-term liquidity volatility more effectively and with greater initiative.

The flexibility of the interest rates of open market operations was strengthened. Greater flexibility, which was achieved in line with market developments and movements in market interest rates, facilitated management of inflationary expectations and allowed market interest rates to better balance financing supply and demand. As of end-June, interest rates for 3-month and 1-year central bank bills were recorded at 3.0801 percent and 3.4982 percent respectively, up 106 and 99 basis points from end-2010.

State treasury cash management operations were continued. In the first half of 2011, in five separate operations the PBC deposited a total of 180 billion yuan of state treasury funds in commercial banks.

II. The reserve requirement ratio was increased on six occasions and a mechanism to adjust the differentiated reserve requirement on a continuous and case-by-case basis was adopted

Against the background of a continued and 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 3 percentage points on a cumulative basis, including 6 increases of an increment of 0.5 percentage points on January 20, February 24, March 25, April 21, May 18, and June 20, with a view to properly managing liquidity aggregates, strengthening management of money and credit aggregates, and keeping all-system financing at a reasonable level.

Following a macro-prudential approach and to support liquidity management, a dynamic adjustment mechanism for differentiated reserve requirements, which was designed to complement conventional monetary policy tools such as open market operations, reserve requirements, and interest rates, went into operation in early 2011. In the first half of the year, it was applied to several financial institutions that saw heightened cyclical risks as a result of low capital adequacy and excessive expansion of lending. Linking credit growth to counter-cyclical capital requirements, the new mechanism proved successful in guiding financial institutions to manage the size of credit extensions, thus effectively supporting management of credit aggregates and contributing to a more balanced pace of credit supply.

III. Benchmark deposit and lending rates increase

Since the beginning of 2011, the PBC raised the benchmark deposit and lending rates on three occasions, i.e., on February 9, April 6, and July 7, increasing the 1-year benchmark deposit rate from 2.75 percent to 3.50 percent and the 1-year benchmark lending rate from 5.81 percent to 6.56 percent, both up by a cumulative 0.75 percentage points. The timely increases of the benchmark deposit and lending rates supported efforts to stabilize inflationary expectations and to guide reasonable money and credit growth. This was also important to reinforce the effect of property market policies by improving the allocation of funds and protecting household wealth.

IV. Strengthened window guidance and credit policy guidance

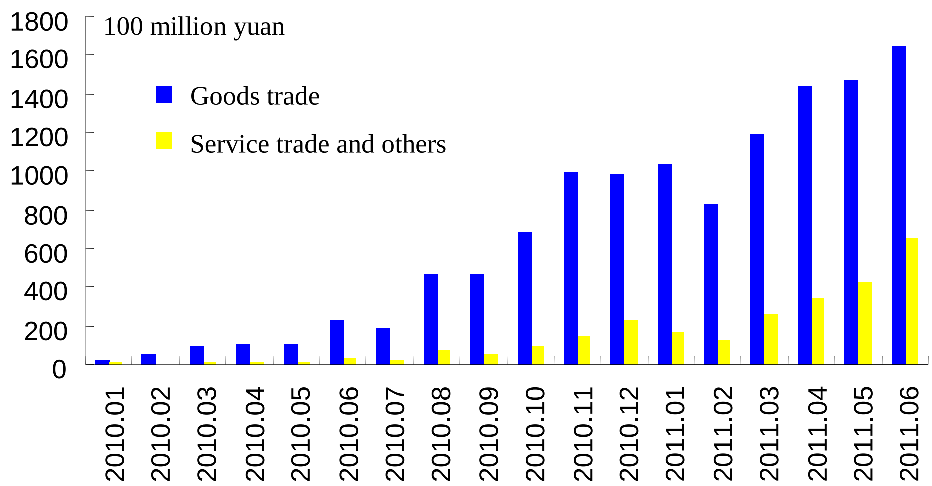
The PBC continued to strengthen and improve window guidance for financial institutions and employed a mix of monetary policy tools, including central bank lending and rediscounts, to encourage financial institutions to improve the structure and pace of credit supply, increase support for economic restructuring and a shift in the development pattern, and expand credit supply to agriculture, rural areas, and farmers, as well as to small- and medium-sized enterprises (SMEs) and other weak links in the economy. As of end-June, outstanding agro-linked central bank lending totaled 97.4 billion yuan, an increase of 25.1 billion yuan from the beginning of the year. The share of outstanding central bank lending to the western regions and the main grain-producing regions, as well as the share of new central bank lending to these regions, both exceeded 93 percent. Outstanding rediscounts registered 81.7 billion yuan, up 2.6 billion yuan from the beginning of 2011, of which 33 percent was rediscounts of agro-linked bills and 92 percent was rediscounts of bills issued by SMEs. The PBC encouraged financial institutions to follow a differentiated credit policy by improving credit support for agriculture, rural areas, and farmers, SMEs, energy conservation and emission reduction, strategic emerging industries, responding to catastrophes and reconstruction, employment, and students with financial difficulties. It encouraged financial institutions to enforce a differentiated mortgage policy, strengthen management of lending to local government financing platforms, and rein in lending to heavily energy-consuming and polluting industries as well as to industries with excess capacity. To enhance the policy effect, the PBC improved assessments of credit policies, including lending policies for agriculture and SMEs. Moreover, it guided financial institutions to step up internal risk controls and properly manage the pace of the supply of credit in order to prevent credit risks.

On the whole, credit support for SMEs continued to increase, and lending to agriculture, rural areas, and farmers remained robust. New lending to SMEs recorded 1.6 trillion yuan in the first six months of 2011, while outstanding lending to SMEs at end-June grew 18.2 percent year on year, outpacing lending to large enterprises by 7.4 percentage points. In particular, loans to small enterprises remained strong, increasing 865.9 billion yuan in the first half of the year and growing 25.9 percent year on year by end-June. Total agro-linked lending in RMB and foreign currency by major financial institutions, rural cooperative financial institutions, city credit cooperatives, township banks, and finance companies expanded 1.5 trillion yuan in the first six months, or 33.9 percent of total lending, and totaled 13.4 trillion yuan at end-June.

V. Progress in the cross-border use of RMB

RMB settlement of cross-border trade registered 957.57 billion yuan in the first half of 2011, expanding 13.3 times year on year, and posted 597.25 billion yuan in the second quarter, representing a quarter-on-quarter increase of 236.93 billion yuan. This included 455.61 billion yuan in goods trade, and 141.63 billion in exports of services and other items under the current account. Actual RMB receipts and payments in the second quarter recorded 409.03 billion yuan, which included 103.78 billion yuan in receipts and 305.25 billion yuan in payments, bringing the receipt-to-payment ratio up to 1:2.9. This suggests the use of RMB for settlement of imports and exports became more balanced. In the meantime, outbound RMB direct investments in pilot areas reached 5.40 billion yuan. As of end-June, mainland agent banks had opened 917 interbank RMB accounts for participating overseas banks, with a total outstanding balance of 133.37 billion yuan, an average of 145.00 million yuan in each account.

Figure 1 Monthly RMB settlement of cross-border trade



Source: The People's Bank of China

VI. Improvement in the RMB exchange rate regime

The RMB exchange rate regime was further improved in line with the principle of making it a self-initiated, controllable, and gradual process. 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. In the first two quarters of 2011, the central parity of the RMB against the US dollar peaked at 6.4683 yuan per dollar and reached a trough of 6.6349 yuan. Among the 119 trading days, the interbank foreign exchange market saw an appreciation on 77 days and a depreciation on 42 days. The largest intra-day appreciation was 0.20 percent (or 133 points), whereas the largest intra-day depreciation was 0.16 percent (or 103 points).

The RMB exchange rate moved in both directions against the euro and the Japanese yen. At end-June, the central parity of the RMB against the euro registered 9.3612 yuan per euro, a depreciation of 5.93 percent from end-2010, and the central parity of the RMB against the Japanese yen stood at 8.0243 yuan per 100 Japanese yen, an appreciation of 1.27 percent from end-2010. Beginning from the RMB exchange rate regime reform in 2005 to end-June 2011, on a cumulative basis the RMB appreciated 6.97 percent against the euro and depreciated 8.95 percent against the Japanese yen.

Quotations of the RMB against the Russian ruble, Malaysian ringgit, and other emerging market currencies were robust in the interbank foreign exchange market in the first half of the year, providing bilateral direct exchange rates for micro-level market players and supporting bilateral trade development.

VII. Progress in the reform of financial institutions

Steady progress was made to reform key financial institutions. The PBC supported and guided the Agricultural Bank of China (ABC) in its reform to build a multi-divisional structure for financial services to rural areas and ensured the implementation of favorable policies, including business tax breaks, regulatory fee cuts, and a differentiated reserve requirement. The PBC closely followed the ABC pilot reform program. To review its progress and address outstanding problems, PBC branches completed on-site inspections and assessments at ABC branch offices in 8 provinces where the pilot program was operating, including Sichuan, Chongqing, and Hubei, and presented proposals for further reform. The PBC continued to lead studies on reform plans for the Export and Import Bank of China and the China Export and Credit Insurance Corporation (Sinosure). After Sinosure's overall reform plan was approved by the State Council in May, the PBC began working with other government agencies on recapitalization and corporate governance modernization. Furthermore, the PBC, in collaboration with other government agencies, encouraged the China Agricultural Development Bank to deepen internal reform, enhance risk management, and improve internal control to pave the way for overall reform.

Important progress was made to reform the rural credit cooperatives (RCCs). First, the asset quality of the RCCs improved notably. Based on the five-category loan classification, at end-June outstanding non-performing loans at RCCs totaled 386.5 billion yuan, down 33.9 billion yuan from end-2010, and their share in total RCC lending dropped 1.3 percentage points from end-2010 to 6.1 percent. The capital adequacy ratio stood at 8.3 percent. Second, the financial position of the RCCs was significantly strengthened. At end-June, total deposits at the RCCs posted 9.5 trillion yuan, accounting for 12.1 percent of the total deposits in all financial institutions, up 0.2 percentage points from end-2010. RCC lending registered 6.4 trillion yuan, or 12.4 percent of the total lending by all financial institutions, an increase of 0.6 percentage points from end-2010. Third, RCC support for agriculture increased remarkably. At end-June, agro-linked loans extended by RCCs reached 4.4 trillion yuan, up 479.9 billion yuan or 12.4 percent from end-2010, while RCC lending to rural households stood at 2.3 trillion yuan, a rise of 257.5 billion yuan or 12.7 percent from end-2010. Fourth, property rights reform in the RCCs was continued. As of end-June, a total of 1,954 RCCs, 115 rural commercial banks, and 216 rural cooperative banks had been established, all with legal person status at the county (city) level.

VIII. Deepened reform of foreign exchange administration

Tougher actions were taken against "hot money" to check illegal capital inflows. In addition to the 7 policy measures adopted in November 2010 to enhance management of the banks' position for foreign exchange purchases and sales, receipts and sales of foreign exchange from exports, and short-term external debt, a contingency plan was re-enacted in March 2011, including measures to enhance management of foreign exchange receipts from entrepôt trade, advance payments, and delayed payments, and the banks' position for foreign exchange purchases and sales. The short-term external debt quota for mainland financial institutions in 2011 was reduced further. Moreover, illegal activities were effectively dealt through the launching of special campaigns to regulate the surrender of foreign exchange capital by foreign-funded enterprises and banks' foreign exchange businesses, and through intensified enforcement efforts that led to a strike against underground banking and online foreign exchange trading cases.

Regulation was improved to prevent risks arising from unusual cross-border capital flows. Supported by enhanced coordination with the commerce authorities, stringent restrictions were imposed on the establishment and registration of foreign-funded property companies and foreign exchange registration and sales by property companies funded by round-trip investments. Assessments of the banks' implementation of foreign exchange regulations were refined to encourage better compliance. Administration of foreign exchange under several capital account items was improved by updating operational procedures for RMB business under the capital account, round-trip investment, and overseas derivatives trading by central government-owned enterprises. Monitoring and analysis of cross-border capital flows were also enhanced, as a monthly reporting mechanism was put into place and the BOP risk monitoring and early-warning indicator system was improved.

