China Monetary Policy Report
Quarter Three, 2011

(November 16, 2011)

Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In the third quarter (Q3) of 2011 the Chinese economy continued its steady and fairly rapid development, gradually moving from policy-stimulus-driven to endogenous growth. Consumer demand remained stable, fixed-asset investments increased relatively rapidly, and external trade was more balanced. Domestic demand became a driving force behind the economic growth, performance in the agricultural and industrial sectors was stable, household income grew, and the momentum for an excessive spike in prices was initially contained. In the first three quarters, the Gross Domestic Product (GDP) registered RMB32.1 trillion, up 9.4 percent year on year, and the Consumer Price Index (CPI) rose by 5.7 percent year on year.

In Q3 the People's Bank of China (PBC), in accordance with the overall arrangements of the State Council, regarded inflation control as the top priority of macroeconomic management, continued its prudent monetary policy, and improved the targeting, flexibility, and effectiveness of its policy measures. A mix of price-based and quantitative monetary instruments as well as macro-prudential tools were employed to step up liquidity management, guide the steady growth of money and credit, maintain all-system financing aggregates at a reasonable volume, and guide financial institutions to properly manage the pace of lending and to improve the credit structure. Meanwhile, the RMB exchange rate regime continued to improve and reform of the financial sector advanced.

The effects of the prudent monetary policy were gradually revealed and growth of money and credit began to return to normal, commensurate with the stable and fairly rapid growth of the economy. At the end of September 2011, broad money supply M2 recorded RMB78.7 trillion, up 13.0 percent year on year. Outstanding RMB loans were up 15.9 percent year on year, representing growth of RMB5.68 trillion from the beginning of the year and 597.7 billion less than the growth registered during the first nine months of 2010. In the first three quarters of 2011, all-system financing aggregates posted RMB9.80 trillion and financing became more diversified. In September, the weighted average lending rate offered to non-financial enterprises and other sectors posted 8.06 percent. At end-September 2011, the central parity of the RMB against the US dollar was RMB6.3549, up 4.21 percent over end-2010.

The current stabilization of economic growth is the outcome of preemptive macroeconomic management. In the period ahead, the world economic situation is likely to remain complex, with the global financial crisis continuing to have a deeply-rooted impact and new problems, changes, and challenges emerging on the domestic front. However, endogenous drivers are readily available for stable economic growth. The economy is likely to continue its stable and fairly rapid development. In line with the overall arrangements of the State Council, the PBC will follow the theme of sustainable development, facilitate the transformation of the patterns of economic growth, continue to implement a prudent monetary policy, place more focus on the policy targeting, flexibility, and forward-looking characteristics , closely monitor economic and financial developments at home and abroad, properly manage the pace and strength of macroeconomic management, and initiate fine-tuning and preemptive adjustments as appropriate in order to consolidate the momentum for stable and rapid development, to maintain price stability, and to step up prevention of systemic risks.

In view of economic and financial developments and the flow of foreign exchange funds, a combination of multiple policy tools will be employed and the macro-prudential policy framework will be improved to keep the all-system financing aggregates at a proper pace. Coordination of credit and industrial policies will be strengthened. The PBC will guide financial institutions to manage the pace of lending, to implement the differentiated credit policy, to make sure the fund demands of ongoing and follow-up projects are satisfied, to focus on supporting SMEs that are compatible with the industrial policies, and to support projects that enhance people's welfare, especially government-subsidized housing projects. Risk management of lending to local government financing platforms, off-balance-sheet assets, and real estate financing will be enhanced, and efforts will be made to beef up prevention of systemic risks. 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, develop financial markets, optimize the financing structure, and promote the development of financial markets to serve the real economy.

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Part 1 Monetary and Credit Performance

In Q3 2011, the prudent monetary policy produced the desired results. China's money and credit growth moved in the direction of a normal level, which is in line with the stable and relatively rapid economic growth. The financial system performed soundly

I. The growth of money supply generally declined

At end-September 2011, outstanding M2 registered RMB78.7 trillion, up 13.0 percent year on year, decelerating 2.9 percentage points over end-June 2011. Outstanding M1 stood at RMB26.7 trillion, an increase of 8.9 percent year on year, decelerating 4.2 percentage points over end-June 2011. Currency in circulation M0 totaled 4.7 trillion, up 12.7 percent year on year, decelerating 1.7 percentage points over end-June 2011. In the first three quarters of 2011, net cash withdrawals posted 255.7 billion, RMB104.5 billion less year on year. In general, as intended by the macroeconomic management measures and the prudent monetary policy, growth of the aggregate money supply was stable, and M2 and M1 growth declined quarter by quarter. Moreover, given the impact of financial innovations such as off-balance-sheet wealth management products since the beginning of 2011 on the moderation of M2 growth, monetary conditions in real terms were at an appropriate level for the real economy.

At the end of September, outstanding base money registered 21.2 trillion, up 32.8 percent year on year and 3.0 trillion more than that at the beginning of the year. At end-September, the money multiplier stood at 3.71, which was 0.13 lower than that at end-June 2011. At end-September, the excess reserve ratio of financial institutions stood at 1.4 percent, and that of rural credit cooperatives (RCCs) stood at 3.4 percent.

Box 1 M2 Growth Steadily Declined

In the first three quarters of 2011, M2 growth gradually returned to normal, declining from 19.7 percent at end-2010 to 13.0 percent at end-September 2011. In general, this was the result of the implementation of the prudent monetary policy and was in line with the expectations of the macroeconomic management. Though M2 growth at end-September 2011 was lower than that in previous years, monetary conditions were basically appropriate for China’s stable and relatively rapid economic growth.

1. Financial innovation is having an increasingly significant influence on monetary statistics

Innovative financial instruments have diversified the ways the corporate and household sectors invest, thereby diverting their savings. This has led to an under-estimation of the total money supply.

(1) Deposits of non-depositary financial institutions at depositary financial institutions, including demand and time deposits of trust companies, lease companies, securities companies, and insurance companies at depositary financial institutions: These deposits follow the operations of the overall financial market very closely and are almost as liquid as the components of M2. At end-September 2011, they stood at 2.8 trillion, increasing 549.9 billion over the beginning of 2011 and up 31.9 percent year on year.

(2) Deposits at centers of housing provident funds, namely the housing reserve funds collected by entrusted banks but not yet disbursed: When claimed by depositors or lent out as housing reserve loans, such deposits constitute money supply to the real economy. At end-September 2011, outstanding deposits at centers of housing provident funds registered 699.2 billion, up 113 billion over the beginning of the year, an increase of 39 percent year on year.

(3) Funds mobilized by off-balance-sheet wealth management businesses, referring to funds acquired by commercial banks for the sale of wealth management products off their balance sheets: Commercial banks, as issuers of such products, bear no credit risks, whereas the buyers are fully exposed to the investment risks. At end-September 2011 the outstanding value of off-balance-sheet wealth management products totaled 3.3 trillion, up 927.5 billion over the beginning of 2011 and 45.7 percent more year on year. Wealth management products as a substitute for deposits have become a popular way for commercial banks to attract funds.

(4) Domestic deposits of overseas financial institutions, referring to RMB deposits of overseas financial institutions flowing back to China via trade settlement or other channels: In general, such deposits are allocated for payment and settlement, and may influence domestic liquidity and aggregate demand.

Despite the rapid growth of the above-mentioned items, other innovative financial institutions and instruments, such as money market funds, trusted investment programs, and bankers’ acceptances, have also diversified deposits, leading to an under-estimation when money growth is used to measure monetary conditions in real terms. All relevant factors should be factored in when attempting to understand and interpret changes in money supply at present.

2. Present monetary conditions meet the goals of macroeconomic management.

As indicated by the M2 growth, due to the changes in currency rates, the volume of loans, and the all-system financing aggregates during the last round of the prudent monetary policy, current monetary conditions basically meet the goals of macroeconomic management.

(1) During the last round of the prudent monetary policy (from 1998 to 2007), M2 growth was lower than 15 percent for half of the period, peaking at 19.6 percent in 2003 and reaching a trough of 12.3 percent in 2000 and with an arithmetic average of 15.9 percent. After taking into account financial innovations, at present money growth in real terms is only slightly below the average noted above. Money supply is at a relatively high level as a result of measures taken to cope with the global financial crisis during the past two years and the fact that China's economic growth is stabilizing. As a result, present money aggregates are basically in line with demand in the real economy.

(2) In the past, the circulation of money generally slowed down due to the market reform and other factors. However, in years of comparatively higher inflation, expectations that there will be a contraction in purchasing power often accelerate the circulation of money, thereby lowering the demand for money. From January through September 2011 the circulation of money in China remained at a relatively high level. In order to stabilize inflation expectations, the growth of money aggregates should be reined in.

(3) Growth of lending and growth of all-system financing aggregates is not slow. By end-September 2011, outstanding RMB loans of financial institutions had grown 15.9 percent year on year, up 0.4 percentage points over that during the period between 2000 and 2008. Meanwhile, China's financing structure has diversified, with a larger share of direct financing. Multiple financing channels, such as debt financing, equity financing, trust loans, entrusted loans, and foreign exchange loans, all play important roles. Operation of the economy is less dependent on an incremental money supply.

Money supply is merely an intermediate goal of monetary policy. Analysis, adjustment, and management of the money supply should serve the ultimate goals of the monetary policy. The development of financial innovations and changes in the economic situation necessitate that the central bank make comprehensive and dynamic assessments of the changes in the intermediate goals in relation to the changes in aggregate demand, and accordingly adopt a monetary policy mix to meet the ultimate goals of monetary policy.

II. Deposit growth of financial institutions slowed down

At end-September 2011, outstanding deposits in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, the same hereinafter) stood at 81.0 trillion, up 13.9 percent year on year and decelerating 3.6 percentage points over the beginning of 2011. Outstanding deposits were RMB8.2 trillion more than that at the beginning of 2011, a deceleration of 2.1 trillion year on year. Outstanding RMB deposits registered 79.4 trillion, up 14.2 percent year on year, decelerating 3.4 percentage points over end-June 2011. This was 8.1 trillion more than that at the beginning of 2011, a deceleration of 2.1 trillion year on year. Outstanding deposits in foreign currencies posted USD255.7 billion at end-Q3, an increase of 9.0 percent year on year or USD30 billion more than that at the beginning of 2011, which was USD6.8 billion more than the growth during the same period of the previous year.

In particular, growth of household deposits and deposits of non-financial institutions continued to slow down. At end-September, outstanding household deposits stood at RMB33.7 trillion, up 13.6 percent year on year, decelerating 3.4 percentage points from end-June. This was also 3.6 trillion more than that at the beginning of 2011 and 258.1 billion less than the growth during the same period of the last year. Outstanding RMB deposits of non-financial institutions totaled RMB29.1 trillion, up 10.9 percent year on year, decelerating 3.9 percentage points over end-June. This was also 1.3 trillion more than that at the beginning of 2011, a deceleration of RMB2.2 trillion year on year. At end-September, outstanding fiscal deposits reached RMB3.8 trillion, up 12.3 percent year on year and 1.2 trillion more than that at the beginning of 2011, an acceleration of 15.1 billion year on year.

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

At end-September, outstanding loans in domestic and foreign currencies of all financial institutions reached 56.2 trillion, up 16.0 percent year on year, a deceleration of 0.8 percentage point over end-June. This was also 6.0 trillion more than that at the beginning of the 2011, a deceleration of RMB488.7 billion.

The growth of RMB loans continued to slow down. At end-September, outstanding RMB loans stood at 52.9 trillion, up 15.9 percent year on year, a deceleration of 1.0 percentage point over end-June. This was also 5.68 trillion more than that at the beginning of 2011, a deceleration of 597.7 billion year on year. Among this total, new loans in Q3 registered RMB1.5 trillion, decelerating RMB148.1 billion year on year but accelerating by 294.9 billion when compared with the same period of 2009. Credit demand for project investments, small- and medium-sized enterprises (SMEs), government-subsidized housing, agriculture, rural areas, and farmers, and disaster relief remained strong. Broken down by sectors, the growth of loans for the household and non-financial corporate sectors slowed down. At end-September, outstanding household loans increased 22.7 percent year on year, decelerating 2.1 percentage points over end-June. This was also 2.0 trillion more than that at the beginning of 2011, a deceleration of 363 billion. Among this total, the growth of home mortgage loans slowed down, growing by RMB657.6 billion over the beginning of 2011 and marking a deceleration of 414.5 billion. Non-housing consumer loans grew robustly by 483.3 billion over the beginning of 2011, an acceleration of 55.5 billion year on year. Loans to non-financial institutions and other sectors increased by 13.5 percent year on year, 0.6 percentage point lower than that at end-June. This was also RMB3.7 trillion more than that at the beginning of 2011, a deceleration of RMB245 billion. Broken down by maturities, medium- and long-term loans grew 1.7 trillion over the beginning of the year, a deceleration of RMB1.9 trillion year on year and marking a continued slowdown. Bill financing was RMB5.9 billion less than that at the beginning of 2011, which was RMB803.9 billion 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 Chinese small- and medium banks accelerated.

Table 1 RMB Loans of Financial Institutions in the First Three Quarters of 2011

Unit: 100 million

	Q1-Q3 of 2011		Q1-Q3 of 2010	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	27, 773	-5, 566	33, 339	-14, 542
Chinese-funded Small and Medium Banks Operating Nationwide②	17, 765	1, 047	16, 718	-6, 807
Chinese-funded Small and Medium Local Banks③	4, 090	-371	4, 461	-1, 845
Rural Cooperative Financial Institutions④	8, 836	-1, 155	9, 992	468
Foreign-funded Financial Institutions	565	-545	1, 109	1, 174

Note: ①Chinese-funded large banks operating nationwide refer to banks with assets denominated in foreign and domestic currencies worth no less than RMB2 trillion (according to the amount of total assets of the financial institutions in both domestic and foreign currencies 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 RMB2 trillion.

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.

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

Source: People’s Bank of China.

The growth of foreign-currency-denominated loans rebounded. At end-September, outstanding foreign-currency loans of financial institutions reached USD523.9 billion, up 24.4 percent year on year and accelerating 2.2 percentage points over end-June. This was also USD73.4 billion more than that at the beginning of 2011, an acceleration of USD30.9 billion year on year. Trade financing increased by USD26.8 billion, accelerating USD19.2 billion year on year, thereby maintaining support for imports and exports. Overseas loans and medium- and long-term loans climbed by USD26.5 billion.