Administration of goods trade-related foreign exchange was reformed to guide the development of foreign exchange businesses. This included efforts to build a balanced approach to reform the verification system by promoting reform of the system for import payments in foreign exchange in more regions and making preparations to reform the system for export receipts in foreign exchange. Moreover, management of several items under the capital account was streamlined and approval authority for trade credits, guarantees for overseas investments and three other businesses was delegated, allowing enterprises to reduce costs and improve efficiency. Management of foreign exchange sales and purchases by the banks was also improved to ensure that such business and the relevant operations are conducted in an orderly manner. Meanwhile, sales and purchases of foreign exchange by individuals via online banking were facilitated by the release of the *Interim Administrative Measures on Foreign Exchange Sales and Purchases by Individuals via Online Banking*. Options on RMB versus foreign currencies were introduced to help banks better manage risks arising from their options trading positions and to meet market needs for diversified alternatives to manage exchange rate risks.

Risk management for foreign exchange reserve investments was strengthened to raise investment returns. To support China's economic and social development, efforts were made to flexibly adjust the investment strategy, optimize the currency structure, pursue diversified portfolios, explore new avenues for reserve investments, and make progress in establishing an entrusted loans office.

Part 3 Financial Market Analysis

In the first half of 2011 China's financial market continued to perform in a healthy and sound manner. The trend in interest rates on the money market moved in an upward direction amid fluctuations, and transactions were buoyant. Bond market yield curves shifted upward, and bond issuances grew significantly. Stock indices declined slightly, and trading on the stock market was relatively stable.

I. Financial market analysis

1. The money market traded briskly and interest rates moved up

Repo transactions and interbank borrowings on the money market were brisk, with the trading volume increasing significantly. In the first half of 2011, the turnover of bond repos totaled 46.5 trillion yuan, with an average daily turnover of 381 billion yuan, up 21.1 percent year on year. The turnover of interbank borrowings reached 14.5 trillion yuan, with an average daily turnover of 119.2 billion yuan, an increase of 30.5 percent year on year. Overnight products still dominated bond repo and interbank borrowing transactions, accounting for 76.8 percent and 86.7 percent of their respective turnovers, down 2.6 and 1 percentage points from the same period of the previous year. The total turnover of government securities repos on the stock exchanges soared 101.4 percent year on year to 5.31 trillion yuan.

In terms of financing by financial institutions, net lending of state-owned commercial banks in the first half of 2011 totaled 8.5 trillion yuan, representing a decline of 1.5 trillion yuan from the same period of the previous year; net borrowing of other commercial banks totaled 1.8 trillion yuan, representing a decline of 2.3 trillion yuan from the same period of the previous year. Net borrowing of non-banking financial institutions increased significantly, accelerating by 536.9 billion yuan from the same period of the previous year; in particular, funding demands by insurance companies increased notably. In addition, with improved balance sheets, funding demands by foreign-funded financial institutions declined by 1.3 trillion yuan from the same period of the previous year.

Table 4 Fund flows among financial institutions in the first half of 2011

Unit：100 million yuan

	Repo		Interbank borrowing	
	First half of 2011	First half of 2010	First half of 2011	First half of 2010
State-owned commercial banks	-99822	-91317	15186	-8552
Other commercial banks	28201	39996	-10550	916
Other financial institutions	66089	37888	-529	6347

Of which: securities companies and fund management companies	27493	37314	4847	642
Insurance companies	11893	908	——	——
Foreign-funded financial institutions	5532	13434	-4108	1290

Note: "Other financial institutions" in the table refer to 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 and a positive sign indicates net borrowing.

Source: China Foreign Exchange Trade System.

Interest rates on the money market moved up amid fluctuations. Due to a number of factors, such as hikes in the benchmark deposit and lending rates and the reserve requirement ratio, heightened inflation expectations, and stricter performance evaluations, interest rates on the money market rose notably amid fluctuations. In June, the weighted average interest rate of interbank borrowing was 4.56 percent, up 263 and 164 basis points from March 2011 and December 2010 respectively; the weighted average interest rate of bond-pledged repo was 4.94 percent, up 296 and 182 basis points from March 2011 and December 2010 respectively. At the end of June, the overnight and 7-day Shibor rate stood at 5.0 percent and 6.6 percent respectively, up 207 and 229 basis points from the beginning of the year. The 3-month and one-year Shibor rate registered 6.39 percent and 5.14 percent, up 183 and 149 basis points from the beginning of the year.

Trading of RMB interest-rate swaps grew rapidly. In the first half of 2011, a total of 9,609 transactions was conducted, with an aggregate nominal principal of 1227.5 billion yuan, up 152.8 percent year on year. The base rate of the floating end of the RMB interest-rate swaps included the 7-day fixing repo rate and the Shibor, and their notional principal accounted for 60.3 percent and 35.3 percent of the total respectively.

Table 5 Transactions of interest-rate derivatives in the first half of 2011

	Bond forwards		Interest-rate swaps		Forward-rate agreements	
	Transactions	Amount ① (100 million yuan)	Transactions	Amount of nominal principal (100 million yuan)	Transactions	Amount of nominal principal (100 million yuan)
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

Q2 2011	66	237.7	4834	6607.6	0	0

Note: ① Beginning in 2009, statistics on transactions of bond forwards are based on the settlement amounts of the transactions.

Source: China Foreign Exchange Trade System

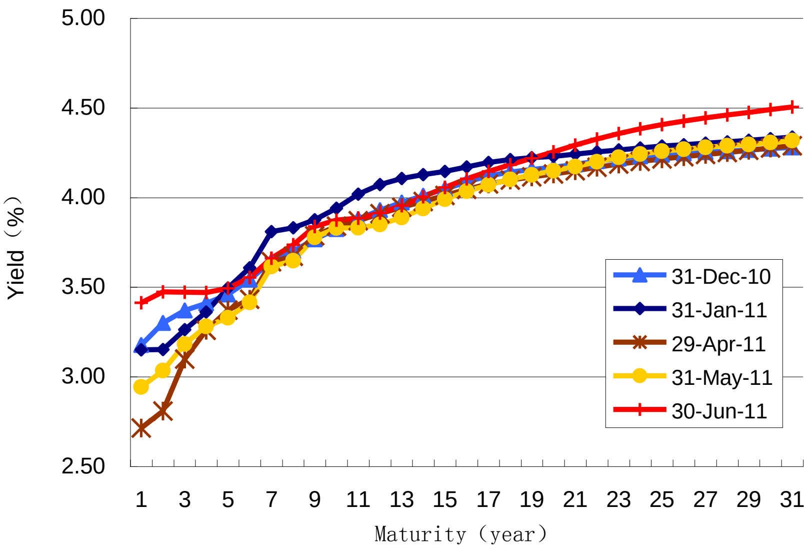
2. The yield curves of government securities shifted upward and bond issuances grew significantly

The volume of spot trading increased steadily on the interbank bond market. In the first half of 2011, the turnover of spot bond trading totaled 30.7 trillion yuan, with a daily average of 251.9 billion yuan, up 25.6 percent year on year. In terms of trading entities, state-owned commercial banks and foreign financial institutions were net bond buyers on the interbank spot bond market, with net purchases of 304.2 billion yuan and 124.4 billion yuan respectively; other commercial banks were net sellers, with net sales of 362.7 billion yuan. A total of 61 billion yuan of spot government securities was traded on the stock exchanges, 36 billion yuan less than that during the same period of the previous year.

The interbank bond market indices showed an overall weakening trend. The China Bond Composite Index (net price)[1] declined from 99.8 points at the beginning of the year to 99.1 points at end-June, or 0.64 percent; the China Bond Composite Index (full price) rose from 132.9 points at the beginning of the year to 134.1 points at end-June, or 0.87 percent. The index of government securities on the stock exchanges rose 1.77 percent, from 126.3 points at the beginning of the year to 128.6 points at end-June.

[1]. The China Bond Composite Index (net price) reflects the movement of bond prices on a net basis and does not include returns on interest reinvestments; the China Bond Composite Index (full price) reflects the total returns of investments, including both the net movements of bond prices and the returns on interest reinvestments.

Figure 2 Yield curves of government securities on the interbank market



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

The yield curves of government securities shifted slightly upward. Interest-rate movements on the money market had a large impact on the yields of short-term government securities during the first half of 2011. From March to April, the yields of government securities at the short-end hovered at a relatively low level. As interest rates moved up rapidly on the money market, the yields of government securities at the short-end reached a higher level by end-June. Since financial institutions had a stronger demand for bond investments, yields of government securities at the medium- and high-ends remained stable during the first four months. In May and June, as the cumulative impacts of the preceding macroeconomic management measures gradually unfolded and inflation expectations heightened somewhat, the yields of government securities at the medium- and long-ends rose substantially, and the yield curves of government securities shifted upward from the beginning of the year.

Bond issuances grew significantly. In the first half of 2011, a total of 3.19 trillion yuan (excluding central bills) was issued, up 38.9 percent year on year. In particular, issuances of subordinated bonds and hybrid capital bonds, which were issued by commercial banks to increase their capital adequacy ratio, increased rapidly, by 183.8 percent year on year. The issuance of policy financial bonds also maintained a rapid pace, increasing 109.2 percent year on year. The issuance of government securities increased steadily. In the first half of 2011, a total of 837.8 billion yuan of government securities was issued, up 1.0 percent year on year. At end-June, a total of 20.4 trillion yuan of bonds was deposited with the China Government Securities Depository Trust and Clearing Co., Ltd.

Table 6 Issuances of bonds in the first half of 2011

Type of bond	Issuance (100 million yuan)	Year-on-year growth (%)
Government securities	8378	1.0
Policy financial bonds issued by the China Development Bank and other policy banks	11274	109.2
Bank subordinate bonds and hybrid bonds	1619	183.8
Bank ordinary bonds	20	100.0
Enterprise bonds	10636	27.9
Of which: short-term financial bills③	4999	41.4
medium-term notes④	3294	14.0
corporate bonds	581	32.6

Notes: ①Including municipal bonds issued by the Ministry of Finance on behalf of local governments;
②Including enterprise bonds, super commercial paper, short-term financing bills, medium-term notes, collective bills of SMEs, corporate bonds, and bonds with detachable warrants (excluding financial bonds with detachable warrants);
③Including super financing bills;
④Including bond financing by non-financial enterprises.

Source: The People's Bank of China, China Government Securities Depository Trust and Clearing Co., Ltd.

In general, the bond issuance rates showed an upward trend. In June 2011, the coupon rate of 10-year book-entry interest-bearing government securities issued by the Ministry of Finance was 3.99 percent, up 16 basis points from those of the same maturity issued in March 2011. The interest rate of 5-year fixed-rate policy financial bonds issued by the China Development Bank was 4.33 percent, up 34 basis points from those of the same maturity issued in March 2011. The Shibor played a greater role in bond pricing. In the first half of 2011, 12 floating-rate bonds based on the Shibor were issued on the primary bond market, with a gross issuance volume of 127.13 billion yuan, accounting for 30.1 percent of the issuance of all floating-rate bonds. In particular, 8 floating-rate policy financial bonds were issued, with a total issuance volume of 114.7 billion yuan. Furthermore, 124 fixed-rate bonds were issued on the primary bond market, all based on the Shibor, with a gross issuance volume of 141.1 billion yuan. A total of 122.5 billion yuan of short-term fixed-rate financing bills based on the Shibor was issued, accounting for 24.8 percent of the issuance of all short-term fixed-rate financing bills.

3. Bill financing rebounded after an earlier fall, and interest rates rose modestly on the bill market

Outstanding bill financing surged again after an earlier fall, and the bill market traded briskly. In the first half of the year, commercial bills issued by enterprises totaled 7.6 trillion yuan, representing year-on-year growth of 38.3 percent; the volume of discounted bills amounted to 13.2 trillion yuan, representing year-on-year growth of 9.0 percent. At end-June, the total value of outstanding commercial bills increased

42.8 percent year on year to 6.7 trillion yuan; and outstanding discounted bills registered 1.4 trillion yuan, down 21.6 year on year.

As financial institutions adjusted their asset structures and the growth of ordinary loans slowed down, financial institutions became more inclined to provide bill financing, which saw gradual growth. The outstanding balance of bill financing at end-June had increased by 120 billion yuan from the end of the last quarter and accounted for 2.6 percent of all kinds of loans, up 0.1 percentage point from the last quarter. Affected by a number of factors such as interest rates on the money market and the change in the supply and demand for bills, there was a trend for bill market interest rates in the second quarter of 2011 to move up amid fluctuations and to hover at an elevated level.

4. Stock indices declined slightly and the stock market traded stably

In general, stock indices declined. At end-June, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index declined 5.7 percent and 3.6 percent from end-March to close at 2762 points and 12111 points respectively, and down 1.6 percent and 2.8 percent from the end of the last year. The average P/E ratio on the A-share market of the Shanghai Stock Exchange declined from 21.6 times at the end of the last year to 16.5 times at end-June; the average P/E on the A-share market of the Shenzhen Stock Exchange declined from 45.3 times to 30.7 times.

Transaction volumes on the stock markets increased slightly. In the first half of 2011, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled 24.7 trillion yuan, an increase of 9.1 percent year on year, and the daily turnover averaged 207.5 billion yuan, 15.6 billion yuan more than that during the same period of the previous year. At end-June, market capitalization increased 4.0 percent from the end of the last year to 20.1 trillion yuan.

Financing on the stock markets declined somewhat. According to preliminary statistics, a total of 336.2 billion yuan was raised in the first half of 2011 by way of IPOs, additional offerings, warrant exercises, right issuances, and bonds with detachable warrants, 66.7 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 the first half of 2011, total premium income in the insurance industry amounted to 805.7 billion yuan,[2] and total claim and benefit payments increased 33.0 percent year on year to 195.9 billion yuan. Specifically, the total claim and benefit payments in the property insurance sector increased 23.4 percent, whereas those in the life insurance sector increased 37.7 percent.

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

Total assets of the insurance industry maintained fairly rapid growth. At end-June 2011, total assets of the insurance industry posted 5.7 trillion yuan, an increase of 27.0 percent year on year, up 1.7 percentage points from the end of the last year. Among this total, bank deposits increased 39.0 percent year on year, up 6.3 percentage points from the end of the last year; investment-type assets increased 18.8 percent, down 6.8 percentage points from the end of the last year.

Table 7 Use of insurance funds, end-June 2011

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-June 2011	End-June 2010	End-June 2011	End-June 2010
Total assets	57470	45235	100.0	100.0
Of which：Bank deposit	17658	12700	30.7	28.1
investments	34393	28954	59.8	64.0

Source: China Insurance Regulatory Commission

6. The foreign exchange market traded briskly

The volume of RMB forward and “currency pair” transactions expanded rapidly. In the first half of 2011, the turnover of spot foreign exchange transactions totaled US$1750.8 billion, representing an increase of 13.2 percent year on year; the turnover of RMB foreign exchange swap transactions totaled US$792.6 billion, representing an increase of 25.7 percent year on year; among this total, overnight RMB/US dollar swap transactions amounted to US$441.8 billion, accounting for 55.4 percent of all currency swap transactions; the turnover on the RMB foreign exchange forward market totaled US$115.9 billion, an increase of 2013 percent year on year. In the first half of 2011, the turnover of foreign currency pairs amounted to US$49.2 billion yuan, an increase of 74.3 percent year on year. In particular, US$/HKD pairs accounted for the lion’s share, or 43.3 percent, down 22.1 percentage points from the same period of the previous year. At the end of June 2011, there were 302 members on the spot foreign exchange market, 73 members on the forward foreign exchange market, 72 members on the foreign exchange swap market, and 16 members on the foreign exchange options market.

7. The gold market operated stably

In the first half of 2011, a total of 1967.8 billion yuan of precious metals was traded on the Shanghai Gold Exchange, an increase of 120.7 percent year on year. In particular, the trading volume of gold was 2906.3 tons, a decrease of 8.4 percent year on year, and its turnover posted 889.11 billion yuan, an increase of 10.1 percent year on year; the trading volume of silver was 132,000 tons, an increase of 630.6 percent year on year, and turnover posted 1066.32 billion yuan, an increase of 1340 percent year on year; the trading volume of platinum was 31.9 tons, an increase of 14.3 percent year on year, and its turnover posted 12.38 billion yuan, an increase of 22.3 percent year on year.

In the first half of 2011, the movement of gold prices on the Shanghai Gold Exchange kept pace with that on the international market. In January, gold prices on the international market showed a downward trend. From February to June, gold prices surged and reached one record high after another, while the afternoon fixing price of gold on the London market reached as high as US$1552.50 per ounce. The highest price on the domestic market was 323.50 yuan per gram, and the lowest price was 281.20 yuan per gram. At end-June, the price of gold was 313.06 yuan per gram, up 3.95 percent from the end of 2010.

II. Institutional building in the financial market

1. Strengthening regulation on the interbank bond market

Management of bond tendering and issuances was improved. Taking stock of the experiences in bond tendering and issuance management during recent years, the People's Bank of China updated the *Administrative Measures on Spot Management of Bond Issuances on the Interbank Bond Market* (PBC Document No.199 [2002]), and released the *Administrative Measures on Management of Bond Tendering and Issuances on the Interbank Bond Market* (PBC General Administration Department Document No.128 [2011]) in May 2011.

Management of trading on the interbank bond market was strengthened. In April 2011, the People's Bank of China issued PBC Announcement No.3 [2011], introducing specific requirements for the management of bond trading, a disclosure system for abnormal material transactions and an ex-ante reporting and filing system for abnormal transactions. The rules further strengthened the supervisory responsibilities of the transaction filing and settlement agents for clients, which helped further standardize trading behavior on the interbank bond market and promote the healthy development of the interbank bond market.

The price discovery mechanism was improved. In April 2011 jointly with the Ministry of Finance the People's Bank of China released a public notice, PBC Announcement, No.6 [2011], introducing a two-way quotation mechanism for key maturities of new issues of government securities. The notice established specific requirements for market-makers on the interbank bond market, including maturities of newly-issued government securities with key maturities, the volume of any single quotation, and the cumulative hours of quotation, thereby further improving the price discovery mechanism and the yield curve of government securities.

Measures were adopted to promote the development of debt financing by non-financial enterprises. After filing with the People's Bank of China, the National Association of Financial Market Institutional Investors (NAMFII) on April 2011 issued the *Rules for the Private Placement of Debt Financing Instruments of Non-financial Enterprises on the Interbank Bond Market*. In May 2011, three enterprise groups, including China Minmetals Corporation, China Guodian Corporation, and Aviation Industry Corporation of China, successfully issued 13 billion yuan of private debt financing instruments, signaling implementation of the private placement of debt financing by domestic enterprises.

2. Improving institutional arrangements on the securities market

Building and improving the classified regulation of futures companies, in April 2011 the China Securities Regulatory Commission issued the *Rules on Classified Supervision of Futures Companies*. Based on their risk management capacity, market competitiveness, records in developing institutional investors, status of continued compliance, different categories of futures companies receive differentiated treatment in terms of allocation of supervisory resources and frequency of on-site and off-site examinations. The ratings will serve as prudential conditions for applying for the opening of new outlets and business lines by futures companies, as well as the basis for innovative pilot businesses and premium payments to the protection funds of institutional investors on the futures market.

Information disclosure was improved on the securities market. In April 2011 the China Securities Regulatory Commission issued the *Rules for Determining Administrative Liabilities for Violations of the Information Disclosure Laws*, which aimed to highlight the specific rules on establishing and identifying the liabilities for the illegal disclosure of information, supervising and guiding market participants to be honest, urging securities issuers and listed companies to improve the quality of disclosed information on a continuous basis, and optimizing the governance structure of legal entities.

Measures were taken to continually promote product and business innovations. In April 2011, with the approval of the China Securities Regulatory Commission, the Dalian Commodities Exchange started trading of coke futures contracts, which sought to improve the coke pricing mechanism, help spot commodity enterprises grasp the changed market conditions on a timely and accurate basis and make scientific decisions and forecasts, and promote stable performance of the coke market. In the meantime, the China Securities Regulatory Commission issued the *Interim Measures on Regulating Futures Companies' Futures Investment-Advisory Services*, specifying rules for futures companies' advisory services in terms of capital requirements and records of compliance.

3. Improving institutional arrangements in the insurance market

Standardizing the operation of personal insurance businesses, in July 2011 the China Insurance Regulatory Commission issued the *Notice on Regulating the Operation of Personal Insurance Businesses*, which for the first time specified that in general the term of insurance policy loans shall not exceed half a year. During the free examination period, the applicant can unconditionally terminate the insurance contract, whereas insurance companies can charge no more than 10 yuan as a cost and shall return all insurance premiums.

Launching insurance businesses with variable annuities on a pilot basis, in May 2011 the China Insurance Regulatory Commission issued the *Notice on Conducting the Variable Annuities Insurance Business* and the *Provisional Rules on the Variable Annuities Insurance Business*, formally launching variable annuities insurance business in 5 cities including Shanghai, Beijing, Guangzhou, Shenzhen, and Xiamen. The variable annuities insurance, combining the three features of pensions, investments, and minimum guarantees, helps to diversify the structure of life insurance products and puts into full play the role of long-time savings of life insurance products so as to meet the real demand of insurance clients.

Adjusting regulation of insurance assets: In order to prevent risks in the use of insurance assets and to promote the development of asset management businesses, in April 2011 the China Insurance Regulatory Commission issued the *Notice on Adjusting Regulation of Insurance Assets Management Companies*, adjusting the business scope and terms for opening insurance assets management companies, e.g., relaxing the limits on the establishment period and increasing the requirements for solvency and total assets.

Market access was strictly regulated. In order to standardize and guide approvals for insurance companies to commence business and to improve the procedures for insurance market access, in April 2011 the China Insurance Regulatory Commission issued the *Guidelines on Approvals for Insurance Companies to Commence Business,* further standardizing the requirements of the application materials for Chinese-invested insurance companies to commence business and stipulating that capital funds shall not be used prior to the commencement of business.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q2 2011 the world recovery was proceeding but remained fragile and imbalanced, with the following features:

First, growth in the advanced economies including the United States and Japan slowed down mildly, with unemployment and fiscal problems still posing great challenges. Sovereign debt risks might spill over from the periphery of the euro area to the core countries. Though QE2 ended at the end of June as planned, the slack in the economy did not improve in the United States due to high unemployment, a sluggish housing market, and looming debt risks. The euro area sovereign debt crisis deteriorated further, reflected in rising risk premiums in Greece, Spain, and Italy. On July 21, a new bailout package for Greece was agreed upon at the European Leaders Summit to protect the financial stability of the euro area and the entire European Union. On July 7, the ECB announced a rise in its benchmark interest rate, the year’s second rate to ameliorate inflationary pressures. The earthquake, tsunami, and nuclear leak affected production, exports, and consumption in Japan and caused disruptions to the global supply chain.

Second, amidst robust economic growth, many emerging and developing economies faced difficulties in terms of macroeconomic management due to intensifying inflationary pressures and cross-border short-term capital flows. Most emerging economies experienced strong expansion but some embarked on a macro policy tightening to fight the large volatility in cross-border capital flows and the overheating, which in turned would slow growth. However, the mixed forces of domestic tightening and increasing risks in the international market made cross-border capital flows more volatile.

Third, commodity prices gradually stabilized but upward pressures still existed. On June 23, out of concern for the shrinking demand from the euro area and the US, the International Energy Agency (IEA) released 60 million barrels of oil, which helped to depress recent international oil prices. But the reconstruction in the aftermath of the Japanese earthquake and the social unrest in west Asia and north Africa made it impossible for oil prices to fall by a large margin in the near future. Furthermore both the advanced and emerging market economies had to tackle the problem of mounting inflation.

1. Economic developments in the major economies

Weighed heavily by unsolved problems such as the high unemployment rate, the weak housing market, and government indebtedness, the US recovery lost momentum. Due to the squeeze on consumer expenditures, real GDP growth in the United States in Q2 registered a mere 1.3 percent (annualized month–on-month rate, initial number), lower than market expectations. Furthermore, GDP growth in Q1 was adjusted downward to 0.4 percent from the previously published 1.9 percent. Though the core CPI remained low, the month-on-month CPI for May and June was pushed up by a 3.6 percent energy and food price hike, a record high since October 2008. With limited newly added jobs, the unemployment rate edged up again after a earlier fall, reaching the year's high of 9.2 percent in June. Housing prices dropped to the level of mid-2002 and the large inventories implied there was room for further drops in prices. Meanwhile, debt risks grew. On May 16, the US national debt touched the US$14.29 trillion official cap and on August 2, after rounds of negotiations, the US Republican and Democratic parties finally agreed upon the Budget Control Act of 2011, which lifted the debt ceiling. Earlier, on April 18 and July 13, Standard & Poor's and Moody's respectively placed the US credit rating on a downgrade watch, and Fitch also expressed concerns about the US sovereign debt outlook. Though the lifting of the debt cap temporarily eased short-term US default risks, medium- or long-term fiscal sustainability remains problematic. On August 5, Standard & Poor's cut the US AAA credit rating to AA+, the first time in history that the country lost its AAA rating. Against the backdrop of a lackluster recovery, the US economy showed some bright spots, reflected by first, exports reached a historical high of US$175.8 billion in April promoted by the National Export Initiatives,; second, increased tax income contributed to a rapid reduction in the federal fiscal deficit, which stood at US$40.8 billion in April and US$57.6 billion in May.