IV. All-system financing aggregates increased steadily, and the means of financing were diversified

According to preliminary statistics, in the first three quarters of 2011 all-system financing aggregates registered RMB9.80 trillion, down RMB1.26 trillion compared with the same period of the previous year. Among this total, new RMB loans posted RMB5.68 trillion, a deceleration of RMB597.7 billion. Foreign-currency-denominated loans increased the equivalent of 477 billion, accelerating by RMB184.9 billion year on year. New entrusted loans rose by RMB1.07 trillion, accelerating by RMB562.5 billion year on year. Trust loans increased by RMB84.8 billion, decelerating by RMB392.4 billion. Non-discounted bankers' acceptances grew by RMB982.5 billion year on year, decelerating by RMB984.3 billion. Net financing through corporate bonds registered RMB839.7 billion, decelerating by RMB137.3 billion. A total of RMB351.5 billion was raised by domestic non-financial institutions via the stock markets, down RMB11.3 billion year on year.

The financing structure became more diversified. First, the share of RMB loans remained stable. In the first three quarters of 2011, new RMB loans accounted for 58.0 percent of the all-system financing aggregates, up 1.0 percentage point year on year. Second, foreign-currency-denominated loans held a much larger share of the all-system financing aggregates. In the first three quarters of the year, the share of new foreign-currency-denominated loans was up 4.9 percent of the all-system financing aggregates, up 2.5 percentage points year on year. Third, the share of direct financing was stable. From January through September, a total of 1.19 trillion was financed through bonds issued by the non-financial corporate sector and the domestic stock markets, accounting for 12.2 percent of the all-system financing aggregates. This was flat with the share during the same period of the last year. Fourth, non-banking financial institutions provided much stronger support for the economy. In the first three quarters, compensation payments by insurance companies and new loans extended by micro-credit companies and loan companies totaled 306.5 billion, marking a significant acceleration year on year. Fifth, off-balance-sheet financing provided by financial institutions to the real economy decreased significantly as a share of total financing. In the first three quarters, a total of 2.14 trillion was financed through non-discounted bankers' acceptances, entrusted loans, and trust loans, accounting for 21.8 percent of the total financing, 4.9 percentage points less year on year.

V. The lending rates of financial institutions climbed slightly

The lending rates offered to non-financial institutions and other sectors maintained a generally upward trend, with growth declining month by month. In September, the weighted average lending rate was 8.06 percent, up 0.77 percentage point over June. The weighted average interest rate of ordinary loans registered 7.80 percent, up 0.44 percentage points over June, and the weighted average bill financing rate posted 9.55 percent, up 2.57 percentage points over June. The weighted average residential mortgage rate rose steadily and stood at 7.36 percent in September, up 0.53 percentage point over June.

Loans with interest rates higher than the benchmark occupied a much larger share. In September, the share of loans with interest rates higher than the benchmark stood at 67.19 percent, up 6.04 percentage points over June. Loans with interest rates lower than or flat with the benchmark accounted for 6.96 percent and 25.86 percent of the total respectively, down 2.98 and 3.05 percentage points over June.

Table 2 Shares of Loans with Rates Floating at Various Ranges of the Benchmark Rate in the First Half of 2011

Unit：%

	Adjusted downward	At the benchmark	Adjusted upward					
	[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
July	8.53	26.72	64.74	20.75	23.98	8.14	8.99	2.89
August	6.05	25.27	68.67	22.40	25.80	8.42	9.06	3.00
September	6.96	25.86	67.19	21.62	25.47	8.29	8.89	2.91

Source: The People’s Bank of China.

Table 3　Average Interest Rates for Large-value Deposits and Loans Denominated in US Dollars, January through September

Unit：%

	Large-value deposits						Loans				
	Demand Deposits	Within 3 months	3-6 months (including 3 months)	6-12 months (including 6 months)	1 year	Above 1 year	Within 3 months	3-6 months (including 3 months)	6-12 months (including 6 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
July	0.33	2.68	2.98	3.39	2.78	5.47	3.30	3.58	4.23	3.90	3.78
August	0.31	2.95	3.47	3.44	3.58	5.36	3.34	3.69	4.03	3.97	3.58
September	0.35	2.99	3.81	3.15	3.86	5.61	3.37	3.75	4.37	3.70	3.76

Source: The People's Bank of China.

In general, foreign currency deposits and lending rates registered a slight increase due to the sustained elevation of interest rates in international markets and the change in supply and demand of foreign-currency funds in China. In September, the weighted average interest rate of demand deposits and large-value US dollar deposits with a maturity of less than 3 months stood at 0.35 and 2.99 percent respectively, up 0.09 and 0.2 percentage point over June. The weighted average interest rate of US dollar loans with a maturity of less than 3 months and 3-6 months (including 3 months) posted 3.37 percent and 3.75 percent respectively, up 0.21 percentage point and 0.29 percentage points over June.

VI. The flexibility of the RMB exchange rate rose significantly

In Q3 2011, the RMB exchange rate moved in both directions and appreciated slightly, with much stronger flexibility and stable expectations. At end-September, the central parity of the RMB against the US dollar was 6.3549 per US dollar, up 1167 basis points or 1.84 percent over end-June and an appreciation of 4.21 percent over the end of 2010. From the reform of the RMB exchange rate regime in July 2005 to end-September 2011, the RMB appreciated a cumulative 30.24 percent against the US dollar. The BIS estimated that the nominal effective exchange rate of the RMB appreciated 1.58 percent and the real effective exchange rate appreciated 4.24 percent in the first three quarters of 2011, and the nominal effective RMB exchange rate appreciated 16.59 percent and the real effective exchange rate appreciated 27.81 percent from the exchange rate reform in 2005 to end-September 2011.

Part 2 Monetary Policy Operations

In the third quarter of 2011, following the overall arrangements of the State Council, the PBC continued its prudent monetary policy as it worked to maintain price stability, which remains the priority of macroeconomic management. Making policies more targeted, flexible, and effective, the PBC ensured steady money and credit growth through strengthened management of liquidity in the banking system, kept total financing to the real economy at an appropriate level, and encouraged financial institutions to properly pace the credit supply and to improve the credit structure. The PBC continued to improve the RMB exchange rate regime and pressed ahead with the reform of financial institutions. All these efforts contributed to stable and sound economic and financial development.

I. Flexible open market operations

Open market operations were conducted in a timely and appropriate manner. Supported by closer monitoring of the dynamics affecting liquidity supply and demand, open market operations were used to complement other monetary policy tools to adjust liquidity in the banking system. In the third quarter, the PBC issued RMB164 billion of central bank notes and conducted RMB629 billion of repo operations. As of end-September, outstanding central bank bills totaled RMB1.93 trillion.

The mix of different tools was improved. In response to short-term liquidity volatility caused by seasonal factors and market developments, and depending on the changes in liquidity supply and demand in the banking system, sterilization operations were conducted to supplement central bank bills and short-term repos, and 7-day short-term repos were introduced, which contributed to a refined mix of tools, making sterilization operations more targeted and flexible.

Interest rates of open market operations remained flexible. Supporting adjustments in the benchmark deposit and lending rates and accommodating the liquidity management measures, such properly managed flexibility, based on market interest rate movements, was successful in shaping market expectations. As of end-September, interest rates for 3-month, 1-year, and 3-year central bank bills stood at 3.1618 percent, 3.5840 percent, and 3.970 percent respectively, up 8.17 percentage points, 8.58 percentage points, and 8.00 percentage points from end-June. Interest rates for repo operations also recorded a rise.

State treasury cash management was conducted in a timely manner, with a total of RMB90 billion of state treasury funds deposited as time deposits in commercial banks in three separate operations during the third quarter.

II. An improved reserve requirement policy

As a regular adjustment and institutional improvement, the scope of deposits against which reserves are required was broadened to cover margin deposits, effective from September 2011 and enforceable within 3 to 6 months depending on the liquidity level at each financial institution. Adjusted on a continuous basis, the scope had already been expanded to include on-balance-sheet wealth management products, time deposits of state treasury funds, and deposits by financial holding companies, making sure it remained adaptable to financial developments and was supportive of the role of monetary policy in macroeconomic management. As financial markets in China deepen and grow wider, businesses based on bankers' acceptances, letters of credit, and letters of guarantee, and subsequently margin deposits have been expanding rapidly. Against this backdrop, the latest expansion of the reserve requirement policy will help ensure that the coverage of required reserves remains complete and that it plays a better role in macroeconomic management.

With appropriate refinements of the parameters, the policy of differentiated reserve requirements with on-going adjustments, while subjecting credit growth to counter-cyclical capital requirements, will continue to encourage financial institutions to maintain steady credit growth and to improve the credit structure.

III. An increase in benchmark deposit and lending rates

The PBC raised the benchmark deposit and lending rates on July 7, increasing the 1-year benchmark deposit rate from 3.25 percent to 3.50 percent and the 1-year benchmark lending rate from 6.31 percent to 6.56 percent, both up by 0.25 percentage point. This timely increase of the benchmark rates supported efforts to stabilize inflationary expectations and to guide reasonable money and credit growth. It was also important to reinforce the effects of property market policies, to improve the allocation of funds, and to protect household wealth.

IV. Strengthened window guidance and credit policy guidance

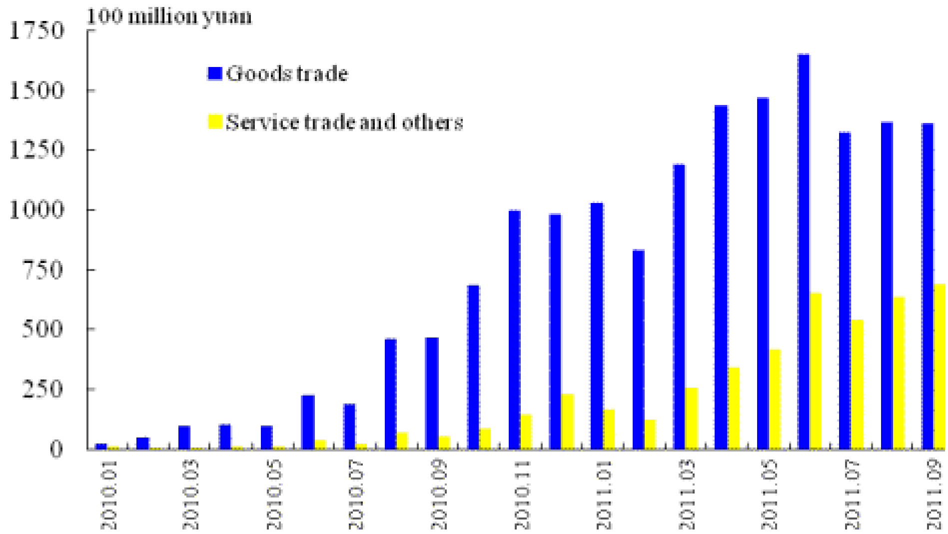
Continuing to strengthen and improve window guidance, the PBC encouraged financial institutions to properly manage the pace of credit supply, improve the credit structure, and prevent credit risks. As part of efforts to better coordinate credit policy with industrial policy, the PBC strengthened the requirements for implementation of the differentiated credit policy and credit structure. With improved assessments of the effects of the credit policy, including lending policies for agriculture and SMEs, the PBC encouraged better financial services to agriculture, rural areas, and farmers, as well as greater lending support for SMEs to meet the reasonable financing needs of SMEs with financial difficulties that have satisfied the industrial, environmental, and lending qualifications. The PBC also supported lending to energy-conservation and emission-reduction projects, strategic emerging industries, cultural industries, and other key areas, and encouraged improved financial support and services to employment programs for women, university graduates, people with disabilities, migrant workers, and other groups, as well as initiatives aimed at better developing the old revolutionary base areas, ethnic minority areas, border regions, and impoverished areas. The PBC also 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, thus supporting the economic restructuring.

On the whole, lending to SMEs, agriculture, rural areas, and farmers remained robust. As of end-September, outstanding loans (including bill discounts) to SMEs totaled RMB20.76 trillion, an increase of RMB2.26 trillion from the beginning of the year. In particular, outstanding loans to small enterprises increased 24.3 percent year on year to RMB10.13 trillion, surpassing lending to large and medium enterprises by 13.9 percentage points and 11.7 percentage points respectively. As of end-September, total outstanding agro-linked loans in both RMB and foreign currencies totaled RMB13.96 trillion, or 24.8 percent of the total lending.

V. Progress in the cross-border use of RMB

On August 22, 2011, the PBC, together with five other government agencies, in the *Notice on Extending the Geographical Coverage of the Use of RMB in Cross-border Trade Settlement,* announced that enterprises in all provinces will be allowed to use RMB to settle cross-border trade. On October 13, the Ministry of Commerce issued the *Notice on Issues regarding Cross-border Direct Investments in RMB*, and the PBC released the *Administrative Measures on Settlement of Foreign Direct Investment in RMB*, which allow overseas investors to invest in RMB in China. In the first three quarters, RMB settlement in cross-border trade recorded RMB1540.98 billion, growing 6.9 times year on year, and in the third quarter RMB settlement registered RMB583.41 billion, representing a drop from the previous quarter. This included RMB396.86 billion in goods trade and 186.55 billion in services trade and other items under the current account. Actual RMB receipts and payments in the third quarter totaled RMB419.57 billion, including RMB156.90 billion in receipts and RMB262.67 billion in payments. As a result, the receipt-to-payment ratio increased to 1.67 from the last quarter’s 1:2.9, suggesting more balanced use of RMB in settling imports and exports. Bank settlement of outbound RMB direct investments in the first three quarters reached RMB10.85 billion. As of end-September, mainland agent banks opened 1,149 interbank RMB accounts for participating overseas banks, with a total outstanding balance of RMB202.52 billion, an average of RMB176.00 million in each account. Overseas enterprises opened a total of 3,734 settlement accounts at mainland banks, with a total balance of RMB86.77 billion and an average of RMB23.24 million 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 PBC further improved the RMB exchange rate regime reform 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 third quarter, the central parity of the RMB against the US dollar peaked at 6.3549 per dollar and reached a trough of 6.4748 per dollar. Among the 65 trading days, the interbank foreign exchange market saw an appreciation of the RMB against the US dollar on 34 days and a depreciation on 31 days. The largest intraday appreciation was 0.28 percent (or 176 points), whereas the largest intraday depreciation was 0.14 percent (or 90 points).