Table 8 Macroeconomic and financial indices of the major economies

Country	Index	2010 Q2			2010 Q3			2010 Q4			2011 Q1			2011 Q2		
		Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun
United States	Real GDP Growth Rate (annualized quarterly rate, YOY, %)	1.7			2.5			3.1			0.4			1.3		
	Unemployment Rate (%)	9.9	9.7	9.5	9.5	9.6	9.6	9.6	9.8	9.4	9.0	8.9	8.8	9.0	9.1	9.2
	CPI (YOY,%)	2.2	2.0	1.1	1.2	1.1	1.1	1.2	1.1	1.5	1.6	2.1	2.7	3.2	3.6	3.6
	DJ Industrial Average (closing number)	11009	10137	9774	10466	10015	10788	11118	11006	11578	11892	12226	12320	12811	12570	12414
	NASDAQ (closing number)	2467	2257	2109	2255	2114	2369	2507	2498	2653	2700	2782	2781	2874	2835	2774
Euro Area	Real GDP Growth Rate (quarterly YOY, %)	1.7			1.9			2.0			2.5					
	Unemployment Rate (%)	9.9	10.0	10.0	10.0	10.1	10.0	10.1	10.1	10.0	10.0	9.9	9.9	9.9	9.9	9.9
	HICP (YOY, %)	1.0	0.9	1.4	1.7	1.6	1.8	1.9	1.9	2.2	2.3	2.4	2.7	2.8	2.7	2.7

	EURO STOXX 50 (closing number)	2479	2470	2629	2476	2450	2482	2543	2478	2601	2654	2713	2583	2661	2632	2561
Japan	Real GDP Growth Rate (annualized quarterly rate, QOQ, %)	1.5			4.5			-1.3			-3.5					
	Unemployment Rate (%)	5.1	5.2	5.3	5.2	5.1	5.0	5.1	5.1	4.9	4.9	4.6	4.6	4.7	4.5	4.6
	CPI (YOY, %)	-1.2	-0.9	-0.7	-0.9	-0.9	-0.6	0.2	0.1	0.0	0.0	0.0	0.0	0.3	0.3	0.2
	NIKKEI225 (closing number)	11057	9768	9383	9537	8824	9369	9202	9937	10229	10238	10624	9755	9850	9994	9816

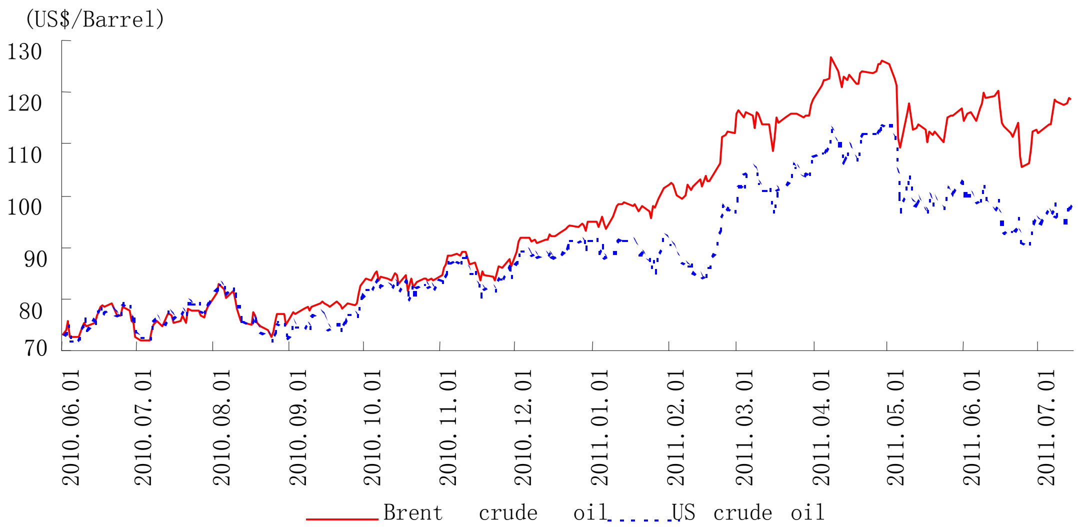
Source: Statistical bureaus and central banks of the relevant economies

Driven by the stable growth of countries such as Germany, the economies in the euro area expanded steadily, with a moderate increase in the core CPI but mounting risks of sovereign debt risks. Due to robust investments in Germany and France, growth in Q1 climbed by 2.5 percent year on year despite persistent downside risks. First, there was substantial variation among the member states. The recovery in Germany rebounded strongly, remained moderate in France and Italy, but appeared to be sluggish in Greece, Portugal, and Ireland, where financing conditions were stressful due to the consecutive downgrading of their sovereign ratings. Second, market concerns about the spillover of the debt crisis to the core countries increased risk premiums in Spain and Italy. Because of the failure of Greece's debt restructuring, Standard & Poor's slashed the country's long-term sovereign credit rating from B to CCC, the lowest in the world. To rebuild market confidence and safeguard financial stability, on July 2 and July 8 the EU and IMF approved the release of a fifth aid loan installment under the first round of a bailout plan for Greece, totaling 15.3 billion euro; at the EU summit held on July 21, a second aid package, worth 109 billion euro, for Greece was agreed upon, to be financed by both the EFSF and the IMF. Third, the price levels continued to rise. Influenced by energy and food price hikes, the euro area HICP picked up by 2.7 percent in June compared with the same period of the last year, higher than the 2 percent target set by the ECB for seven successive months.

The earthquake, tsunami, and nuclear leak weighed heavily on Japan's production and exports. First, economic and employment conditions were gloomy. Real GDP growth in Japan during Q1 slumped by 3.5 percent (annualized quarter-on-quarter figure). Although the unemployment rate in June remained at the pre-earthquake level of 4.6 percent, the statistics excluded figures from the areas most severely affected by the earthquake. Second, the core CPI changed from negative to positive but deflationary pressures still existed. The year-on-year core CPI crept up for three months through June after 28 negative readings, but the prices of durable consumer goods were still declining. Third, the trade deficit soared. Because of severe disruptions in the supply chains of the automobile and electronics industries, Japan's exports plummeted after the earthquake, with the trade deficit in May registering 853.7 billion yen, just below the January 2009 pre-crisis level.

Cross-border capital flows and overheating were the major risks facing the emerging market economies, as well as the danger that the political upheavals in West Asia and North Africa would cast shadows on the economic stability of the region or even the world. Facilitated by external and domestic demand, the production and trade volume of the major emerging market economies had already exceeded pre-crisis levels, however domestic tightening of policy, increasing international market risks, and cross-border capital flows featured by " inflows first and outflows later" added to the difficulties of policy making. Since the beginning of 2011, social unrest in West Asia and North Africa had spread to more than a dozen countries, including Tunisia and Egypt, and war broke out in Libya. Market panic and flight to safety led to rocketing oil and gold prices in the international market. On June 23, out of concern for the shrinking demand from the euro area and the US, the International Energy Agency (IEA) released 60 million barrels of crude oil reserves, which helped to contain recent international oil prices. But heightened energy price fluctuations amplified the risks in the financial market and the real economy.

Figure 3 Trends in crude oil prices



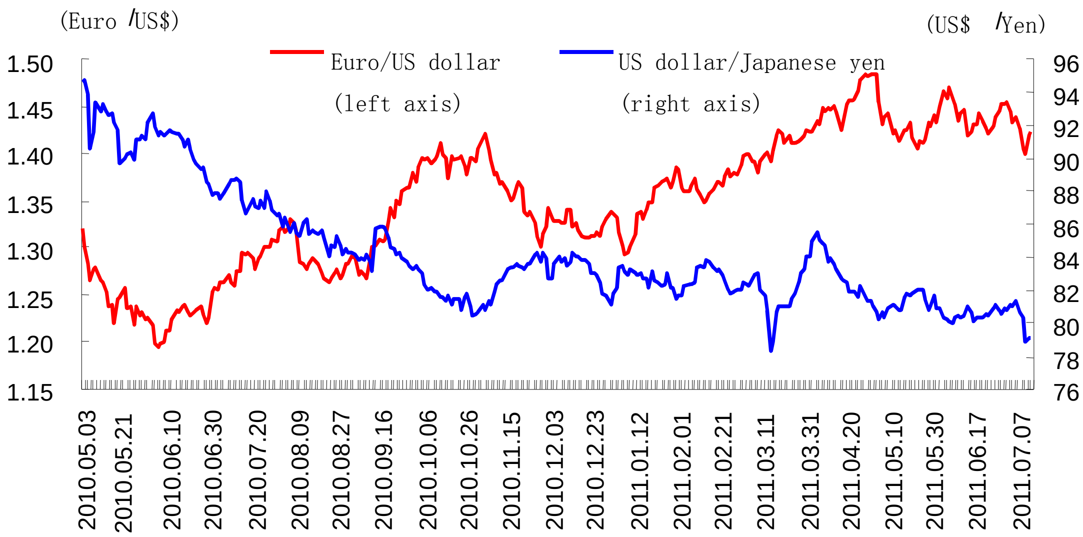
Source: Reuters

2. Development of global financial markets

In the first half of 2011, the exchange rates of the major currencies fluctuated within a large band against the US dollar. The developments can be divided into two stages: from January to April, against the overall picture of smooth growth in the world economy and reduced risk aversion, investors acquired more risk assets, causing the major currencies to surge against the US dollar. The Japanese yen was greatly strengthened, reaching a record high after the earthquake due to the repatriation of assets and foreign currencies. From May to June, factors such as the deteriorating Greek sovereign debt crisis, the deceleration of the growth momentum in the US and the avalanche in global stock markets caused the major currencies to gain and to fluctuate against the US dollar. At the end of June, the exchange rate of the euro against the US dollar closed at 1.4504 dollar per euro, up by 8.4 percent from the end of the last year; and the exchange rate of the Japanese yen against the US dollar closed at 80.52 yen per dollar, appreciating by 0.8 percent from the end of the last year. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, depreciated by a cumulative 4.2 percent in the first half of the year.

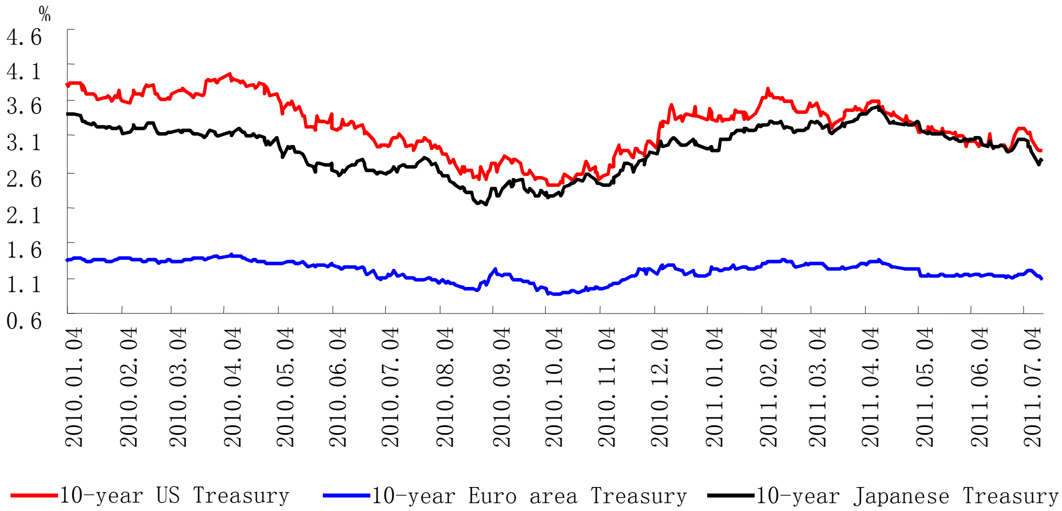
The yields of major securities remained down by the flight for safety. On April 6, Portugal became the third country, after Greece and Ireland, requesting EU financial aid. Thereafter, in succession the international rating companies slashed the sovereign ratings in the euro area. As a result, the yields of government securities in Greece and Ireland rocketed. Against this backdrop, though fiscal conditions in the United States and Japan were also not optimistic, the yields of the major securities still moved downward due to risk aversion demands for safe assets. On June 30, 10-year treasury bonds of the United States, the euro area (German bonds), and Japan closed at 3.16 percent, 3.01 percent, and 1.14 percent respectively, down by 31, 34, and 12 basis points compared with end-March.

Figure 4 Movements of exchange rates of the major currencies



Source: Reuters

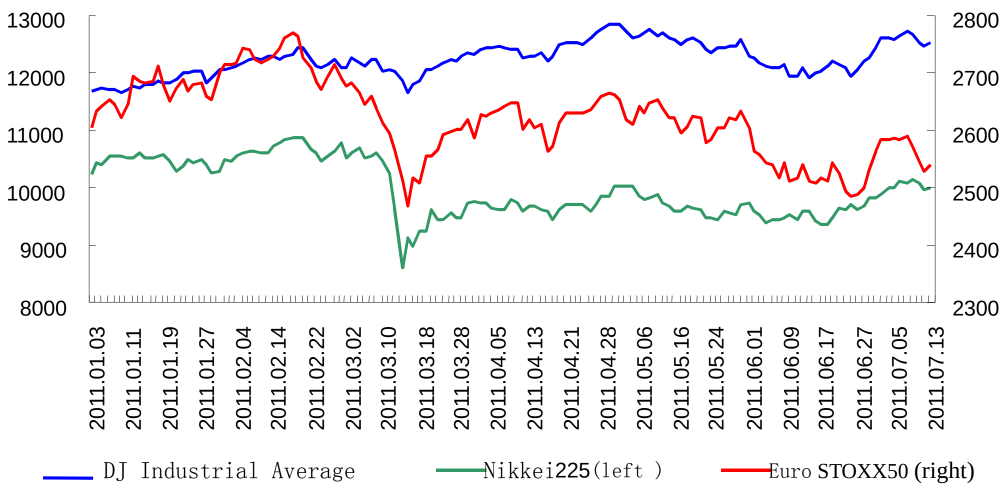
Figure 5 Movements in the yields of the major treasuries



Source: Reuters

The economic slowdown in the advanced economies and the debt crisis in the euro area put a drag on major stock markets. Due to Japan's large-scale liquidity injection into the financial market and the downward movement of the yields of the major securities caused by the US QE2, starting from Q2 the major stock markets rallied. Later, as activities in the advanced economies slowed and the sovereign risks in the euro area intensified, the major stock indices retreated. But with the news of the Greek government's fiscal consolidation, the stock markets rebounded a bit. On June 30, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 12414, 2774, 2561, and 9816 respectively, up by 0.8 percent, slightly down by 0.3 percent, down by 0.8 percent, and up by 0.6 percent respectively compared with end-March.

Figure 6 Movements of the major stock indices



The US housing market continued to be tepid. According to the National Association of Realtors, housing sales (annualized rate) fell by 3.8 percent month on month in May, or by 15.3 percent year on year. In May, the median existing home price averaged US$1,665.000, down by 4.6 percent year on year. The Case-Schiller Home Price Index also indicated the average year-on-year house price in 20 US cities had dropped by 4.5 percent, registering the largest fall over the past 18 months.

Overall, the euro area housing market showed signs of improvement. In June, the UK HALIFAX Housing Index edged up by 1.2 percent month on month, a rebound from the 1.4 percent decrease in April. But the gloomy economic outlook still weighed on housing prices. Stimulated by the strong growth, the demand for both commercial and residential housing continued to rise in Germany. The French housing market experienced a large price surge but the volume of transactions declined. Burdened by the economic recession and the debt crisis, the housing market in the periphery countries of the euro area continued to be depressed.

The Japanese market was bolstered by the demand for post-disaster reconstruction. According to the Ministry of Land, Infrastructure, Transport, and Tourism, new starts in May went up by 6.4 percent compared with the same period of the last year and construction orders received by the 50 big construction companies increased by 25.5 percent year on year. The Japanese housing market had basically freed itself the negative influence of the earthquake. It is estimated that with the shortage of construction materials gradually improving, demand from reconstruction will continue to propel the growth of the housing market.

4. The monetary policies of the major economies

The uneven pace of recovery led to notably different monetary policies across the various economies. Some economies continued to implement loose monetary policies. The U.S. Fed ended QE2 as planned, and kept its benchmark rate unchanged at 0-0.1 percent. The minutes of the FOMC meeting show that in April there were differences of opinion about whether the QE2 should be terminated before schedule. However, because the growth momentum again slowed down, the US Fed decided to end the QE2 by the end of June as planned and to keep the size of its balance sheet unchanged. The Bank of Japan carried out a “zero interest rate” policy, keeping the range of the overnight call rate unchanged at 0-0.25 percent and maintaining the scale of its asset purchase program for the post-quake recovery at 40 trillion yen. On May 23, the Bank of Japan released its first loan disbursement, totaling 74.1 billion yen, to financial institutions in the disaster-stricken area, and decided to bring the total amount to 1 trillion yen by the end of October. On June 14, the Bank of Japan unveiled a 500 billion yen lending program to financial institutions and encouraged them to provide preferential loans to small and medium enterprises with technical advantages in order to promote an economic recovery. Faced with the dilemma of mounting inflation and a sluggish domestic economy, on July 7 the Bank of England chose to maintain the official Bank Rate at 0.5 percent and the stock of asset purchases at GBP200 billion.

Other central banks, including the Bank of Canada and the Reserve Bank of Australia, also left their benchmark rates unchanged.

Some central banks decided to raise their interest rates in response to inflationary pressures. On July 7, the ECB increased interest rates on the main refinancing operations, the marginal lending facility, and the deposit facility each by 25 basis points to 1.5 percent, 2.25 percent, and 0.75 percent respectively for the second time since April and against the backdrop of rising inflation. In Q2, Republic of Korea, Russia, India, Brazil, Poland, Malaysia, Thailand, Philippines, Norway, Sweden, and Chile boosted their interest rates and reserve requirement ratios to ease inflationary pressures. The Monetary Authority of Singapore re-centered the exchange rate policy band of the Singapore dollar upward against a basket of currencies, allowing the Singapore dollar to appreciate so as to relieve domestic inflationary pressures. In Q2, Vietnam increased its refinancing rate on three occasions, but on July 4, the Central Bank of Vietnam cut the rate out of concern that tightening might cause a negative impact on the economy.

5. World economic outlook

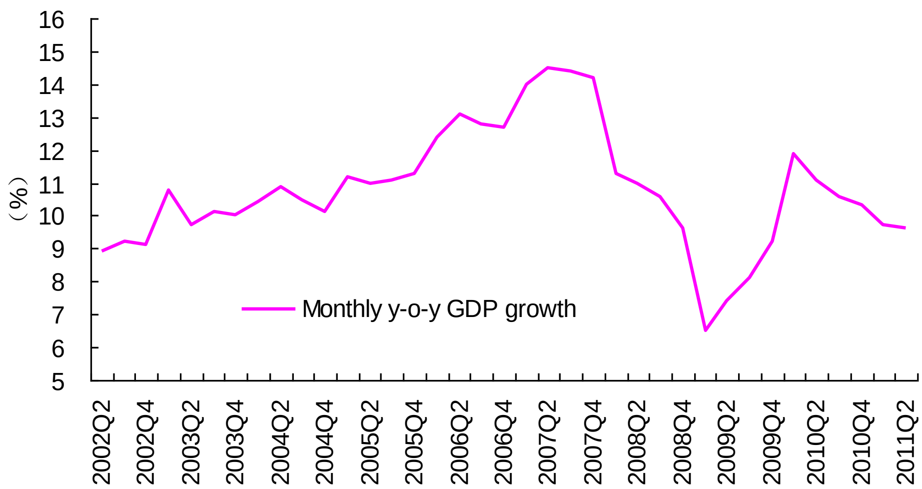
In Q2 2011, factors such as the disappointing growth in the United States, the deteriorating sovereign debt crisis in the euro area, the devastating earthquake and tsunami in Japan, and the political unrest in West Asia and North Africa led to increased downside risks and great volatility in the global economy and financial markets. In its June 2011 *World Economic Outlook*, the IMF set 2011 global economic growth at 4.3 percent, a downward adjustment from the April forecast of 4.4 percent. The IMF also cut the 2011 growth rate projection of the United States and Japan to 2.5 percent and –0.7 percent respectively but increased that of the euro area to 2 percent. The projection for the emerging market economies growth was 6.6 percent, lower than the 7.4 percent of last year.

The key downside risks to growth in the near future are as follows: first, continuously elevated unemployment in the advanced economies such as the United States could dampen global demand; second, debt burdens in the advanced economies might cause a bottleneck for recovery in the medium and longer term; third, large fluctuations of commodity prices, such as food and energy prices, might adversely influence producers and consumers, adding to uncertainties; fourth, inflationary pressures and cross-border capital flows might pose great challenges for policy making in the major emerging market economies; and fifth, there are underlying risks persisting in the financial system.

II. Analysis of China's macroeconomic performance

In the first half of 2011 China's economy maintained stable and relatively rapid growth and developed in the direction as intended by the macroeconomic management policies. Consumer demand stabilized, fixed-asset investments grew rapidly, imports and exports increased in a stable and relatively fast manner, agricultural production performed well, industrial enterprises achieved fairly good profitability, and household income grew, but prices rose rather quickly. In the first half of 2011, the Gross Domestic Product (GDP) registered RMB 20.4 trillion, up 9.6 percent year on year. In the second quarter, year-on-year GDP growth posted 9.5 percent, representing a deceleration of 0.2 percentage points from the previous quarter; quarter-on-quarter GDP growth registered 2.2 percent, representing an acceleration of 0.1 percentage points from the previous quarter. In the first half of the year, the Consumer Price Index (CPI) was up 5.4 percent year on year, and up 5.7 percent in the second quarter year on year, representing an acceleration of 0.7 percentage points from the previous quarter. The trade surplus posted US$44.93 billion in the first half of the year and US$46.4 billion in the second quarter, signaling a return of trade surplus.

Figure 7 Continued rapid growth of GDP

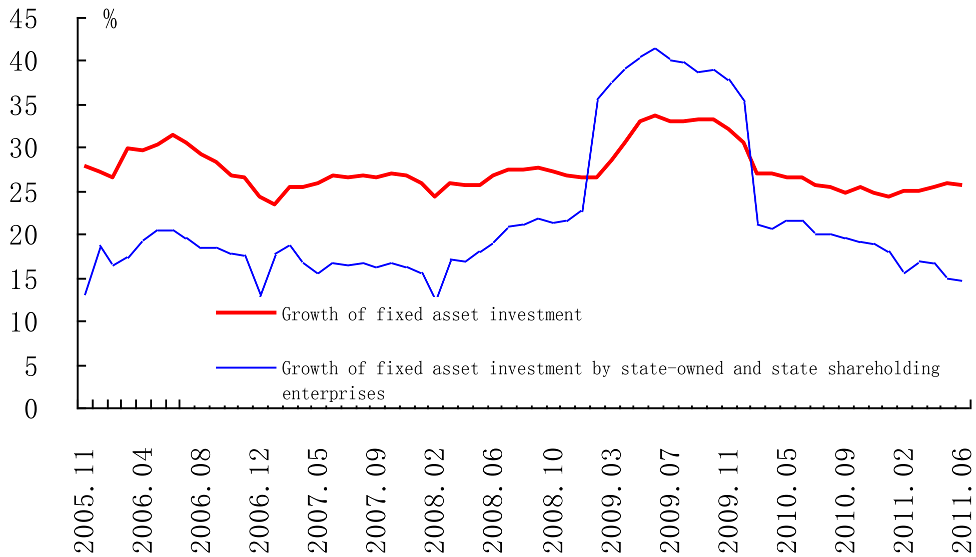


Source: National Bureau of Statistics

1. Consumer demand stabilized, investments grew rather rapidly, and the foreign trade surplus recovered

Supported by the stable income gains of urban residents and the rapid income gains of rural residents, domestic consumption remained stable. In the first half of 2011, the per capita disposable income of urban households posted 11,041 yuan, representing year-on-year growth of 13.2 percent and real growth of 7.6 percent. The per capita cash income of rural households registered 3,706 yuan, up 20.4 percent, or 13.7 percent in real terms. The PBC survey of urban depositors in the second quarter shows that the income index of residents in the period under review posted 52.1 percent, slightly lower than that in the previous quarter, due to seasonal factors, but 2.6 percentage points higher than that in the same period of the previous year. As a result, the propensity to consume rebounded from a low level, and the willingness to save increased. In the first half of the year, retail sales of consumer goods totaled 8.6 trillion yuan, representing a year-on-year increase of 16.8 percent, or 11.6 percent in real terms, at a par with the real growth in the first quarter. The consumption growth gap between the urban and rural areas remained basically stable. In the first half of the year, retail sales in the urban areas registered 7.4 trillion yuan, up 16.9 percent year on year, whereas retail sales in the rural areas posted 1.1 trillion yuan, up 16.2 percent year on year.