The RMB exchange rate moved in both directions against the euro, Japanese yen, and other major international currencies. At end-September, the central parity of the RMB against the euro registered 8.6328 per euro, an appreciation of 8.44 percent from end-June, and the central parity of the RMB against the Japanese yen stood at 8.2978 per 100 Japanese yen, a depreciation of 3.30 percent from end-June. Beginning from the RMB exchange rate regime reform in 2005 to end-September 2011, on a cumulative basis the RMB appreciated 16.00 percent against the euro and depreciated 11.95 percent against the Japanese yen.

In the third quarter, the interbank foreign exchange spot market recorded RMB6470.71 billion of transactions in RMB against the US dollar, RMB19.63 billion in RMB against the euro, RMB19.49 billion in RMB against the Hong Kong dollar, RMB6.77 billion in RMB against the Japanese yen, RMB2.93 billion in RMB against the Russian ruble, RMB280 million in RMB against the pound sterling, and RMB500 million in RMB against the Malaysian ringgit. RMB trading against the Russian ruble, the Malaysian ringgit, and the currencies of the other emerging markets was becoming increasingly brisk in the interbank foreign exchange market, providing direct bilateral exchange rates for micro-level market players and supporting bilateral economic and trade development.

Box 2 Direct Trading Between the RMB and Currencies of the Emerging Market Economies

After the RMB exchange rate reform in 1994, the China interbank foreign exchange market began to offer RMB exchange rates against five international reserve currencies, i.e., the US dollar, the euro, the Japanese yen, the pound sterling, and the Hong Kong dollar. Following the recent financial crisis, the market witnessed a growing demand for trading between the RMB and the currencies of the emerging market economies as micro-level market participants sought to reduce exchange costs amid the heightened volatility of the major currencies.

In response to this growing demand, the PBC explored the possibility of introducing direct trading between the RMB and the currencies of the emerging market economies in the interbank foreign exchange market. As a result, direct trading between the RMB and the Malaysian ringgit was launched on August 19, 2010. China also agreed to support Russia's proposal to start trading between the RMB and the Russian ruble in the two countries' interbank foreign exchange markets, as stated in the *China-Russia Joint Statement on Comprehensively Deepening Coordination of the Strategic Partnership*, which was released by the Chinese and Russian governments in September 2010. With vigorous efforts by the central banks in both countries, trading between the two currencies was launched in the interbank foreign exchange market in China on November 22, 2010, and in the Moscow Interbank Currency Exchange (Micex) on December 15, 2010.

Direct trading between the RMB and the currencies of the emerging market economies differs in two ways from that between the RMB and the reserve currencies other than the US dollar. First, they have different mechanisms for determining the central parity. While the central parities for the RMB against the euro, the Japanese yen, the pound sterling, and the Hong Kong dollar are calculated based on the central parity of the RMB against the US dollar and the exchange rates between the US dollar and these currencies, the central parities for the RMB against the ringgit and the ruble are quoted directly from the market makers without involving a third currency, and their market exchange rates are generated directly at commercial banks on the basis of supply and demand. Second, they have different floating bands. The trading prices of the RMB against the ringgit and the ruble are allowed to fluctuate within 5 percent around their central parities, which is wider than the 3 percent range for trading between the RMB and non-US dollar reserve currencies.

With brisk trading and growing volume, trading between the RMB and the currencies of the emerging market economies in the China interbank foreign exchange market developed in a healthy manner. Trading between the RMB and the ruble totaled RMB 3.31 billion as of end-September. In the second half of 2011, its trading volume exceeded the trading between the RMB and the pound sterling, and was also close to that between the RMB and the euro, the Japanese yen, and the Hong Kong dollar. Trading between the RMB and the ringgit is becoming increasingly brisk. Meanwhile, in overseas markets RMB trading with the currencies of the emerging market economies is off to a good start. As of end-September, RMB trading with the ruble in the Moscow interbank foreign exchange market reached RMB 449 million.

Trading between the RMB and the currencies of the emerging market economies in the interbank foreign exchange markets brings notable benefits. First, it cuts exchange costs for exporters by avoiding double exchanges via a third currency. Second, it reduces exchange rate risks arising from the volatility of a third currency and it facilitates settlement in local currencies. Third, it produces single, transparent, and direct exchange rates, thereby facilitating trading. Fourth, it lowers the costs and risks for banks by allowing them to square their positions in related currencies accumulated from the sales and purchases of these currencies from customers, encouraging RMB trading with such currencies at banks. Fifth, it supports the development of offshore RMB markets.

The currencies of the emerging market economies are playing a greater role, backed by their rapid growth and increasing importance in the global economy. To meet market demand, further efforts will be made to promote trading between the RMB and the currencies of the emerging market economies in the interbank foreign exchange markets so as to facilitate bilateral economic and trade ties and to better support the use of RMB in cross-border trade settlement.

VII. Progress in the reform of financial institutions

Steady progress was made to reform key financial institutions. In September 2011, the PBC issued the *Notice on Expanding the Pilot Reform Program of the Agricultural Bank of China (ABC) to Build a Multi-divisional Structure for Financial Services to Agriculture, Rural Areas, and Farmers*. According to this *Notice*, the pilot reform will be expanded to include 371 ABC county-level sub-branches in Heilongjiang, Henan, Hebei, and Anhui provinces, bringing the total coverage to 929 counties in 12 provinces (autonomous regions or municipalities). The PBC encouraged the ABC to intensify its institutional reforms, step up financial services for agriculture, rural areas, and farmers, and at the county-level. Reforms in the policy financial institutions were also advanced. At end-June, the China Export and Credit Insurance Corporation (Sinosure) received RMB20 billion as a capital injection from the

China Investment Corporation, and it is making progress in implementing a reform plan. The China Agricultural Development Bank also began its reform process by launching a reform working group in August.

Important progress was made in reforming the rural credit cooperatives (RCCs). First, the quality of RCC assets improved significantly. Based on the five-category loan classification, at end-September outstanding non-performing loans at RCCs totaled RMB373.8 billion, down RMB46.6 billion from end-2010, and the NPL ratio declined 1.7 percentage points from end-2010 to 5.7 percent. The capital adequacy ratio stood at 9.6 percent, up 1.2 percentage points from end-2010. Second, the RCCs' financial position was strengthened significantly and their agro-linked lending expanded by a large margin. At end-September, total deposits at RCCs posted RMB9.7 trillion, accounting for 12.2 percent of the total deposits of all financial institutions, up 0.3 percentage point from end-2010. RCC lending registered RMB6.6 trillion, or 12.4 percent of the total lending by all financial institutions, an increase of 0.6 percentage point from end-2010. Agro-linked loans extended by RCCs reached RMB4.5 trillion, an increase of RMB625.2 billion or up 16.1 percent from end-2010, while RCC lending to rural households stood at RMB2.4 trillion, a rise of RMB316.1 billion or 15.5 percent from end-2010. Third, progress was made in RCC property rights reform. As of end-September, a total of 1,942 RCCs, 134 rural commercial banks, and 214 rural cooperative banks had been established, all with legal person status at the county (city) level.

VIII. Deepened reform of foreign exchange administration

Efforts were intensified to monitor and fight “hot money” inflows. These efforts included greater scrutiny of key cases and special campaigns aimed at regulating the surrender of foreign exchange capital by foreign-funded enterprises and the banks' foreign exchange businesses, tougher actions against other illegal activities, which led to the identification of criminal cases involving underground banking and illegal online foreign exchange trading, and greater publicity of foreign exchange violations by banks, enterprises, and individuals helped discourage irregularities.

Monitoring of cross-border capital flows was strengthened. To deal with cross-border arbitrage activities, contingency plans were developed to enhance foreign exchange market administrative measures. Effective measures were implemented to verify the authenticity of trade-based foreign exchange inflows while also encouraging foreign exchange purchases and payments with authentic trade and investment backgrounds. Moreover, management of capital from foreign direct investments was strengthened by using the tax leverage and enterprises were encouraged to deposit their proceeds from exports in overseas banks. The establishment and registration of foreign-funded property companies were placed under stringent scrutiny, supported by enhanced coordination with the commerce authority, and assessments of the banks' observance of foreign exchange regulations were improved to encourage better compliance.

Reform of foreign exchange administration for goods trade and other key areas was advanced. In early September, the State Administration of Foreign Exchange (SAFE) announced in the *Public Notice on the Pilot Reform of Foreign Exchange Administration for Goods Trade*, a document issued jointly with the State Administration of Taxation and the General Administration of Customs, that starting from December 1, a pilot program designed to reform the verification system for goods trade would be launched in Jiangsu and 6 other provinces (municipalities) as part of the efforts to enhance the system's regulatory effectiveness while improving its efficiency.

Part 3 Financial Market Analysis

In the third quarter of 2011, China's financial market continued to perform in a healthy and sound manner. The money market traded briskly and interest rates declined slightly. Bond market yield curves shifted upward and bond issuances grew significantly. Stock indices declined and financing on the stock markets declined.

I. Financial market analysis

1. The money market traded briskly, and market interest rates declined from a high level

Repo transactions and interbank borrowings on the money market were brisk and the trading volume increased. In the first three quarters of 2011, the turnover of bond repos totaled RMB71.8 trillion, with an average daily turnover of RMB384.2 billion, up 11.1 percent year on year. The turnover of interbank borrowings reached RMB23.9 trillion, with an average daily turnover of RMB127.6 billion, an increase of 18.4 percent year on year. Market transactions still focused on overnight products, with overnight bond repo and interbank transactions accounting for 75.5 percent and 84.2 percent of their respective turnovers, down 4.5 and 3.5 percentage points from the same period of the previous year. The total turnover of government securities repos on the stock exchanges soared 202.2 percent year on year to RMB13.6 trillion.

The financing structure remained unchanged. Stated-owned commercial banks continued to be the main fund provider, although their net lending declined, whereas foreign-funded financial institutions, as net borrowers during the same period of the previous year, became net lenders of RMB219.1 billion. The funding demands of securities and fund management companies declined by a large margin.

Table 4　Fund Flows among Financial Institutions in the First Three Quarters of 2011

Unit：RMB100 million

	Repo		Interbank borrowing	
	In the first three quarters of 2011	In the first three quarters of 2010	In the first three quarters of 2011	In the first three quarters of 2010
State-owned commercial banks	-151,721	-182,021	33,417	-22,842
Other commercial banks	47,273	70,866	-20,381	6,791
Other financial institutions	99,006	84,319	-5,404	13,313
Of which: Securities companies and fund management companies	42,429	57,981	7,214	2,274
Insurance companies	19,055	10,414	——	——
Foreign-funded financial institutions	5,441	26,835	-7,632	2,738

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 declined slightly. Since the beginning of 2011, money market interest rates in general were higher than in the previous year. After the monthly weighted average interest rate of bond-pledged repo and interbank borrowing reached respective yearly highs of 4.94 percent and 4.56 percent in June, both declined. Due to a number of factors, such as the volume of cash withdrawals before the National Day holiday and the end-of-quarter performance evaluations of the commercial banks, interest rates climbed appreciably in September compared with July and August. The weighted average interest rate of bond-pledged repo and interbank borrowing posted 3.75 percent and 3.74 percent respectively in September, down 119 and 82 basis points from June, but up 63 and 82 basis points from December 2010. The Shibor rates of all maturities declined. At end-September, the overnight, 7-day, and 3-month Shibor rate stood at 4.8925 percent, 5.0025 percent, and 5.6466 percent respectively, down 11, 160, and 75 basis points from end-June.

Trading of RMB interest-rate swaps grew rapidly. In the first three quarters of 2011, there were 16,925 transactions, with an aggregate nominal principal of RMB2,154.6 billion, up 170.0 percent year on year. In terms of the maturity structure, RMB interest-rate swaps with maturities of one year and or less traded most briskly, with a nominal principal of RMB1,553.9 billion, accounting for 72.1 percent of the total. The base rate of the floating end of the RMB interest-rate swaps mainly included the 7-day fixing repo rate and the Shibor, and their nominal principal accounted respectively for 55.7 percent and 40.6 percent of the total.

Table 5 Transactions of Interest Rate Derivatives from 2006 to Q3 2011

	Bond forwards		Interest-rate swaps		Forward-rate agreements	
	Transactions	Amount① (RMB100 million)	Transactions	Amount of nominal principal (RMB100 million)	Transactions	Amount of nominal principal (RMB100 million)
2006	398	664. 5	103	355. 7	——	——
2007	1, 238	2, 518. 1	1, 978	2, 186. 9	14	10. 5
2008	1, 327	5, 005. 5	4, 040	4, 121. 5	137	113. 6
2009	1, 599	6, 556. 4	4, 044	4, 616. 4	27	60. 0
2010	967	3, 183. 4	11, 643	15, 003. 4	20	33. 5
Q1 2011	159	212. 6	4, 775	5, 667. 9	2	2. 0
Q2 2011	66	237. 7	4, 834	6, 607. 6	0	0
Q3 2011	148	431. 1	7, 316	9, 271. 0	1	1. 0

Note: ① In 2009 statistics for transactions of bond forwards were changed to the settlement amount of the transactions.

Source: China Foreign Exchange Trade System.