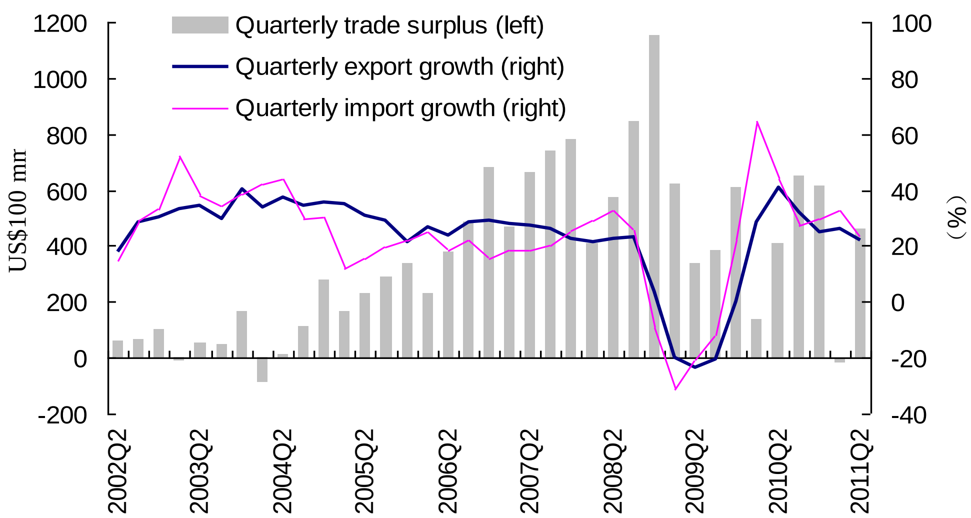
Figure 8 Fixed-asset investments grew relatively rapidly



Source: National Bureau of Statistics

The growth of fixed-asset investments remained relatively rapid, with the growth in central and western China outpacing that in the east. In the first half of the year, completed fixed-asset investments (excluding investments by rural households) totaled 12.5 trillion yuan, up 25.6 percent year on year. Among this total, investments by state-owned and state shareholding enterprises registered 4.3 trillion yuan, up 14.6 percent year on year. Broken down by region, growth of fixed-asset investments in the eastern, central, and western regions registered 22.6 percent, 31 percent, and 29.2 percent respectively. Broken down by industry, fixed-asset investments in the primary, secondary, and tertiary industries grew 20.6 percent, 27.1 percent, and 24.7 percent respectively, with growth in the primary and secondary industries accelerating by 9.8 and 2.3 percentage points respectively from the first quarter, and growth in the tertiary sector decelerating by 0.9 percentage points from the first quarter. In the first half of the year, total planned investment in new projects grew by 14.9 percent year on year to 11.2 trillion yuan, and total planned investment in projects under construction grew 19.6 percent year on year to 47.1 trillion yuan.

Figure 9 Y-o-y growth of imports and exports decelerated, the trade surplus reemerged



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

The growth of imports and exports decelerated in year-on-year terms, and the trade surplus recovered. In the second quarter, exports posted US$474.8 billion, up 22.1 percent year on year, representing a deceleration of 4.4 percentage points from the first quarter; imports posted US$428.4 billion, up 23.2 percent year on year, representing a deceleration of 9.4 percentage points from the previous quarter. In terms of absolute volume, exports reached new highs from April through June and imports remained high. Due to the growth in the volume of exports, after registering a trade deficit in the first quarter, the situation was reversed and the trade surplus recovered. The strong growth of imports and exports, which is at a historical high, can be attributed to the rapid year-on-year increase in import and export prices since the beginning of 2011. In price-adjusted terms, y-o-y imports and exports grew by 5.6 percent and 12.5 percent respectively in the second quarter.

2. Agricultural production remained generally stable, and industrial production rose rapidly

In the first half of the year, the added value of the primary, secondary, and tertiary industries reached 1.6 trillion yuan, 10.2 trillion yuan, and 8.7 trillion yuan respectively, up 3.2 percent, 11.0 percent, and 9.2 percent. The share of the three industries in GDP was 7.7 percent, 50.0 percent, and 42.3 percent respectively.

The area of summer grain increased modestly and grain output grew. According to a sample survey of the major summer grain-planting regions and statistics about the non-major grain-planting regions, total summer grain output in 2011 posted 126.27 million tons, up 2.5 percent from the previous year. In 2011 the area of planted grain for the summer season increased modestly to 27.557 million hectares, up 0.4 percent from 2010. Grain output per hectare grew to 4,582 kilograms, an increase of 2.1 percent from the previous year. In the first half of the year, the total output of meat (including pork, beef, mutton, and poultry) posted 37.22 million tons, up 0.2 percent year on year. Among this total, pork production dropped by 0.5 percent to 24.43 million tons.

Industrial production posted rapid growth and corporate profitability was stable. In the first half of the year, the added value of statistically large enterprises grew 14.3 percent year on year. Production and sales of industrial products were well connected, and 97.8 percent of manufactured goods were sold. The profitability of industrial enterprises continued to improve. In the first half of the year, profits of statistically large enterprises posted 2.4 trillion yuan, up 28.7 percent year on year. The survey of 5,000 industrial enterprises conducted by the PBC in the second quarter reveals that enterprises fared well, market demand declined slightly, inventories continued to drop, and corporate profitability was stable. In the second quarter, the corporate business index edged down from a high level by 0.5 percentage points to 70.6 percent. Building on the decline from the high level in the previous quarter, the market demand index in the second quarter shed another 0.6 percentage points to 62.9 percent. Among the total, the domestic orders index dipped for a second consecutive quarter by 0.2 percentage points from the previous quarter to 56.7 percent. The export order index ended its decline of the previous two quarters and gained 1.4 percentage points to reach 52.5 percent, the third highest gain in the past 12 quarters. Inventories of finished products dropped 0.88 percentage points from the first quarter to 48.7 percent. After a short-lived decline in the previous quarter, the corporate profitability index regained its upward trend that had started at the beginning of 2009, rising by 0.5 percentage points to 58.6 percent.

Box 3 SME operations and access to financing

Recent SME operations and access to financing have attracted wide-ranging attention from the general public. The PBC conducted timely surveys and analyses in various forms, and reports the following:

1. At present, SME operations are generally stable

The survey reveals that at present there are no substantive changes in SME orders and sales; production and operations are generally stable; and there is no such phenomenon of a “massive collapse” of SMEs as reported by some media. According to the Ministry of Industry and Information Technology, in the first quarter of 2011 added value of small- and medium-sized industrial enterprises grew 16.9 percent year on year, about 2.5 percentage points higher than the growth of statistically large industrial enterprises. A business survey conducted by the National Bureau of Statistics shows that in the second quarter of 2011 the business indices for medium-sized and small-sized enterprises posted 135.4 and 116.8 respectively, up 1.9

and 2.7 from the first quarter. In addition, according to the Questionnaire Survey on Entrepreneurs in the Second Quarter of 2011 conducted by the PBC, the export orders index rallied in the second quarter, gaining 1.4 percentage points from the first quarter to reach 52.5 percent.

2. The financial sector has taken various measures to improve financial services to SMEs, hence financial support to SMEs has been bolstered

In recent years, the PBC and other financial regulatory agencies have announced various policy measures to support SME development, through which financial services to SMEs have been improved. First, credit policy guidance has been strengthened to guarantee reasonable growth of lending to SMEs. The PBC, working with other government agencies and in June 2010 issued the *Several Opinions on Further Improving Financial Services to SMEs*, in order to guide and urge financial institutions to improve their financial services to SMEs in an all-round manner and to guarantee reasonable growth of SME loans. Second, innovation in financial products has been promoted, with a view to finding diversified financing methods for SMEs. Great efforts have been made to develop the interbank bond market, introducing a series of bond financing instruments, including SME short-term financial bills, SME collective notes, and so forth. Third, the building of new-type rural financial institutions has been advanced so as to boost support for SME access to financing. As of end-June 2011, a total of 615 new-type rural financial institutions had been set up, including village and township banks, loan companies, and rural credit shops. About 3,366 micro credit companies have been established, with outstanding loans posting 287.5 billion yuan. Fourth, the building of the credit information system and the SME credit system have been actively promoted. In May 2010 the PBC issued the *Guiding Opinions on the Building of Pilot Regions for the SME Credit System*, and continued to beef up efforts to build the credit information system and the SME credit system. As of end-June 2011, the enterprise credit information system covers 17.87 million enterprises and other organizations.

As of end-June 2011, outstanding RMB loans (including note discounts) extended by financial institutions to SMEs reached 20.1 trillion yuan, up 18.2 percent year on year. Among this total, outstanding loans to SMEs posted 9.7 trillion yuan, up 25.9 percent year on year and about 9 percentage points higher than the average growth of various loans; new loans to SMEs reached 865.9 billion yuan in cumulative terms. As of end-June 2011, about 160 SMEs had issued non-financial enterprise debt financing instruments, totaling 11.367 billion yuan.

3. Present challenges to SME production, operations, and financing activities

First, prices of energy and raw materials have risen by a large margin. In the first half of 2011, the producer purchasing price of industrial products increased 10.3 percent year on year, higher than the hike in the ex-factory price of industrial products during the same period. Second, labor costs have risen rather rapidly. In various provinces wages for SME employees have gone up by 10-30 percent in various provinces. Third, power shortages have become worse in some regions. In certain provinces, brownouts were imposed on some SMEs during the production process. Fourth, in the process of normalizing monetary conditions, the credit supply cannot remain as loose as it was two years ago. As a result, both big enterprises and SMEs have more practical difficulties in accessing financing. After the market-based reform, the risk mitigation awareness and risk control ability of commercial banks have been continually improved, and they might raise stricter requirements on lending interest rates and even lending conditions for those SMEs with grim market outlooks, piling inventories, and obviously falling profitability. Looking at the national picture, lending to SMEs is imbalanced across regions. For example, localities with more projects under construction are more likely to suffer from capital shortages. Fifth, rapidly rising interest rates for informal lending in some regions have pushed up financing costs for SMEs. Against the backdrop of price hikes, the financing interest rates of SMEs will go up and as a result the SMEs will face greater pressures. Once the price levels are under effective control, the pressures will subside.

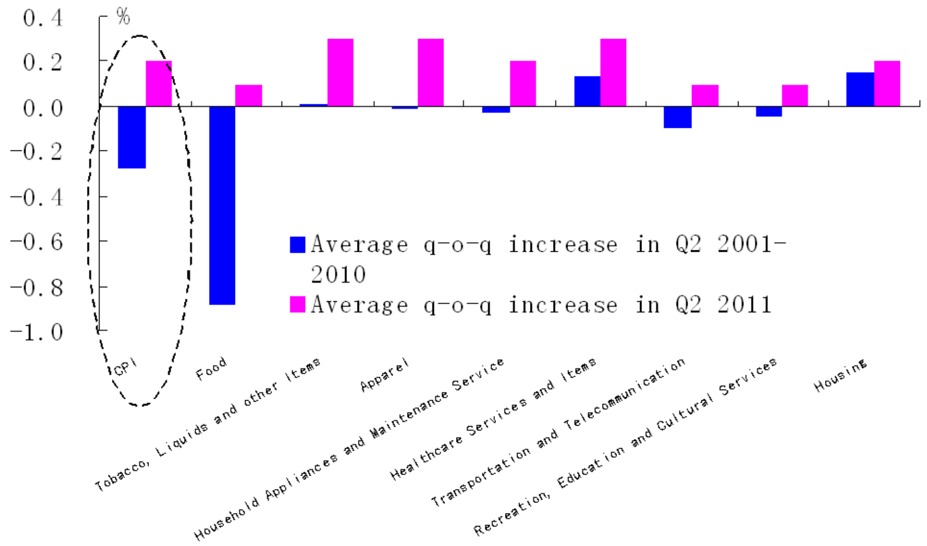
4. Policy recommendations

In general, despite many challenges, Chinese enterprises are resilient and overall SME production and operations are good. Although some enterprises have suffered losses, and even a few have closed down, this has not fundamentally influenced the pattern of relatively fast development of SMEs and there has been no massive collapse. The operational difficulties and capital crunch that some SMEs have experienced are mainly due to cost constraints on the supply side, including cost factors in terms of raw materials, the labor force, and resources. Problems of rising cost constraints accompany the industrial restructuring and upgrading, the transfer of the labor force, the reforms of the income distribution system, and the resource pricing mechanism, and inevitable pains that enterprises will have to endure during economic structural adjustments. The short-term drop in profits is the cost of the restructuring, which, to some extent, has become the very force driving enterprises to transform themselves. Only by continuing the structural adjustments as in the past, by gradually changing the pattern of extensive operations, and by moving up along the international industrial chain will the SMEs break the cost-constraints bottlenecks. However, efforts should be made to improve the multi-layered financial services system and to speed up the establishment of a deposit insurance system, to promote healthy and sustainable development of small- and medium-sized financial institutions, and to make good institutional arrangements to ensure that small- and medium-sized financial institutions provide services for SMEs. Active efforts have been made to encourage and urge financial institutions to strengthen adjustments of the credit structure, attach importance to technology-based innovation, and improve the quality of financial services rendered to SMEs. More attention has been paid to the financing demands of small and micro enterprises. At the same time, coordination among government agencies has been improved through coordinated fiscal, tax, and private capital policies, with a focus on establishing and improving a SME guarantee system and a risk compensation mechanism, so as to further broaden the financing channels available to SMEs and to establish and improve institutional arrangements and financing environments favorable to SMEs.

3. The general price level continued to rise

The growth in the CPI accelerated. In the second quarter, the CPI gained 5.7 percent year on year, an acceleration of 0.7 percentage points from the previous quarter. The monthly CPI was up 5.3 percent, 5.5 percent, and 6.4 percent respectively. Broken down by food and non-food items, food prices increased by 12.5 percent, representing an acceleration of 1.5 percentage points from the previous quarter and driving the CPI up by 3.7 percentage points. In particular, pork prices went up by 44.2 percent year on year, an acceleration of 25 percentage points from the previous quarter, driving the CPI up by 1.1 percentage points. Non-food prices gained 2.9 percent, an acceleration of 0.4 percentage points from the previous quarter, contributing to the CPI increase by 2.0 percentage points. Broken down by consumer goods and services, the prices of consumer goods grew by 6.5 percent year on year, up 1.1 percentage points from the previous quarter, showing a marked acceleration; and the prices of services were up 3.9 percent, representing a modest deceleration of 0.3 percentage points from the previous quarter. In terms of quarter-on-quarter data, the quarter-on-quarter growth of the CPI and its eight categories were above the historical average. In particular, affected by the substantial increase in the price of pork, the quarter-on-quarter increase in the price of food items notably outpaced the historical average.

Figure 10 Quarter-on-quarter CPI in Q2 2011 was notably higher than the historical average



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

Producer prices continued to rise, and the ex-factory producer prices of industrial products decelerated modestly year on year. In the second quarter, the ex-factory producer prices of industrial products gained 6.9 percent year on year, a deceleration of 0.2 percentage points from the previous quarter. The monthly price hikes were 6.8 percent, 6.8 percent, and 7.1 percent respectively year on year. In particular, the prices of capital goods decelerated by 0.4 percentage points from the previous quarter to 7.6 percent year on year, and the price of consumer goods accelerated by 0.5 percentage points to 4.6 percent in year-on-year terms. The producer purchasing prices increased by 10.4 percent year on year, representing an acceleration of 0.2 percentage points from the previous quarter, and the increase in the three months of Q2 posted 10.4 percent, 10.2 percent, and 10.5 percent respectively year on year. In the second quarter, the producer prices of agricultural products (the prices at which farmers sell their products) climbed by 18.0 percent year on year, 6.3 percentage points higher than the increase in the prices of agricultural capital goods during the same period. In the first half of 2011, the Corporate Goods Price Index (CGPI) grew 8.8 percent in year-on-year terms. Broken down by the application of goods in the CGPI basket, the prices of investment goods and consumer goods rose 8.1 percent and 10.1 percent respectively. Broken 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 17.9 percent, 13.0 percent, 8.4 percent, and 6.5 percent respectively.

Commodity prices in the international market fell. In the three months of the second quarter, the average monthly price of crude oil futures on the New York Mercantile Exchange gained 6.9 percent, -7.9 percent, and -5.0 percent respectively month on month, with the average price in June dropping by 12.5 percent from April. The spot copper price on the London Metals Exchange grew by -0.5 percent, -5.6 percent, and 1.0 percent respectively, with the average price in June about 4.6 percent lower than the price in April. The spot aluminum price in the three months gained 4.7 percent, -2.7 percent, and -1.7 percent respectively in month-on-month terms, and the average price in June was 4.3 percent lower than the price in April.

Import prices continued to rise year on year. Despite the recent fall in international commodity prices, affected by base period factors import prices continued to increase in year-on-year terms. In the three months of the second quarter, import prices went up by 12.9 percent, 16.7 percent, and 15.7 percent respectively, averaging 15.1 percent. Export prices grew by 10.9 percent, 9.4 percent, and 10.9 percent respectively in the three months year on year, averaging 10.4 percent.

The GDP deflator continued to rise. The GDP in the first half of the year registered 20.4 trillion yuan, up 9.6 percent year on year in real terms. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 7.5 percent, up 2.0 and 0.3 percentage points respectively from the same period of the previous year and the previous quarter.

The resource products pricing reform advanced steadily. In July, the National Development and Reform Commission issued a notice to put in place a new pricing mechanism for ex-factory aviation fuel starting from August 1, 2011. According to the new mechanism, the ex-factory price of aviation fuel shall be determined by the suppliers and the buyers through negotiations, based on the principle of not exceeding the CIF price in the Singapore market. Specifically, the ex-factory price is made up of the CIF price and the premium. The premium is determined on a yearly basis by the supplier and the buyer after taking into account market supply and demand, freight, volume, the movement of oil prices in the international market, and other factors. The ex-factory price of aviation fuel is adjusted every month on the first day of each month.

4. Fiscal revenue maintained rapid growth

In the first half of the year, fiscal revenue (excluding debt income) surged by 31.2 percent year on year to 5.69 trillion yuan, representing a deceleration of 1.9 percentage points from the first quarter, whereas fiscal expenditures registered 4.44 trillion yuan, up 31.4 percent year on year and an acceleration of 5.4 percentage points from the previous quarter. As a result, revenue was 1.24 trillion yuan more than expenditures.

As for the structure of fiscal revenue, tax revenue posted 5.0 trillion yuan in the first half of the year, up 29.6 percent year on year, representing a deceleration of 2.8 percentage points from the previous quarter. In particular, the domestic VAT, business tax, consumption tax, the VAT and excise tax of imported products, corporate income tax, and personal income tax were up 19.7 percent, 24.4 percent, 20.2 percent, 37.1 percent, 38.3 percent, and 35.4 percent respectively year on year. These six categories of tax revenue drove national fiscal revenue income up by 23.2 percentage points.

As for the structure of fiscal expenditures in the first half of the year, spending for medical services, housing subsidies, social security and employment, and urban and rural community affairs registered relatively rapid growth of 61.4 percent, 76.6 percent, 40.5 percent, and 43.0 percent year on year respectively. Within the expenditure basket, the three largest items were education, social security and employment, and general public services, accounting for 13.8 percent, 13 percent, and 10.3 percent respectively.

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

In the first quarter of 2011 China's balance of payments (BOP) continued to run a “twin surplus” and foreign exchange reserves assets continued to rise. In particular, the current account surplus declined by 21 percent year on year to US$28.8 billion, the capital and financial account surplus was up 41 percent to US$86.1 billion, and foreign exchange reserve assets grew by US$138 billion. In the first half of 2011, against the background of the complex and changing macroeconomic conditions both at home and abroad, pressures of net inflows of foreign exchange mounted and foreign exchange reserves grew rapidly. As of end-June, foreign exchange reserves posted US$3197.5 billion, an increase of 30.3 percent year on year. Given the economic fundamentals both at home and abroad, the interest rate spread, the expected exchange gains, and other factors, it is expected that China will continue to have net inflows of foreign exchange in the second half of the year.

The volume of external debt grew rapidly and the share of outstanding short-term debt increased. As of end-March 2011, the stock of China's external debt stood at US$586 billion, up 32.2 percent year on year. Among this total, the stock of registered external debt posted US$366.9 billion, up 32.7 percent year on year; short-term external debt posted US$411.7 billion, a year-on-year increase of 49 percent, accounting for 70.3 percent of the stock of external debt and representing an acceleration of 7.9 percentage points from the same period of the previous year.

6. Sectoral analysis

Industrial profits grew rapidly. In the first half of the year, among all 39 industrial sectors, 38 sectors reported year-on-year growth in profits, and one sector experienced a year-on-year decline in profits. Among the industries, the profits of the oil and natural gas exploration industry, the mining of ferrous metals industry, the chemical raw materials and chemical products manufacturing industry, and the chemical fiber manufacturing industry grew 37.7 percent, 61.7 percent, 57.1 percent, and 49.8 percent respectively, whereas the profits of the oil processing, coking, and nuclear fuel processing industry tumbled by 66 percent. In the first half of the year, crude coal output grew by 12.7 percent year on year to 1.77 billion tons, power generation increased 13.5 percent year on year to 2216.6 billion kilowatt hours, and the output of crude oil grew 4.6 percent year on year to 102.89 million tons. A total of 17.09 billion tons of cargo was transported, up 13.9 percent year on year.

(1) The real estate sector

In January 2011 the General Office of the State Council issued the *Notice of the General Office of the State Council on Further Improvements in Real Estate Market Regulatio*n (State Council General Department Document [2011] No. 1, hereinafter referred to as State Council General Department Document No. 1). In order to implement the principles outlined in the State Council General Department Document No. 1, the concerned central government agencies and various local governments subsequently announced related measures. With the various policy measures put into place and with the continuous and intensive regulation, positive changes have emerged in the nationwide real estate market, the excessive hike in housing prices has been contained, and the growth of real estate loans has continued to decelerate.

The excessive hike in housing prices decelerated. In June, prices of newly built commercial residential housing dropped month on month in 12 out of 70 large- and medium-sized cities, and remained flat in 14 cities. In total, 6 more cities joined the group experiencing no month-on-month hike in commercial residential housing prices compared with those in March. About 44 cities reported month-on-month price hikes that were smaller than those in March; 19 cities reported a month-on-month price decline; and 12 cities saw basically no change, among which no city showed a month-on-month price increase larger than 1.0 percent.

The growth of sales of commercial real estate first decelerated and then accelerated. From January to April, the year-on-year growth of sales of commercial real estate first decelerated and then picked up. In the first half of the year, the sold floor area of commercial real estate was up 12.9 percent year on year to 444.19 million square meters, representing a deceleration of 2.0 percentage points from the previous quarter but an acceleration of 3.8 percentage points from the first five months of the year; sales of commercial real estate were up 24.1 percent year on year to 2458.9 billion yuan, representing a deceleration of 3.2 percentage points from the first quarter, but an acceleration of 6.0 percentage points from the first five months of the year. In particular, the sold area of commercial residential housing rose 12.1 percent, down 2.2 percentage points from the first quarter but an acceleration of 3.6 percentage points from the first five months; the sales value of commercial residential housing grew 22.3 percent, representing a deceleration of 3.6 percentage points from the first quarter and an acceleration of 6.3 percentage points from the first five months.

Investment in real estate development continued to grow rapidly. In the first half of 2011, completed investment in real estate development totaled 2625 billion yuan, up 32.9 percent year on year, representing a deceleration of 1.2 percentage points from the first quarter. In particular, completed investment in commercial residential housing reached 1864.1 billion yuan, up 36.1 percent year on year. Completed investment in commercial residential housing accounted for 71 percent of the total investment in real estate development, a rather stable percentage. In the first half of 2011, the floor area of newly built housing increased by 23.6 percent year on year to 994 million square meters, representing an acceleration of 0.2 percentage points from the previous quarter. The floor area of housing under construction grew 31.6 percent to 4.057 billion square meters, a deceleration of 3.6 percentage points from the first quarter. The floor area of completed housing stood at 276 million square meters, up 12.8 percent year on year and representing a deceleration of 2.6 percentage points from the first quarter.