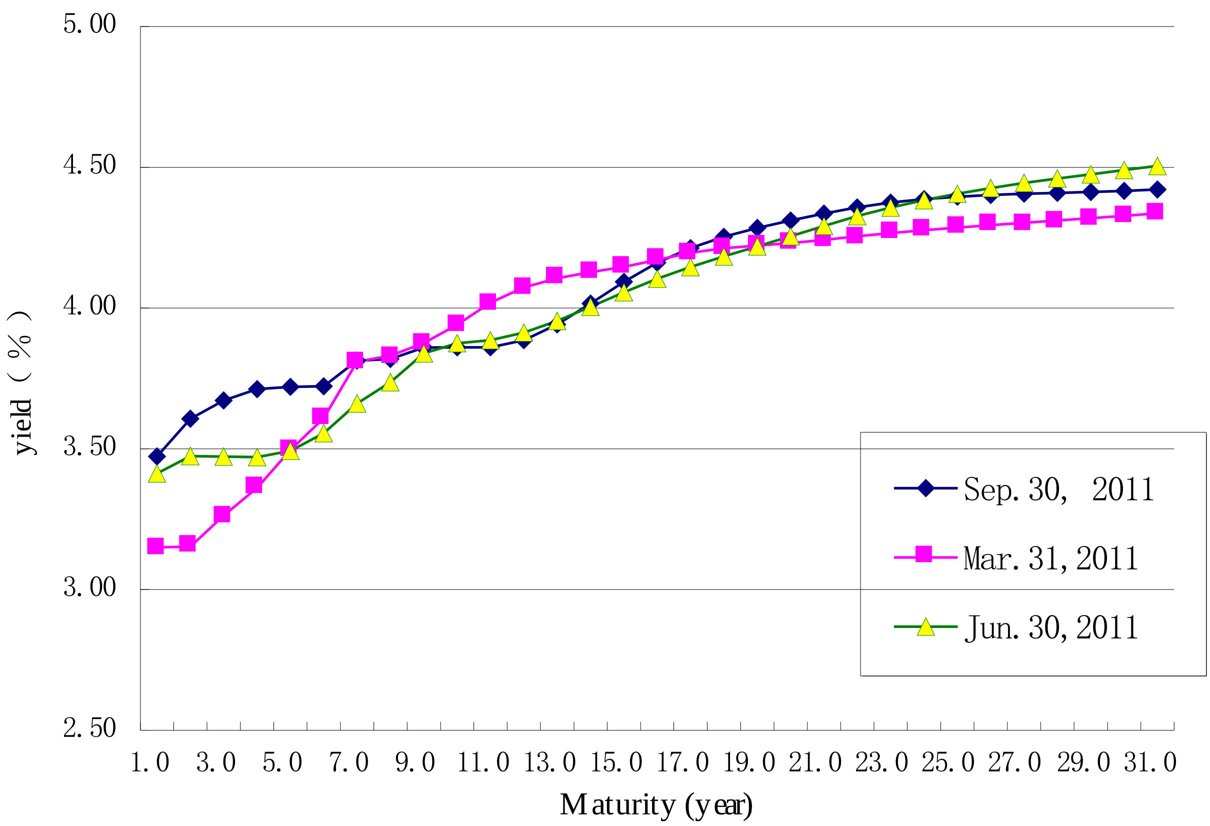
2. The yield curves of government securities shifted upward and bond issuances grew significantly

The volume of spot trading increased steadily on the interbank bond market. In the first three quarters of 2011, the turnover of spot bond trading totaled RMB47.8 trillion, with a daily average of RMB255.4 billion, up 7.4 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 RMB472.1 billion and RMB164.1 billion respectively; other commercial banks and other financial institutions were net bond sellers, with net sales of RMB494 billion and RMB1422 billion respectively. A total of RMB98.8 billion of spot government securities was traded on the stock exchanges, RMB33.2 billion less than that during the same period of the previous year.

At end-September, the China Bond Composite Index (net price) declined 0.61 percent from end-June to 98.5 points, while the China Bond Composite Index (full price) rose 0.31 percent to 136.31 points. From end-June, the index of government securities on the stock exchanges rose 0.93 percent to 129.8 points.

The yield curves of government securities shifted slightly upward. Due to a number of factors, such as the continuous elevation of the CPI and hikes in the reserve requirement ratios, the yield curves of government securities showed an upward trend. At end-September, the average yields of 1-year, 5-year, 15-year, and 20-year government securities were respectively 13, 17, 5, and 4 basis points higher than those at end-June.

Figure 2　Yield Curves of Government Securities on the Interbank Market



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

Bond issuances grew significantly. In the first three quarters of 2011, a total of RMB4.69 trillion of bonds (excluding central bills) was issued, up 20.2 percent year on year. In particular, issuances of subordinate bonds and hybrid bonds, which were issued by commercial banks to increase their capital adequacy ratio, increased rapidly by 109.8 percent year on year. Issuances of policy financial bonds also maintained a rapid pace, increasing 78.4 percent year on year. Issuances of government securities fell slightly, with the volume of total issuances at RMB1.4 trillion in the first three quarters, down 6.0 percent year on year. At end-September, a total of RMB20.7 trillion of bonds was deposited with the China Government Securities Depository Trust and Clearing Co., Ltd., an increase of 3.5 percent year on year.

Table 6 Issuances of Bonds in the First Three Quarters of 2011

Type of bonds	Issuances (RMB100 million)	Year-on-year growth (%)
Government Securities①	14,017	-6.0
Of which：municipal bonds	1,416	-16.4
Policy financial bonds issued by the China Development Bank and other policy banks	16,168	78.4
Bank subordinate bonds and hybrid bonds	1,669	109.8
Bank ordinary bonds	20	100
Enterprise bonds②	14,572	13.8
Of which： Short-term financial bills	7,182	27.6
Medium-term notes	4,801	12.4
Corporate bonds	973	178.9

Notes: ① Including municipal bonds issued by the Ministry of Finance on behalf of local governments.

② Including enterprise bonds, short-term financing bills, medium-term notes, collective bills of SMEs, and corporate bonds.

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

Against the background of the volatility in global financial markets and due to the changed expectations, risk preferences, and demands for asset allocations by market institutions, the issuance rates of bonds showed a diversified trend. The coupon rate of 10-year government securities issued in September was 3.93 percent, down 6 basis points from those of the same maturity issued in June, while the interest rate of 10-year policy bonds issued by the China Development Bank was 5.07 percent, up 46 basis points from those of the same maturity issued in June. The Shibor played a greater role in bond pricing. In the first three quarters of 2011, 11 floating-rate bonds based on the Shibor were issued on the primary bond market, with a gross issuance volume of RMB112.1 billion, accounting for 25 percent of the issuance of all floating-rate bonds. In particular, 7 floating-rate policy financial bonds were issued, with a total issuance of RMB109.7 billion. Furthermore, 137 enterprise bonds were issued, with a total volume of RMB160.6 billion, all based on the Shibor.

3. Bill financing grew slightly, and interest rates on the bill market moved up amid fluctuations

Outstanding bill financing grew slightly and the bill market traded briskly. In the first three quarters, commercial bills issued by enterprises totaled RMB11.2 trillion, representing year-on-year growth of 26.3 percent; the volume of discounted bills amounted to RMB18.2 trillion, representing a year-on-year decrease of 5.2 percent. At end-September, the total value of outstanding commercial bills increased 23.9 percent year on year to RMB6.5 trillion;

outstanding discounted bills registered RMB1.5 trillion, down 5.3 percent year on year. In the third quarter, financial institutions continued to adjust the aggregate credit and loan structure and reasonably controlled the growth of bill financing. The outstanding balance of bill financing at end-September increased by RMB136.3 billion from the end of the last quarter, representing an acceleration of RMB16.2 billion and accounting for 2.8 percent of all kinds of loans, down 0.6 percentage point year on year. Affected by a number of factors, such as interest rates on the money market and changes in supply and demand for bills, interest rates in the bill market in the third quarter of 2011 continued to move up and hovered at a historical high level.

4. The stock indices and equity financing both declined

In general, the stock indices declined. At end-September, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index declined 14.6 percent and 15.0 percent from end-June to close at 2,359 points and 10,292 points respectively. The average P/E ratio on the A-share market of the Shanghai Stock Exchange declined from 16.5 times at end-June to 14.2 times at end-September; the average P/E on the A-share market of the Shenzhen Stock Exchange declined from 30.7 times to 27.0 times. The indices on the Shenzhen GEM Board also declined. At end-September, the Shenzhen Stock Exchange SME Price Index closed at 791 points, down 6.5 percent from end-June.

The volume of transactions on the stock markets declined marginally. In the first three quarters of 2011, turnover on the Shanghai and Shenzhen Stock Exchanges totaled RMB34.8 trillion, down 0.6 percent year on year, and the daily turnover averaged RMB189.4 billion, RMB4.4 billion less than that during the same period of the previous year. The volume of transactions on the GEM Board amounted to RMB1.29 trillion, representing an increase of 27.1 percent year on year. At end-September, market capitalization declined 8.8 percent from the end of the last year to RMB17.6 trillion, representing an increase of 15.5 percent year on year. Market capitalization on the GEM Board amounted to RMB251.6 billion, representing an increase of 124.8 percent year on year.

Financing on the stock markets declined somewhat. A total of RMB468.2 billion was raised by all kinds of enterprises and financial institutions in the first three quarters of 2011 by the way of IPOs, additional offerings, warrant exercises, right issuances, and bonds with detachable warrants, RMB296.9 billion less than that during the same period of the previous year. Among this, RMB391.4 billion was raised by IPOs and warrant exercises on the A-share market, RMB193.7 billion less than that during the same period of the previous year.

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

In the first three quarters of 2011, total premium income in the insurance industry amounted to RMB1.13 trillion, and total claim and benefit payments increased 27.0 percent year on year to RMB287.3 billion. Specifically, total claim and benefit payments in the property insurance sector increased 24.1 percent, whereas those in the life insurance sector increased 30.3 percent.

Total assets in the insurance industry maintained fairly rapid growth. At end-September, total assets in the insurance industry posted RMB5.7 trillion, an increase of 19.3 percent year on year. Among this total, bank deposits increased 31.5 percent and investment-type assets increased 13.4 percent.

Table 7 Use of Insurance Funds at end-September 2011

	Outstanding balance (RMB100 million)		As a share of total assets (%)	
	End-September 2011	End-September 2010	End-September 2011	End-September 2010
Total assets	57,257	47,995	100	100
Of which: Bank deposits	17,183	13,070	30.0	27.2
Investments	35,428	31,253	61.9	65.1

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 three quarters of 2011, the turnover of spot foreign exchange transactions totaled USD2,766.7 billion, representing an increase of 20.5 percent year on year; the turnover of RMB foreign exchange swap transactions totaled USD1,316.5 billion, representing an increase of 38.5 percent year on year; among this total, overnight RMB/USD swap transactions amounted to USD752.4 billion, accounting for 57.2 percent of all currency swap transactions; the turnover on the RMB foreign exchange forward market totaled USD176.7 billion, an increase of 2343.0 percent year on year. In the first three quarters of 2011, the turnover of foreign currency pair transactions amounted to USD73.4 billion, an increase of 63.7 percent year on year. In particular, USD/HKD pairs accounted for the lion’s share, or 44.6 percent, down 20.5 percentage points from the same period of the previous year. The number of participants on the foreign exchange market further expanded. At end-September 2011, there were 307 members on the foreign exchange spot market, 71 members on the foreign exchange swap market, and 20 members on the foreign exchange options market.

7. Operations on the gold market remained stable

In the first three quarters of 2011, a total of RMB3.34 trillion of precious metals was traded on the Shanghai Gold Exchange, an increase of 150.4 percent year on year. In particular, the trading volume of gold was 5291.1 tons, an increase of 14.6 percent year on year, and its turnover posted RMB1741.8 billion, an increase of 46.1 percent year on year; the trading volume of silver was 194,300 tons, an increase of 529.0 percent year on year, and its turnover posted RMB1583.16 billion, an increase of 1126.2 percent year on year; the trading volume of platinum was 50.18 tons, an increase of 23.7 percent year on year, and its turnover posted RMB19.14 billion, an increase of 31.7 percent year on year.

The movement of domestic gold prices kept pace with that on the international market and showed an upward trend. In the third quarter, the peak of the afternoon fixing gold price on the London market was USD1895 per ounce, and the lowest price was USD1598 per ounce; while the highest price（AU9995）on the domestic market was RMB395 per gram, and the lowest price was RMB322. At end-September, the price of gold was RMB337.77 per gram, up 7.9 percent from end-June.

II. Institutional building in the financial market

1. Strengthening regulation on the interbank bond market

Efforts were made to strengthen regulation of the agent bond settlement business on the interbank bond market. In August 2011, the PBC General Administration Department issued the *Notice on Further Strengthening Regulation of the Agent Bond Settlement Business on the National Interbank Bond Market*, further defining and clarifying the provisions on institutional building, the set-up of departmental posts, and risk prevention for 46 agent settlement agencies.

The Shanghai Clearing House launched registration and custody services for short-term financing bills. In August 2011, with the approval of the People's Bank of China, the Shanghai Clearing House released the *Notice on Providing Registration and Custody Services for Short-term Financing Bills*, and from September 1, 2011 it began providing registration and custody services for newly issued short-term financing bills. The launch of short-term financing bill registration and custody services represented a substantial step in implementing the OTC derivative market reform proposed by the Group of Twenty (G20) and will help in the building of Shanghai as an international financial hub.

2. Improving institutional arrangements on the securities market

Promoting the building of a margin trading system. In August 2011, the China Securities Regulatory Commission issued the *Draft Administrative Measures on Managing and Supervising the Securities Margin Trading Business* and relevant supporting documents to solicit public opinions. To launch the securities margin trading business, i.e., to set up securities financial companies that can use their own or legally raised funds to lend to securities companies, will help alleviate the problem of fund or securities shortages of securities companies when conducting margin trading for customers, will play a positive role in balancing market supply and demand, and will allow margin trading to promote price discovery.

Strengthening regulation of securities investment institutions. In August 2011, the China Securities Regulatory Commission issued the *Guiding Opinions on the Fair Trading System of Securities Investment Fund Management Companies*, requiring that fund management companies establish a portfolio investment confidentiality system to strengthen supervision of abnormal trading behavior in day-to-day investments, to improve the fair trading system and control methods, to earnestly protect the legitimate rights of investors, and to build a fair and orderly competitive industrial environment.

Beginning to regulate accounts in the futures market. In September 2011, the China Securities Regulatory Commission issued the *Decisions on Regulating Accounts in the Futures Market* to begin to deal with dormant accounts and to regulate historical accounts. Carrying out this work will help to implement the requirements of a real-name system in the futures market, to improve the authenticity and integrity of customer information, to improve monitoring and analysis of the futures market, and to forcefully crack down on illegal behavior such as market manipulation.

3. Improving institutional arrangements in the insurance market

Release of the outline for the development of the insurance industry under the 12th Five-Year Plan. In August 2011, the China Insurance Regulatory Commission issued the "*Outline for the Development of the Insurance Industry under the 12th Five-Year Plan,*" clarifying the direction, priorities, and policy measures for the development of the insurance industry.