The expansion of outstanding real estate loans decelerated. The year-on-year growth of outstanding real estate loans peaked at 46.4 percent in April 2010 and since then has continued to pull back. As of end-June 2011, outstanding real estate loans of the major financial institutions (including foreign financial institutions) reached 10.26 trillion yuan, up 16.9 percent year on year and a deceleration of 4.4 percentage points from end-March; in particular, outstanding mortgage loans posted year-on-year growth of 17.5 percent to 6.26 trillion yuan, representing a deceleration of 5.3 percentage points from end-March, the fourteenth consecutive month of decline. Outstanding real estate development loans were up 18.4 percent year on year to 2.62 trillion yuan, representing a deceleration of 0.9 percentage points from end-March. Outstanding land development loans were up 0.5 percent year on year to 796.8 billion yuan, representing a deceleration of 12 percentage points from end-March. As of end-June 2011, outstanding real estate loans accounted for 20.5 percent of the total outstanding loans. In terms of new loans, new real estate loans in the first half of 2011 reached 791.2 billion yuan in cumulative terms, a reduction of 598.5 billion yuan year on year. New loans posted 67.8 billion yuan in June, about 63 billion yuan less than that during the same period of the previous year. In the first half of the year, new real estate loans accounted for 19.7 percent of the total new loans, representing a deceleration of 4.3 percentage points from the first quarter and a deceleration of 7.2 percentage points from 2010.

The "12th Five-Year Plan" envisages a large increase in the supply of government-subsidized housing. State Council General Department Document No.1 outlined the objective of building government-subsidized housing and transforming shanty housing—a total of 10 million units in 2011. With the progress and acceleration of the construction of government-subsidized housing, financial institutions have rendered more support. In the first half of 2011, new loans for the building of government-subsidized housing amounted to 90.8 billion yuan, a surge of 54.8 percent from the beginning of the year and 48.3 percentage points faster than the growth in real estate development loans at the beginning of the year.

(2) The power sector

In the first half of the year power supply and demand were generally balanced; however, there were structural problems of power shortages in some regions. In the first five months, statistically large power plants generated 1816.2 billion kilowatts of electricity and total power consumption reached 1854.5 billion kilowatts, up 12.8 percent and 12.0 percent respectively year on year. Affected by such short-term factors as the dwindling hydropower output due to the protracted drought in some regions in southern China, some provinces (municipalities) took brownout and other measures in the off-season. In terms of the structure of power consumption, rapid growth of some highly energy-consuming industries exacerbated the shortage in supply. In the first five months, the six highly energy-consuming industries, including the power industry, the iron and steel industry, the non-ferrous metals industry, the chemical industry, and the petro-chemical industry consumed a total of 887.3 billion kilowatts of power, accounting for 48 percent of total consumption, thus making structural adjustments, energy savings, and pollution reductions even more necessary and urgent. The newly installed capacity is on the decline and more of the installed power generation capacity has gone to western China. In the first five months, the total newly installed capacity reached 24.49 million kilowatts, down 3.69 million kilowatts from the same period of the previous year. In particular, the newly installed thermal power generation capacity dropped by 4.97 million kilowatts from the same period of 2010. The installed capacity in the western, central, and eastern regions grew 16.7 percent, 8.6 percent, and 8.1 percent respectively year on year.

Production costs of thermal power plants rose and the profitability of the entire industry declined. The high price of coal pushed up the production costs of thermal power plants. In the first four months, profits of thermal power plants tumbled 58.6 percent to 5.7 billion yuan, and their sales profitability stood at 1.4 percent. As of end-April, their assets-to-liabilities ratio was 73.8 percent, up 2.1 percentage points from end-March. Since the capacity of thermal power plants accounted for more than 70 percent of the total capacity nationwide, the profitability of thermal power plants would directly affect e the profitability of the entire industry. In the first four months, total profits of the industry amounted to 41.5 billion yuan, down 0.4 percentage points year on year and the first negative year-on-year growth since May 2009.

Sustainable and healthy development of the power sector is necessary for the shift in the economic growth pattern, for energy conservation and pollution reduction, and for coordinated regional economic development. The current power supply shortages in some regions are a result of the impact of short-term factors and certain structural problems, such as the geographical distribution of the power plants, the under-developed grids, and the insufficient role of the market in allocating power resources. Efforts should be made to continue to deepen the reform, increase the share of green power generation, diversify the sources of power supplies, increase the resource- allocation ability of grids, correct price distortions in coal supply and power generation, establish a reasonable power pricing mechanism, educate the public on energy savings, and contain the disorderly expansion of the highly energy-consuming industries, so as to promote economic structural adjustments, optimization, and upgrading.

Part 5 Monetary Policy Stance for the Next Period

I. Outlook for the Chinese economy

Since the beginning of 2011 the growth of the Chinese economy has been fairly rapid and stable and it has moved in the direction intended by macroeconomic management. Though unstable and uncertain factors emerged in the global economy from time to time, the tepid recovery of the world economy continues and China's exports have maintained relatively fast growth. As a result of pro-active macroeconomic management, the Chinese economy continued its momentum of stable and fairly rapid growth in the first half of 2011, and the month-on-month GDP growth in Q2 accelerated slightly, an indication of the strong dynamics of growth and investment expansion. Though the investment growth of central government-supported projects has slowed since the beginning of 2011, the investment growth of local projects has maintained a rapid increase. Local governments are all keen to promote urbanization, industrialization, and balanced regional development, to expand the vast potential of consumption, and to accelerate the construction of welfare housing. These will provide a driving force for sustained economic growth. It should be acknowledged that having the growth rate return to a sustainable level and keeping it at a proper and stable level will help contain excessive price hikes and facilitate the economic restructuring and the shift in the growth pattern. According to the PBC's survey of enterprises, bankers, and urban depositors in Q2, the major indices remained elevated even after a slight moderation. About 70 percent of the respondents expected future employment to be "good" or to "remain basically unchanged," a fairly good level compared with the survey results since the beginning of 2009; the enterprise demand expectation index, domestic order index, and export order index all declined slightly; and the bank loan demand index fell 2.2 percentage points from Q1 but remained fairly high. As financial institutions still have many potential loan projects and enterprise credit demand is strong, lending is still under expansionary pressures. With fiscal accounts burdened by debt and sovereign debt crises occurring in succession, economic growth in the major advanced countries lacks steam. The recovery is likely to be fraught with setbacks and fluctuations. The downward risks are not to be ruled out as there are multiple uncertain and unstable factors. On the one hand, we need to closely follow developments in the global picture and promptly respond to major events; on the other hand, it is necessary to accelerate adjustments of the economic structure by boosting consumer demand at the core, improve the quality of economic development, taking effective measures to expand the domestic market and improve the environment for market activities and expansion, and achieving more balanced and sustainable economic development based on endogenous drivers.

The price situation provides no room for optimism. As a series of policy measures gradually have an impact, aggregate demand will remain generally stable. Growth of money and credit has continued to moderate since the second half of 2010 and monetary conditions are returning to normal. Furthermore, global growth has slowed modestly and recent international commodity prices have been stable, adding to the factors favorable to price stability in China. Yet the basis is not yet solid for the general price level to remain stable and the situation is not optimistic. As new growth drivers have not yet emerged in the major advanced economies, the extremely loose international monetary conditions with tepid growth and prominent fiscal problems are not likely to change in the short run, thus a large amount of capital is still likely to flow into the growing emerging market economies. This, plus the uncertainties in commodities price movements, points to the possibility of imported inflation. The upward tendency in domestic labor costs and resource prices will act as driving forces for price hikes. In addition, as a result of the domestic investment boom in response to the global financial crisis, many projects are still under construction and aggregate demand has rebounded sharply. Though aggregate demand is kept stable under the impact of macroeconomic management policies, it is increasing rapidly and there are still pressures supporting its expansion. As such, it is necessary to properly manage the pace and intensity of macroeconomic management. According to the PBC's Q2 urban depositors' survey, the respondents' expectations of a price hike weakened and the price expectation index declined slightly. This is an indication of the unfolding effect of the policy measures. But in general inflation expectations have remained high. In the survey, the percentage of respondents who believed current housing prices were excessively high was flat with Q1, a rather high percentage since the question was included in the survey and more respondents thought that in the second half of 2011 housing prices would "remain stable" or "difficult to judge."

II. Monetary policy during the next stage

Going forward, the PBC will follow the overall arrangements of the State Council, take sustainable development as the central theme and acceleration in the shift of the growth pattern as the core of its policy conduct, implement a prudent monetary policy, maintain the general direction of the macroeconomic management policies, continue to pursue stability of the general price level as the central task of macroeconomic management, strengthen monitoring and analysis of the economic situation at home and abroad, properly manage the intensity and pace of policy measures, make macroeconomic management policies well-targeted, more flexible, and more forward-looking, preserve the outcome of the macroeconomic management measures adopted during the previous stage, make good assessments of the current and anticipated effects of the policy measures, and properly handle the relationship among preserving stable and fairly rapid economic growth, adjusting the economic structure, and managing inflation expectations.

First, a combination of multiple policy tools will be used to keep the all-system financing aggregates at a proper volume, including interest rates, exchange rates, open market operations, the required reserve ratio, and macro-prudential management measures. Liquidity management will be strengthened to keep liquidity at reasonable levels. In line with economic performance, the situation in the financial sector, and the change in foreign exchange flows, a combination of policy tools with a proper maturity structure and intensity of operations will be used to strengthen liquidity management in order to maintain liquidity in the banking system and growth of money and credit at appropriate levels. Price instruments such as interest rates will be used to adjust demand for funds as well as investment and deposit activities and to manage inflation expectations. The macro-prudential policy framework will be improved to combine the adjustment of aggregates in the form of money, credit, and liquidity management with stronger macro-prudential management; to properly adjust the measures in line with the macroeconomic changes and the soundness of the banking system. The adjustment of the differentiated required reserve ratio will continue to encourage financial institutions to maintain sound operations, to adjust lending, and to boost their risk-prevention capability. The monitoring and adjustment of the all-system financing aggregates will be intensified to keep them at an appropriate level.

Second, measures will be taken to optimize the credit structure, improve financial services, and enhance credit support to structural adjustments, in particular to the agricultural sector and small enterprises. The PBC will guide financial institutions to manage the pace of lending, to beef up innovation in financial products and services, and to increase support to priority areas and weak links. While keeping the necessary intensity in adjusting the aggregate level, measures will be taken to guide more credit support to rural areas, the agricultural sector, and farmers as well as to SMEs, and to provide good financial services to support job creation, students in need of loans, and poverty reduction. Financial institutions will be urged to improve financial support to strategic and emerging industries, energy conservation and environmental protection industries, modern services sectors, and projects of independent innovation in science and technology, to strictly control lending to industries that consume excessive energy and pollute heavily and industries with excess capacity, and to support development of a low-carbon economy in accordance with the requirements of economic restructuring and the shift in the economic development pattern. Consumer credit will be developed to support expansion of domestic demand. Financial support will continue for balanced regional development. The differentiated mortgage credit policy will be implemented and loans will be promptly disbursed to qualified welfare housing projects to promote the healthy development of the real estate market. Efforts will be made to strengthen systemic risk prevention. Risk management will be enhanced regarding lending to local government financing platforms, off-balance sheet assets, and real estate financing.

Third, 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 guide financial institutions to build interest rate pricing mechanisms and to explore effective ways to promote market-based interest rates. 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 more balanced BOP account. Development of the foreign exchange market will be enhanced and innovation in exchange rate risk management tools will be encouraged. 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. The impact of international developments on capital flows will be closely monitored and effective measures will be adopted to enhance monitoring and management of cross-border capital.

Fourth, the PBC will continue to promote the healthy development of financial markets and to deepen the reform of financial institutions so that financial markets will be in a better position to play a fundamental role in resource allocations. Direct financing will be expanded and financing instruments, such as stocks, bonds, and industrial funds, will each play a role in this process. To promote market development, efforts will be made to support financial product innovation and to improve the institutional framework and infrastructure building in the financial market to enable the financial market to serve the real economy. The opening-up of the interbank bond market will be actively and prudently advanced. Large commercial banks that have undergone joint stock reform will be encouraged to promote a sound modern financial enterprise system. The reform of the Agricultural Bank of China will be promoted, and the reform of its Agricultural and Rural Business Department will be advanced to improve services for the agricultural sector, the rural areas, and farmers. Reform of policy financial institutions will be advanced. Study will continue on how to deepen the reform of rural credit cooperatives with a view to further improving their capital quality, legal person governance, and services to the agricultural sector, farmers, and rural areas.