Standardizing administration of insurance business transfers by insurance companies. In September 2011, the China Insurance Regulatory Commission issued the *Provisional Measures on Administration of Insurance Business Transfers by Insurance Companies*, specifying that the transfer of insurance business by insurance companies should adhere to the principles of making it a "voluntary, open, and fair process." Efforts were made to set up the institutional framework and basic procedures for the transfer of insurance businesses and to define the obligations of each party engaged in the transfer process and the conditions and required qualifications for the recipient companies so as to improve the exit mechanism from the insurance market.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q3 2011, the recovery in the global economy became much more unstable and uncertain. First, the rebound in some of the advanced economies stalled in the face of the twin perils of fiscal and financial risks, indicating increased uncertainties and instabilities. Second, the outlook for most emerging market economies was bright, but they had to deal with the challenges of rising inflation and volatile cross-border capital flows, which also added to macro-adjustment difficulties. Third, overshadowed by the continued spread of the sovereign debt crisis in the euro area and the U.S., global financial markets experienced great volatility, major stock indices plummeted, and the prices of commodities, including energy, raw materials, and food, fluctuated dramatically. Against the background of dimmed prospects for growth, the major advanced economies continued to ease their monetary policies or to maintain an accommodative monetary policy stance. There were differences in the macroeconomic policies of the major emerging market economies in response to the new uncertainties regarding the recovery of the world economy.

1. Economic developments in the major economies

The U.S. economy has been struggling to pick up momentum, but problems such as high unemployment, weakness in the housing market, and low consumer and business confidence have not shown any obvious improvement. Boosted by consumption and investment, the initial real GDP growth in Q3 registered 2.5 percent, higher than that in the previous two quarters. In September, the trade deficit drifted downwards to USD 43.1 billion. Sluggish economic activities translated into an unemployment rate of more than 9 percent for six consecutive months. Furthermore, the fiscal deficit continued to climb. On October 14, the U.S. Treasury announced that the deficit in fiscal year 2011 remained elevated at USD 1.299 trillion, though somewhat lower than the historical high of fiscal year 2009. Although the housing market rebounded moderately, prospects for its recovery were still clouded by high levels of inventories and foreclosures. CPI inflation had been edging up for ten consecutive months, reaching 3.9 percent year on year in September, a record high since September 2008.

In the euro area, the adverse effects of the sovereign debt crisis have spilled over into the banking system and the real economy, leading to weakening economic activities in the member-states and greater volatility in financial markets. First, growth in the core countries lost momentum, reflected in a mere 0.1 percent MOM GDP growth in Germany — the lowest level in two years, economic slack in France, and persistently deteriorating conditions in countries such as Greece and Ireland. In Q2, GDP in the euro area grew by only 1.6 percent year on year, down 0.9 percentage point from Q1. Second, inflationary pressures increased. In September, the year-on-year HICP registered 3.0 percent, making it higher than the 2 percent target set by the ECB for ten consecutive months. Third, in September the unemployment rate in the euro area remained high, at 10.2 percent.

Table 8 Macroeconomic and Financial Indices of the Major Economies

Country	Index	2010 Q3			2010 Q4			2011 Q1			2011 Q2			2011 Q3		
		Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.
United States	Real GDP Growth Rate (annualized quarterly rate, YOY, %)	2.5			3.1			0.4			1.3			2.5 (initial number)		
	Unemployment Rate (%)	9.5	9.6	9.6	9.6	9.8	9.4	9.0	8.9	8.8	9.0	9.1	9.2	9.1	9.1	9.1
	CPI (YOY, %)	1.2	1.1	1.1	1.2	1.1	1.5	1.6	2.1	2.7	3.2	3.6	3.6	3.6	3.8	3.9
	DJ Industrial Average (closing number)	10,466	10,015	10,788	11,118	11,006	11,578	11,892	12,226	12,320	12,811	12,570	12,414	12,143	11,613	10,913
	NASDAQ (closing number)	2,255	2,114	2369	2,507	2,498	2,653	2,700	2,782	2,781	2,874	2,835	2,774	2,756	2,579	2,415
Euro Area	Real GDP Growth Rate (quarterly YOY,%)	2.0			1.9			2.5			1.6					
	Unemployment Rate (%)	10.1	10.1	10.1	10.1	10.1	10.0	10.0	10.0	10.0	9.9	10.0	10.0	10.1	10.1	10.2
	HICP (YOY, %)	1.7	1.6	1.9	1.9	1.9	2.2	2.3	2.4	2.7	2.8	2.7	2.7	2.5	2.5	3.0
	EURO STOXX 50 (closing number)	2,476	2,450	2,482	2,543	2,478	2,601	2,654	2,713	2,583	2,661	2,632	2,561	2,511	2,238	2,160
Japan	Real GDP Growth Rate (annualized quarterly rate, %)	4.0			-2.4			-3.7			-2.1					
	Unemployment Rate (%)	5.2	5.1	5.0	5.1	5.1	4.9	4.9	4.6	4.6	4.7	4.5	4.6	4.7	4.3	4.1
	CPI (YOY, %)	-0.9	-0.9	-0.6	0.2	0.1	0.0	0.0	0.0	0.0	0.3	0.3	0.2	0.2	0.2	0.0
	NIKKEI225 (closing number)	9,537	8,824	9,369	9,202	9,937	10,229	10,238	10,624	9,755	9,850	9,694	9,816	9,833	8,955	8,700

Source: Statistical bureaus and central banks of the relevant economies.

To contain the sovereign debt crisis, at the euro summit on July 21 European leaders agreed on the second round of a 109 billion euro bailout plan for Greece. But financial markets continued to fluctuate because of differences of opinion on the details and the delayed tempo of the fiscal consolidation in Greece. First, there were market concerns that the crisis might spread to the core countries. Second, the sovereign crisis slowly evolved into a banking crisis. According to the September 2011 Global Financial Stability Report released by the IMF, direct losses from sovereign debts incurred by European banks might be as high as 208 billion euros (about 12 percent of the total equity of banks), or as high as 397 billion euros if derivatives are also taken into account. On September 14, Moody's cut the ratings of two French banks, Société Générale and Crédit Agricole, and on October 4, the Belgian government announced that it would break up and nationalize the Belgian unit of the

Franco-Belgian banking group Dexia, becoming the first bank to be dragged down by the crisis. To maintain financial stability and to restore market confidence, European leaders unveiled a basket of bailout plans after the Euro Area Summit on October 26 and reached a consensus on a framework to write down the Greek debt and to optimize the resources of the European Financial Stability Fund (EFSF) so as to enhance the banks' capital adequacy ratio.

Notwithstanding an enlarged trade deficit, there was a rebound in the Japanese economy In Q2, real GDP fell by 2.1 percent, a moderate decline compared with the previous two quarters. The year-on-year core CPI had registered six positive readings ending in September, but prices of durable consumer goods continued to drop. In August, year-on-year exports expanded for the first time after the earthquake, but the monthly deficit in goods trade reached 779.6 billion yen due to the appreciation of the Japanese yen and the strong post-quake demand for energy. Employment conditions brightened, with the unemployment rate for August and September contracting to 4.3 percent and 4.1 percent respectively, the lowest level in the year (excluding in the areas most severely hit by the disaster).

Growth in the major emerging market economies remained robust but they also faced some risks, including rising inflation, volatile cross-border capital flows, and weak demand from the advanced countries. The output and trade of the emerging market economies returned to or even exceeded their pre-crisis levels. But the concerted effects of the tightened domestic policy, the volatility in international financial markets, the tepid recovery of the advanced economies, and the enlarged risks caused by disorderly capital flows posed difficulties for policymakers. Furthermore, considering the economic and financial linkages between the Middle Eastern countries and those in the euro area, downside risks will clearly increase in the near future.

Box 3 Latest Developments in the European Sovereign Debt Crisis

Greece recently slid rapidly into an economic recession and was also on the verge of a debt default, while sovereign risks also picked up in countries like Spain and Italy. Worries about the contagion of the crisis intensified, leading to a new round of turmoil in financial markets. To properly deal with the debt issues, EU members met twice in Brussels, on October 23 and 26, for summits to discuss plans for the recapitalization of the EU banks. At the Euro Area Summit held in the evening of October 26, members finally reached a consensus to write down the Greek debt and to maximize the resources of the EFSF.

I. Overview of developments in the euro area debt crisis

The debt crisis deepened in Greece. First, a bailout fund was not put in place on time. The European finance ministers' summit in September could not come to agreement as to whether the last batch of the six-batch rescue fund should be released. Second, Greece missed the key deficit-reduction targets. According to the preliminary budget published by the Greek government on October 2, the budget deficit for 2011 and 2012 would be 8.5 percent and 6.8

percent of GDP respectively, higher than the respective targets of 7.6 percent and 6.5 percent. Third, Germany and other euro members did not approve of the second rescue plan for Greece. And there were also differences of opinion on the ratio of the private bailout. As a result, Greek bond yields and credit default swaps (CDS) soared starting from September.

Italy and Spain were hit once again. The purchase of Italian and Spanish treasuries by the ECB in August drove down bond yields. However, Italy's hesitancy to reduce the deficit at the beginning of September and to improve the vitality of its economy fueled investors' fears about its debt servicing capability. On September 19, Standard & Poor's cut Italy's sovereign credit rating from A+ to A, making it, until now, the largest euro area country to have its rating cut during the crisis. Later, Moody's also downgraded Italy's long-term rating from Aa2 to A2. On October 7, Fitch's slashed the long-term ratings of Italy and Spain, which added to market pressures and pushed up the yields and the CDS spreads of the two countries.

The European banking system was also affected. Due to market concerns about the banking system's exposure to the debt crisis, the performance of the stocks of the European banks was generally weaker than the broader indices and most dropped to their lowest levels in three years. The total amount of Greek treasuries and private bonds held by French banks was estimated at 56.7 billion euros, making France the largest creditor for Greece. Due to the strained interbank market, French banks also faced rising financing pressures. On September 13, Moody's downgraded two French banks, Société Générale and Crédit Agricole. On October 4, the Belgian government announced it would break up the stressed Franco-Belgian banking group Dexia, whose rating was cut by Standard & Poor's from A to A- on October 7.

II. Causes of the crisis and the bailout progress

There are several root causes behind the worsening of the European debt crisis. First, the financial crisis dampened economic growth in the EU countries, reduced their tax income, and impaired their repayment ability. Since 2010, Italy, Spain, Portugal, Greece, and Ireland have taken strict fiscal austerity measures under market pressures. Except for Ireland whose fiscal deficit continued to climb due to injections in the banking system and lower than anticipated tax income, all four other countries saw a remarkably decreased deficit in 2010 compared with the previous year. But factors such as rising financing costs resulted in a further accumulation of government debt. The total Greek debt accounted for 142.8 percent of GDP, the highest level among all EU countries. The growing government debt made it more difficult to solve the debt problem. Second, the European Union lacked effective measures to restrain the fiscal policies of member-states. The euro area is only a monetary union, lacking a common fiscal budget, a unified transfer payment system, and a centralized economic management institution. Though decided by the EU, rescue measures still have to be ratified by the relevant national authorities. Third, the impact of the crisis was expanded by the rating agencies. Since the start of the crisis, the three major rating agencies slashed their long-term credit ratings in the relevant countries in succession, thereby sparking controversy. The consecutive downgrading raised financing costs in those countries and made it even more difficult for them to sustain their debts.

To secure market confidence and stabilize financial markets, Greece, Italy, and Spain either continued their existing fiscal austerity measures or launched new ones. France and Germany vowed to back up the bailout and the ECB was also committed to purchasing more national bonds and to providing short-term liquidity to banks in need. However, there were still market doubts and risk aversion was quite strong. In line with these conditions, the EU and the Euro Area Summit held on October 26 agreed on a basket of rescue plans: first, there would be a nominal writedown of 50 percent on Greek debt held by private investors; second, the capability of the EFSF would be leveraged to about one trillion euros; third, the capital ratio of the highest quality capital held by banks would be lifted to 9 percent by end-June of next year. The above-mentioned plans brightened the outlook for a sustainable Greek debt, enhanced the crisis-relief capability of the EU, and improved the resilience of banks toward risk.

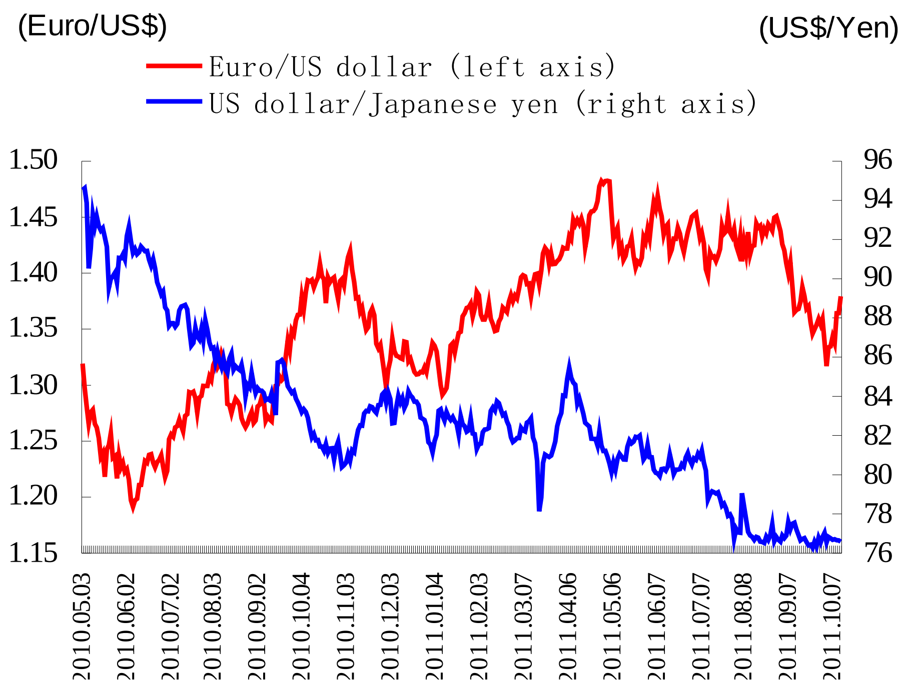
The release of the basket of bailout plans brought hope that a proper remedy for the EU sovereign debt crisis would be found and also provided an increased impetus for the international community to address the current economic impasse. The details of the plans would be determined at the finance ministers' meeting in November. However, Greek Prime Minister, George Papandreou stunned the market on October 31 by stating that his country should hold a referendum on the bailout package. Under pressure from home and abroad, Papandreou finally backed down from his referendum plan after an emergency cabinet meeting held on November 3.

The EU debt crisis caused more uncertainties for a global recovery. At present, the euro area is discussing how to accelerate the bailout with help from international institutions such as the IMF. If the rescue plans and the countermeasures to stem the crisis could gain market acceptance, the boosted confidence would promote a global economic recovery.

2. Global financial market development

Major currencies fluctuated. From July to August, the exchange rate of the euro against the US dollar saw large fluctuations due to the uncertain outlook for the euro area debt problem and the sluggish U.S. recovery. In September, weighed down by unpromising economic data in the euro area and the deepening crisis, the euro weakened against the major currencies by a large margin. Factors including the post-disaster repatriation of the yen and the lackluster recovery in the U.S. and Europe continuously drove up the Japanese yen. At end-September, the exchange rates of the euro and Japanese yen against the US dollar stood at 1.3384 US dollar per euro and 77.04 yen per US dollar, a depreciation of the euro by 7.72 percent and an appreciation of the yen by 4.52 percent compared with end-June. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, registered 100.33, up by 5.82 percent compared with end-June.

Figure 3 Exchange Rate Movements between the Major Currencies

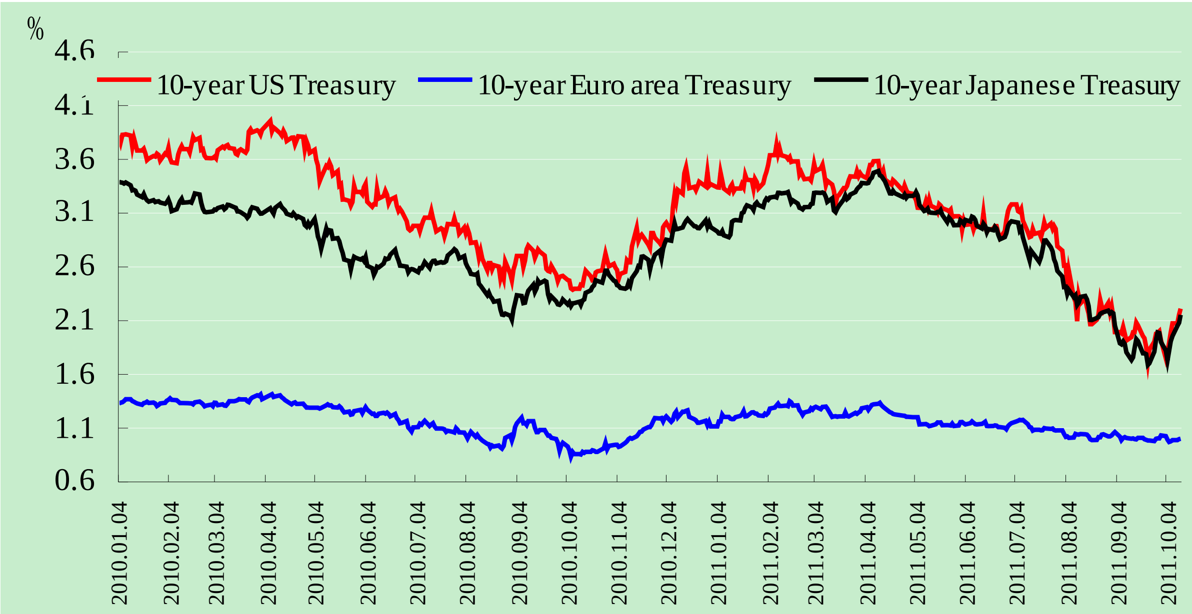


Source: Reuters.

Due to concerns about the European banks' risk exposure to the debt crisis, the credit risk premium and money market interest rates edged up. Starting from Q3, against the background of tepid growth in the U.S. and risk-aversion sentiment in the money market, the US dollar Libor picked up. At end-September, the one-year Libor read at 0.86 percent, up 0.13 percentage point from end-June. The Euribor remained volatile and elevated due to the worsening debt crisis. In end-September, the one-year Euribor read at 2.08 percent, down by 0.08 percentage point from end-June and up by 0.58 percentage point from the beginning of the year.

The yields of major bonds were dragged down by risk-aversion demands. In August, Moody's downgraded the sovereign ratings of Portugal and Ireland to junk level. By September, the Greek government had failed to meet the requirements of the EU and the IMF for assistance, leading to higher default risks of Greek bonds. Against this backdrop, yields of U.S. treasury bonds moved upward instead of downward despite the downgrading of the U.S. sovereign rating by Standard & Poor's on August 5. The yields of the bonds of the major countries such as Germany, France, and Japan, drifted downward. In end-September, 10-year treasury bonds in the U.S., euro area (Germany), and Japan closed at 1.92 percent, 1.90 percent, and 1.03 percent respectively, down 124, 111, and 10 basis points compared with the end of the last quarter.

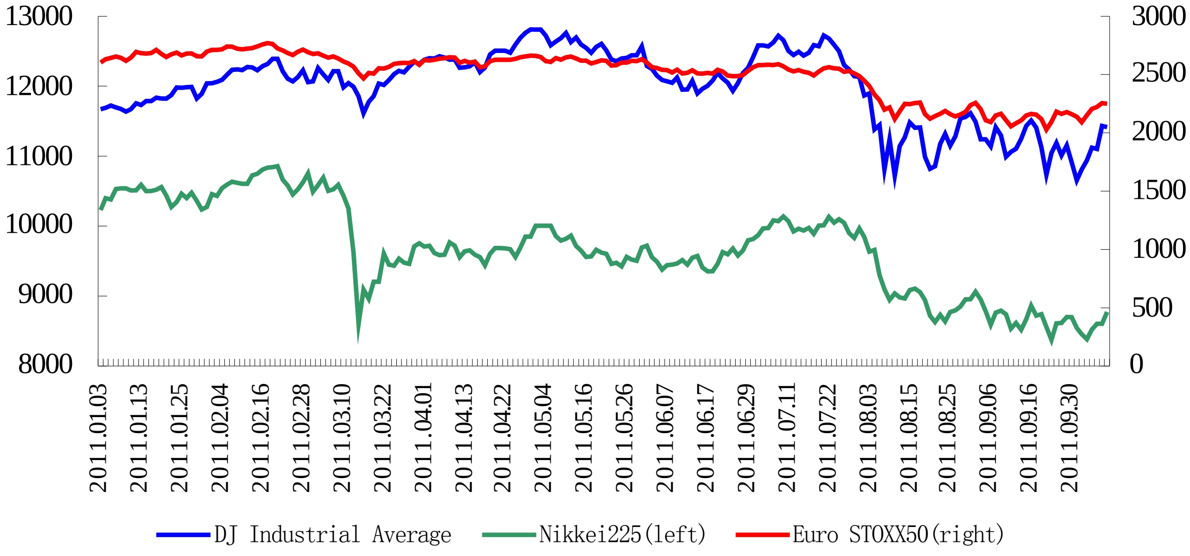
Figure 4　Movements in the Yields of the Major Treasuries



Source: Reuters.

The major stock indices plummeted and remained volatile at a low level. From end-July to the beginning of August, the major stock markets experienced an avalanche triggered by Standard & Poor's downgrading of the U.S. rating and the deepening of the EU crisis. Later, worse than anticipated U.S. economic data and the dim global outlook intensified market panic, causing the major stock markets to fluctuate dramatically at a low level. At end-September, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 10,913, 2,415, 2,160, and 8,700 respectively, down 12.1 percent, 12.9 percent, 15.7 percent, and 11.4 percent respectively compared with end-June.

Figure 5　Movements of the Major Stock Indices



Source: Reuters.

3. Development of the housing market in the major economies

The U.S. housing market rebounded but the outlook for recovery remained unclear. According to data published by the U.S. Department of Commerce, new home sales in September declined by 0.9 percent year on year. The median price for new homes was USD204,000 per unit, down 10 percent year on year. New construction of homes rose by 10.2 percent year on year. According to the National Association of Realtors, sales of existing homes in September increased by 11.3 percent year on year, and the median price of existing homes averaged USD165,400, down 3.5 percent year on year.

There were some differences in the conditions of the housing markets in Europe. Though the momentum for growth was dampened by the debt crisis, demand for residential and commercial housing in Germany was still robust. Housing prices continued to rise in France, but the pace of the recovery of the housing market moderated. The UK HALIFAX housing index contracted by another 0.5 percent month on month in September after a 1.2 percent decrease in August. And British housing prices still faced downward pressures caused by gloomy growth prospects. The housing markets in the European periphery countries saw no signs of recovery due to the negative impact of slow growth and the worsening debt problem.

The global economic slowdown and the appreciation of the Japanese yen put a drag on the rebound in the Japanese housing market. According to the Ministry of Land, Infrastructure, Transport, and Tourism, new construction of homes in September slumped by 10.8 percent year on year, registering the first decline during the past six months. Construction orders received by the 50 big construction companies increased by 9.3 percent year on year in August but fell by 9.3 percent year or year in September.

4. The monetary policies of the major economies

The major advanced economies continued to implement accommodative monetary policies. On August 9, the FOMC announced it would keep the federal fund rate unchanged at 0-0.25 percent and indicated that current interest rates would remain in place until at least mid-2013. On September 22, the Federal Reserve launched a "reverse operation," a bold attempt to buy USD400 billion of 6- to 30-year government bonds before June of 2012 and at the same time sell an equivalent amount of 3-year or less short-term bonds to raise the necessary funds. On November 2, the FOMC decided to keep the policy unchanged. On September 15, the ECB announced that in coordination with the U.S. Federal Reserve, the Bank of England, the Bank of Japan, and the Swiss National Bank, it would conduct three US dollar liquidity-providing operations to help European banks weather the storm. On October 6, while keeping the benchmark interest rates unchanged, the ECB announced a plan that from November it would spend 40 billion euros to buy covered bonds and from October it would conduct two longer-term fixed-rate refinancing operations (LTROs) with a maturity of approximately 12 months and 13 months respectively. On November 3, 2011, the ECB decided to cut the interest rates on the main refinancing operations, the marginal lending facility, and the deposit facility by 0.25 percentage point to 1.25 percent, 2.00 percent, and 0.50 percent respectively. The Bank of Japan left its key rate at near zero. On August 4, it announced that the size of the Asset Purchase Program would be expanded by about 10 trillion yen. Later, on October 27, the size of the program was boosted once again by another 5 trillion yen, making the total amount around 55 trillion yen. In Q3 the bank continued to offer a maximum of one trillion yen in loans at a very low rate to financial institutions in the earthquake-hit areas. Such lending will be extended until April 30, 2012 to support post-disaster reconstruction.

In response to new uncertainties about the world recovery, there were differences among the policies adopted by the major emerging market economies. In Q3 India, Malaysia, Thailand, and Vietnam increased their interest rates or reserve requirement rates to restrain domestic inflation. Against the moderated pace of growth in the world economy, some emerging market economies loosened their monetary policies. In August 2011, Turkey and Brazil cut their benchmark rates by 50 basis points respectively.

5. World economic outlook

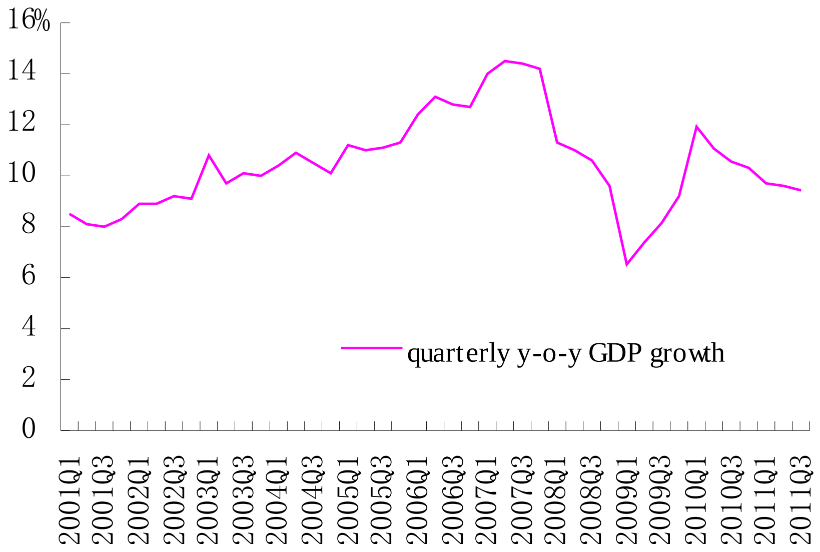
In its September 2011 *World Economic Outlook*, the IMF revised downwards its global growth prospects and that of most countries. Global GDP was expected to expand by 4 percent in both 2011 and 2012, with the growth rates of the United States standing at 1.5 percent and 1.8 percent, the euro area at 1.6 percent and 1.1 percent, Japan at –0.5 percent and 2.3 percent, and the emerging market economies at 6.4 percent and 6.1 percent for 2011 and 2012 respectively. The IMF also projected that as the developed countries have generally adopted an accommodative monetary policy, coupled with the high commodity prices, global inflationary pressures will continue to show an overall upward trend. Inflation in the advanced countries would increase from the 1.6 percent in 2010 to 2.6 percent in 2011, and in the emerging market economies inflation would pick up from the 6.1 percent in 2010 to 7.5 percent in 2011.

The key downside risks for the global economy in the near future are as follows: first, heightened tensions in the financial markets from the EU debt and the spillover from the periphery to the core countries might result in global systemic risks; second, the political impasse over the fiscal consolidation, the tepid housing market, and the deteriorating financial conditions might combine to curb the momentum for recovery in the United States; third, the negative impacts of the accommodative monetary policy: the protracted loose policy stance adopted by the major advanced economies might exacerbate disorderly cross-border capital flows and financial turmoil as well as undermine world financial stability; fourth, policymakers in the emerging market economies will face increasing difficulties. Robust demand might keep inflation elevated in the major emerging market economies despite steady movement in recent commodity prices. On the one hand, interest rate increases might be a cure for the rising inflation in the emerging market economies, but, on the other hand, rate hikes might attract more capital inflows to the emerging market economies against the background of generally low interest rates in the advanced economies.

II. Analysis of China's macroeconomic performance

In the third quarter of 2011, China's economy maintained stable and relatively rapid momentum for development, with economic development gradually shifting from stimulus-driven to endogenous growth. Consumer demand stabilized, fixed-asset investments grew rapidly, foreign trade became more balanced, domestic demand picked up, agricultural production performed well, industrial production grew steadily, household income continued to increase, and the momentum for a rapid price hike was contained. In the first three quarters, the Gross Domestic Product (GDP) registered RMB32.1 trillion, up 9.4 percent year on year in terms of comparable prices. In the third quarter, GDP grew 9.1 percent year on year, or 2.3 percent quarter on quarter. The Consumer Price Index (CPI) was up 5.7 percent year on year in the first three quarters, and up 6.3 percent year on year in the third quarter. The trade surplus posted USD107.1 billion in the first three quarters and USD62.69 billion in the third quarter.

Figure 6   Stable and Rapid GDP Growth



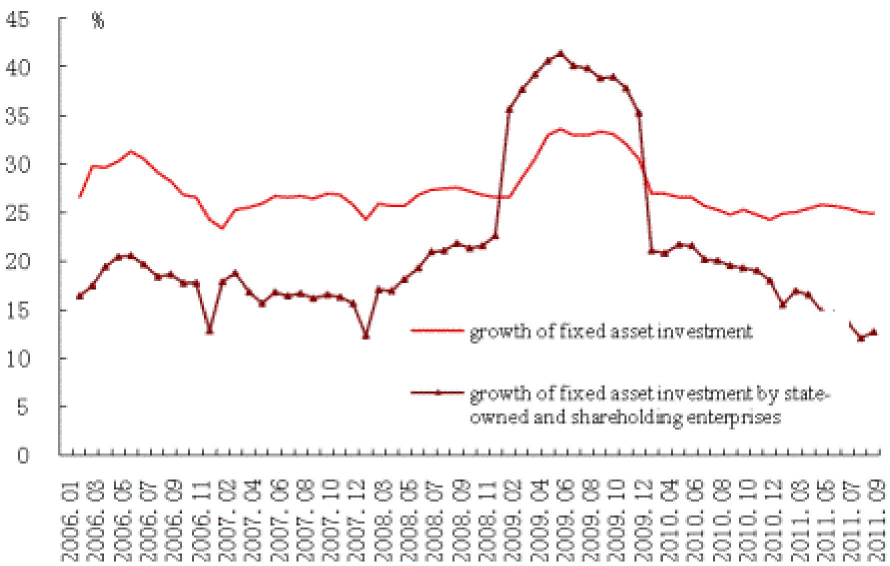
Source: National Bureau of Statistics.

1. Domestic and external demand became more balanced in terms of driving economic growth

Supported by the stable income gains of urban residents and the rapid income gains of rural residents, domestic consumer demand remained stable. In the first three quarters, the per capita disposable income of urban households posted RMB16,301, representing year-on-year growth of 13.7 percent and price-adjusted real growth of 7.8 percent. The per capita cash income of rural households registered RMB5,875, up 20.7 percent or 13.6 percent in real terms. The PBC survey of urban depositors in the third quarter shows that the income index of residents posted 50.3 percent, 1.8 percentage points lower than that in the previous quarter; the propensity to consume remained low, the willingness to save increased, and the willingness to invest declined. In the first three quarters, retail sales of consumer goods totaled RMB13.1 trillion, representing a year-on-year increase of 17.0 percent or 11.3 percent in real terms, a deceleration of 0.3 percentage point from the first half of the year. Consumption growth in the urban areas outpaced that in the rural areas. In the first three quarters, retail sales in the urban areas registered RMB11.3 trillion, up 17.1 percent year on year, whereas retail sales in the rural areas posted RMB1.8 trillion, up 16.4 percent year on year.

The growth of fixed-asset investments remained relatively rapid, with growth in central and western China outpacing that in the east. In the first three quarters, completed fixed-asset investments (excluding investments by rural households) totaled RMB21.2 trillion, up 24.6 percent year on year or 16.9 percent in real terms. Among this total, investments by state-owned and state shareholding enterprises registered RMB7.3 trillion, up 12.7 percent year on year. Broken down by region, growth of fixed-asset investments in the eastern, central, and western regions registered 22.3 percent, 29.9 percent, and 29.5 percent respectively. Broken down by industry, fixed-asset investments in the primary, secondary, and tertiary industries grew 25.5 percent, 26.9 percent, and 23.4 percent respectively, with growth in the primary industry accelerating by 4.9 percentage points from the first half of the year, and growth in the secondary and tertiary industries decelerating by 0.2 and 1.3 percentage points respectively from the first half of the year. In the first three quarters, total planned investment in new projects grew by 23.4 percent year on year to RMB18.0 trillion, and total planned investment in projects under construction grew 19.8 percent year on year to RMB55.8 trillion.

Figure 7 Fixed-asset Investments Grew Relatively Rapidly

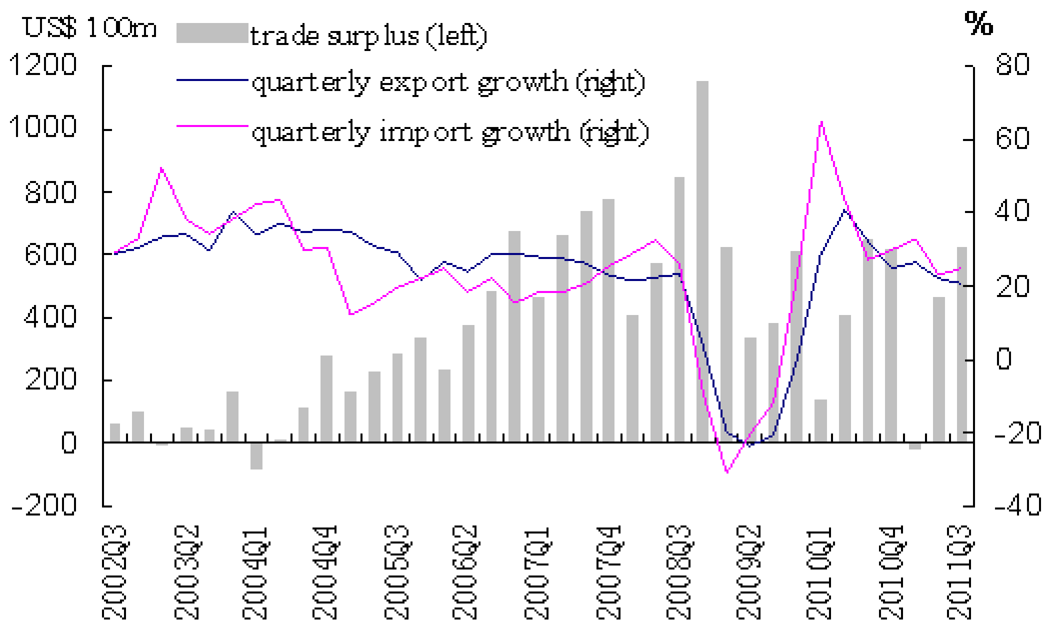


Source: National Bureau of Statistics.

Export growth decelerated year on year, whereas import growth accelerated year on year; as a result, the trade surplus declined modestly from the same period of the previous year and domestic and external demand became more balanced in terms of driving economic growth. In the third quarter, exports posted USD518.16 billion, up 20.6 percent year on year, representing a deceleration of 1.5 percentage points from the previous quarter; imports posted USD455.46 billion, up 24.9 percent year on year, representing an acceleration of 1.8 percentage points from the previous quarter. In the third quarter, the price-adjusted real growth of imports and exports posted 5.1 percent and 8.9 percent respectively. In the third quarter, the trade surplus with the U.S. and the EU registered USD60.88 billion and USD45.08 billion respectively, and the trade deficit with Japan, South Korea, and the ASEAN countries reached USD11.96 billion, USD21.61 billion, and USD7.91 billion respectively. In the first three quarters, actually utilized foreign direct investment grew by

16.6 percent year on year to USD86.68 billion, representing a deceleration of 1.8 percentage points from the first half of the year.

Figure 8 Foreign Trade Became More Balanced



Source: The PBC; the General Administration of Customs.

2. Agricultural and industrial production performed well

In the first three quarters, the value-added of primary, secondary, and tertiary industries reached RMB3.0 trillion, RMB15.5 trillion, and RMB13.6 trillion respectively, up 3.8 percent, 10.8 percent, and 9.0 percent. The share of the three industries in GDP was 9.5 percent, 48.3 percent, and 42.3 percent respectively.

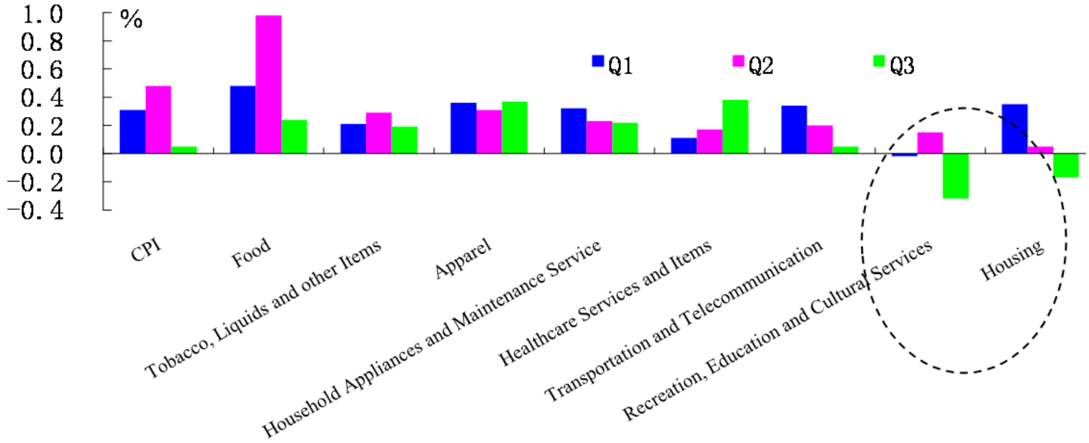
The output of summer grain increased, and there were expectations that there would be a bumper autumn harvest. Total summer grain output in 2011 posted 126.27 million tons, up 2.5 percent from the previous year. The output of early season crops grew 4.5 percent from the previous year to 32.76 million tons. There were expectations that there would be a bumper autumn grain harvest and that total output would exceed that in the previous year. In the first three quarters, the total output of meat (including pork, beef, mutton, and poultry) posted 54.53 million tons, up 0.2 percent year on year. Among this total, pork production dropped by 0.6 percent to 35.68 million tons.

Industrial production posted stable growth, and production and sales of industrial products were well matched. In the first three quarters, the value-added of statistically large enterprises grew 14.2 percent year on year, representing a deceleration of 0.1 percentage point from the first half of the year. Production and sales of industrial products were well matched, and 97.9 percent of manufactured goods were sold. The profitability of industrial enterprises continued to improve, with the profits of statistically large enterprises posting RMB3.7 trillion, up 27 percent year on year, and the profitability of the main businesses posting 6.1 percent. The survey of 5,000 industrial enterprises conducted by the PBC in the third quarter reveals that the business index dipped from a high level, market demand continued to decline, and corporate profitability dropped slightly. In the third quarter, the corporate business index continued the declining trend seen in the previous three quarters, edging downward by 1.3 percentage points to 69.3 percent from the previous quarter. In a downward trajectory similar to that in the past three quarters, the market demand index in the third quarter shed another 2.3 percentage points to 60.6 percent. Among this total, the domestic orders index dropped for a third consecutive quarter to 55.3 percent, by 1.4 percentage points from the previous quarter. The export orders index declined by 0.9 percentage point to 51.6 percent. The corporate profitability index fell by 1.1 percentage points to 57.6 percent.

3. Growth of the price indexes moderated

Growth in the CPI decelerated month by month. In the third quarter, the monthly CPI was up 6.5 percent, 6.2 percent, and 6.1 percent respectively, averaging 6.3 percent. Broken down by food and non-food items, growth of food prices accelerated whereas growth of non-food items stabilized. In the third quarter, food prices gained 13.9 percent year on year, an acceleration of 1.4 percentage points from the previous quarter, thereby driving the CPI up by 4.2 percentage points. In particular, pork prices went up by 48.6 percent year on year, an acceleration of 4.4 percentage points from the previous quarter, thereby driving the CPI up by 1.3 percentage points. Non-food prices gained 2.9 percent, at a par with the previous quarter and contributing to a CPI increase of 2.1 percentage points. Broken down by consumer goods and services, the prices of consumer goods grew by 7.4 percent year on year, up 0.9 percentage point from the previous quarter, and the prices of services were up 3.4 percent, representing a deceleration of 0.5 percentage point from the previous quarter. In terms of quarter-on-quarter data, the degree to which the quarter-on-quarter growth of the CPI was above the historical average diminished markedly. Among the eight categories in the CPI basket, the quarter-on-quarter growth of recreation, education, and cultural services as well as housing was already below the historical average.

Figure 9 The Quarter-on-Quarter CPI in Q3 2011 Compared to the Historical Average



Source: National Bureau of Statistics and calculations by the staff of the People's Bank of China.

Year-on-year growth of producer prices decelerated month by month. In the third quarter, the monthly ex-factory producer prices of industrial products rose by 7.5 percent, 7.3 percent, and 6.5 percent respectively, averaging 7.1 percent. Among this total, producer prices of capital goods gained 8.4 percent, 8.0 percent, and 7.1 percent respectively, averaging 7.8 percent and representing an acceleration of 0.2 percentage point from the previous quarter. The growth of consumer goods posted 4.8 percent, 4.8 percent, and 4.6 percent year on year, averaging 4.7 percent and an acceleration of 0.1 percentage point from the previous quarter. Producer purchasing prices increased by 11 percent, 10.6 percent, and 10.0 percent respectively year on year in the three months, averaging 10.5 percent and an acceleration of 0.1 percentage point from the previous quarter. In the third quarter, producer prices of major agricultural products (the prices at which farmers sell their products) climbed by 20.5 percent year on year, 5.7 percentage points higher than the increase in the prices of agricultural capital goods during the same period. In the first three quarters, the Corporate Goods Price Index (CGPI) grew 9.0 percent in year-on-year terms. Broken down by the application of the goods in the CGPI basket, the prices of investment goods and consumer goods rose 8.5 percent and 10.2 percent respectively. Broken down by categories within the CGPI basket, the prices of agricultural products, mineral products, coal, oil, and electricity, and processed products were up 14.9 percent, 14.2 percent, 11.8 percent, and 7.1 percent respectively.

Commodity prices in the international market fell, and due to low base-period figures in the previous year, the year-on-year growth of import prices remained high. In the third quarter, the average price of crude oil futures on the New York Mercantile Exchange dropped by 12.5

percent from the previous quarter, but up by 17.5 percent compared to the same period of the previous year. The spot copper and aluminum prices on the London Metals Exchange tumbled by 1.7 percent and 7.7 percent respectively from the previous quarter, but up by 24.0 percent and 14.8 percent respectively in year-on-year terms. In the three months of the third quarter, import prices gained 15.0 percent, 15.6 percent, and 14.8 percent respectively, averaging 15.1 percent, at a par with the previous quarter. Export prices grew by 10.3 percent, 9.2 percent, and 9.5 percent respectively, averaging 9.7 percent and representing a deceleration of 0.7 percentage point from the second quarter.

The GDP deflator continued to rise. GDP in the first three quarters registered RMB32.1 trillion, up 9.4 percent year on year in real terms. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 7.7 percent, up 1.4 and 0.3 percentage points from the same period of the previous year and from the previous quarter respectively.

The resource products pricing reform advanced steadily. First, reform of the resources tax was promoted. Building on the experiences of the pilot program to reform the resources tax on crude oil and natural gas, the State Council decided to revise the *Tentative Regulations of the People's Republic of China on the Resources Tax* by adding new regulations on levying an ad valorem tax in addition to the specific tax, and adjusting the tax rate on items such as crude oil and natural gas. At the current stage, the valorem tax has only been levied on crude oil and natural gas, at a rate of 5 to 10 percent of sales, but the scope will be expanded to include other resource products when conditions are met. Second, research has been conducted on levying an environmental protection tax. On October 20, the State Council issued the *Opinions on Strengthening the Focus on Environmental Protection,* which stipulates explicitly that economic policies should be conducive to environmental protection, a reform of the environmental tax should be advanced, and studies should be conducted on levying an environmental protection tax.

4. Fiscal revenue maintained rapid growth

In the first three quarters, fiscal revenue (excluding debt income) surged by 29.5 percent year on year to RMB8.17 trillion, representing a deceleration of 1.7 percentage points from the first half of the year, whereas fiscal expenditures registered RMB6.95 trillion, up 27.5 percent year on year, representing a deceleration of 3.9 percentage points from the previous quarter. As a result, revenue was RMB1.22 trillion more than expenditures.

As for the structure of fiscal revenue, tax revenue posted RMB7.13 trillion in the first three quarters, up 27.4 percent year on year, representing a deceleration of 2.2 percentage points from the first half of the year. In particular, the domestic VAT, business tax, consumption tax, the VAT and excise tax on imported products, the corporate income tax, and the personal income tax were up 18.7 percent, 24.0 percent, 17.7 percent, 33.6 percent, 35.8 percent, and 34.4 percent respectively year on year. These six categories of tax revenue drove national fiscal revenue income up by 21.6 percentage points.

As for the structure of fiscal expenditures in the first three quarters, spending for housing subsidies, medical services, and urban and rural community affairs registered relatively rapid growth of 73.9 percent, 50.5 percent, and 42.0 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 13.7 percent, 11.5 percent, and 10.2 percent respectively.

5. The current account surplus declined

China's balance of payments (BOP) continued to post a twin surplus, but the surplus in the current account decreased year on year. In the first half of the year, the current account surplus declined by 13 percent year on year to USD87.8 billion, the capital and financial account surplus was up 98 percent year on year to USD183.9 billion, and foreign exchange reserves grew by USD354.4 billion from end-2010 to USD3,201.7 billion.

The volume of external debt grew rapidly and the share of outstanding short-term debt in external debt increased. As of end-June 2011, the stock of China's external debt stood at USD642.53 billion, up 25.1 percent year on year. Among this total, the stock of the registered external debt posted USD402.83 billion, up 31.1 percent year on year; the short-term external debt posted USD462.11 billion, a year-on-year increase of 34.4 percent, accounting for 71.9 percent of the stock of the external debt and representing an acceleration of 5 percentage points from the same period of the previous year.

6. Sectoral analysis

Industrial profits grew rapidly. In the first three quarters, among all 39 industrial sectors, 37 sectors reported a year-on-year growth in profits, whereas two sectors experienced a year-on-year decline in profits. Among the industries, the profits of the ferrous metals mining industry and the non-ferrous metals smelting and rolling industry grew by 55.2 percent and 61.9 percent respectively, whereas the profits of the oil refinery, coking, and nuclear fuel industry, and the communications equipment, computers, and other electronics manufacturing industry declined by 83.9 percent and 2.5 percent respectively. In the first three quarters, crude coal output grew by 11.6 percent year on year to 2.691 billion tons, power generation increased 12.7 percent year on year to 3,454 billion kilowatt hours, and the output of crude oil grew 2.2 percent year on year to 153.612 million tons. A total of 26.61 billion tons of cargo was transported, up 14.2 percent year on year.

(1) The real estate sector

In the first three quarters of 2011, excessive hikes in housing prices were further contained, the growth of sold area of commercial housing stabilized, the growth of investment in real estate development slowed down, and construction of affordable housing made rapid progress; as a result, the real estate market developed in the direction intended by the macroeconomic management policies. Though the growth of various real estate loans decelerated, credit to affordable housing grew continuously.

The excessive hikes in housing prices decelerated. In September, prices of newly built commercial residential housing dropped month on month in 17 out of 70 large- and medium-sized cities, and remained flat in 29 cities. Compared to the number in June, 20 more cities joined the group experiencing either flat or a month-on-month decline in commercial residential housing prices. Among the cities with month-on-month price hikes, no cities reported growth higher than 0.3 percent. In the pre-occupied housing market, 25 cities reported a month-on-month price decline and prices remained flat in 21 cities; compared to June, 15 more cities joined the group of cities reporting no month-on-month price increase. Among the cities experiencing a month-on-month price hike in pre-occupied housing, no city showed an increase larger than 0.6 percent, and 22 cities reported growth below 0.5 percent.

The growth of sales of commercial real estate remained basically stable. In the first three quarters, the sold floor area of commercial real estate posted 710 million square meters, up 12.9 percent year on year, at a par with the first half of the year; sales of commercial real estate were up 23.2 percent year on year to RMB3.9 trillion, representing a deceleration of 0.9 percentage point from the first half of the year. In particular, the sold area of commercial residential housing rose 12.1 percent, at a par with the first half of the year; the sales value of commercial residential housing grew 21.2 percent, representing a deceleration of 1.1 percentage points from the first half of the year.

Investment in real estate development decelerated. In the first three quarters, investment in real estate development totaled RMB4.4 trillion, up 32.0 percent year on year, representing a deceleration of 0.9 percentage point from the first half of the year. In particular, investment in commercial residential housing reached RMB3.2 trillion, up 35.2 percent year on year, representing a deceleration of 0.9 percentage point from the first half of the year. In the first three quarters, the floor area of newly built housing increased by 23.7 percent year on year to 1.48 billion square meters, representing an acceleration of 0.1 percentage point from the first half of the year. Among this total, the floor area of newly built residential housing registered 1.14 billion square meters, a year-on-year increase of 21.3 percent and an acceleration of 0.6 percentage point from the first half of the year. The floor area of housing under construction grew 29.7 percent to 4.61 billion square meters, a deceleration of 1.9 percentage points from the first half of the year. The floor area of completed housing stood at 430 million square meters, up 17.8 percent year on year and representing an acceleration of 5.0 percentage points from the first half of the year.

The expansion of outstanding real estate loans continued to decelerate. As of end-September 2011, outstanding real estate loans posted RMB10.5 trillion, up 14.6 percent year on year and representing a deceleration of 2.3 and 12.8 percentage points from end-June 2011 and end-2010 respectively. In particular, outstanding mortgage loans posted year-on-year growth of 16.2 percent reaching RMB6.4 trillion, representing a deceleration of 1.3 percentage points from end-June and the seventeenth consecutive month of decline. Outstanding real estate development loans were up 14.9 percent year on year to reach RMB2.6 trillion, representing a deceleration of 3.5 percentage points from end-June and the fifth consecutive month of decline. Outstanding land development loans declined 4.8 percent year on year to reach RMB788.7 billion, declining in year-on-year terms for three consecutive months. As of end-September 2011, outstanding real estate loans accounted for 20.3 percent of the total outstanding loans, 0.2 percentage point lower than that at end-June. In terms of new loans, new real estate loans in the first three quarters reached RMB992.3 billion in cumulative terms, a reduction of 743.9 billion year on year. New real estate loans accounted for 18.3 percent of total new loans, representing a deceleration of 1.4 percentage points from the first half of the year and a deceleration of 8.6 percentage points from 2010.

Construction of affordable housing made rapid progress due to greater financial support. As of end-September 2011, a total of 9.86 million units of affordable housing and renovation of shanty housing broke ground in urban areas, accounting for 98 percent of the planned number of units. In order to provide greater financial support to public rental housing and other affordable housing projects, the PBC and the CBRC issued the *Circular on Providing Quality Financial Services to Public Rental Housing and Other Government-Subsidized Housing Projects* (PBC Document No. 193 [2011]), which requires banking financial institutions to actively make loans to qualified projects based on strengthening management and risk prevention. As of end-September, outstanding loans for affordable housing reached RMB280.8 billion, with new loans in the first three quarters posting RMB115 billion, accounting for 52.3 percent of the total new loans in the real estate sector and representing an acceleration of 9 percentage points from the first half of the year. In September, outstanding commercial housing development loans showed a net decrease, whereas new loans for affordable housing development accounted for 123.4 percent of the new residential housing development loans. On September 28, the General Office of the State Council issued the *Guiding Opinions on the Construction and Management of Affordable Housing Projects* (Guo Ban Fa No. 45 [2011]), which explicitly specifies the general requirements, basic principles, and policy measures for the construction and management of affordable housing projects. With implementation of the above-mentioned document, construction of affordable housing is expected to make further progress and financial-sector support to affordable housing will gradually increase.

(2) The logistics sector

The logistics sector, as a service sector comprising industries such as transportation, warehousing, cargo brokerage, the information industry, and so forth creates many jobs and therefore provides important support to the economy. The logistics sector, although a late-starter, has been developing rather rapidly. The value-added of the sector surged from merely RMB742.9 billion in 2001 to RMB2.7 trillion in 2010, growing at an annual rate of 14.8 percent over the past ten years. Since issuance of the *Plan of the State Council on*

Adjusting and Revitalizing the Logistics Sector, the capacity of the sector's infrastructure has been gradually improved and a more favorable environment and conditions for development have been created; as a result, the sector has maintained steady and rapid development momentum, with improved overall quality. In the first three quarters of 2011, the value-added of the logistics sector reached RMB2.2 trillion, up 14.6 percent year on year, whereas the total social logistics sector posted RMB117.7 trillion, an increase of 13.4 percent year on year.

However, the sector is generally fledgling and more efforts are needed to improve the quality of services. First, efficiency in the total social logistics sector remains low. In the first three quarters of 2011, total expenditures of the social logistics sector as a share of GDP stood at 18 percent, about twice the average in the developed countries. Second, the pattern of extensive operations has not yet fundamentally changed. Taking small- and medium-sized road transport service providers as an example, they offer similar services and compete aggressively in terms of prices; in the first half of the year, despite the continuous surge in oil prices, the comprehensive SME road transport price index hovered at a low level of around 60 points. Third, the handling capacity of the logistics infrastructure is inadequate, lacking a comprehensive transport system featuring a reasonable layout, smooth connections, and adequate capacity, convenience, and efficiency. In addition, the degrees of organization and intensive operations in logistics services need to be elevated.

The high costs of logistics have attracted wide-ranging attention, influenced by the level of development of the sector and the management capability on the one hand, and by some structural factors on the other. Furthermore, multiple regulators and a tax system dominated by a business tax (turnover tax) constrain the use of "multi-modal transport," posing a barrier to the development of third-party logistics and specialization and leading to high overhead for logistics enterprises. In 2010 the overhead in the logistics industry accounted for 12.1 percent of overall expenditures in the total social logistics sector in China, in contrast to merely 3 percent in the U.S. Moreover, excessively high toll fees have become a difficult challenge for the reform of the sector. According to estimates by the China Federation of Logistics and Purchasing, toll fees account for one-third of the total operational costs of logistics enterprises. At the same time, hikes in the prices of land, fuel, and human resources have built up pressures on the cost side of the industry.

The development of a modern logistics sector and the establishment of a socialized, specialized, and informatized modern logistics service system are needed not only for the structural adjustment and industrial upgrading of the sector itself, but also for the development of the economy. Thus, efforts should be made to improve the relevant policy measures, including alleviation of the tax burdens on logistics enterprises, greater support for land policies, reductions in toll fees to facilitate the passage of logistics vehicles, acceleration of institutional reform by improving the fragmented supervision, and integration of the resources of the logistics facilities through M&As and cooperation. Funds from multiple sources should be channeled into the sector. Efforts should also be made to guide banking financial institutions to increase credit support to logistics enterprises. Financial innovation, including collateral, pledges, and other forms of guarantees, should be promoted to cater to the needs of logistics enterprises so as to improve financial services to logistics enterprises. Financing mechanisms should be streamlined to broaden the financing channels and to encourage qualified logistics enterprises to be listed through IPOs and to issue enterprise bonds.

Part 5 Monetary Policy Stance for the Next Period

I. Outlook for the Chinese economy

Since the beginning of 2011 the Chinese economy has gradually shifted from policy-stimulus growth to endogenous growth in the direction intended by macroeconomic management and it has continued its momentum for stable and fairly rapid growth. At present, the global financial crisis is having a deep-rooted impact as the major advanced economies are still de-leveraging and sovereign debt problems and other problems have worsened, thereby seriously threatening the banking systems in the advanced economies. The global recovery is teetering with increased uncertainties; therefore, China may be affected through trade, capital flows, expectations, and other channels. In the recent two years, aggregate demand in China has recovered rapidly. As economic growth returns to normal, new problems and issues may emerge. In general, the domestic and external environments are very complicated and it will be necessary to closely follow developments both at home and abroad and to beef up the prevention of systemic risks. It should be noted that the current stabilization of economic growth is the outcome of preemptive macroeconomic management. The endogenous drivers are readily available for stable economic growth. The localities are keen to promote urbanization, industrialization, and balanced regional development; the momentum is good for expanding consumer demand; the services sector has enormous potential; and endogenous drivers are strong for economic growth. In the first three quarters of 2011, external trade became more balanced, the contributions of fixed assets and final consumption to GDP growth were 5 and 4.5 percentage points respectively, indicating a stronger role of domestic consumption in driving economic growth. The recent elevated level of the non-manufacturing PMI is also an indication of good momentum to upgrade consumption, develop the services sector, and promote more balanced growth with stronger endogenous growth. This differs from the performance during the pre-crisis period in 2008 when external demand contributed a fairly large share of Chinese growth. According to the PBC's survey of enterprises, bankers, and urban depositors in Q3, the decline in the major indices was within expectations and the indices remained at sound levels. Against the background of sluggish external demand and a gradual shift in the growth model, China's growth potential will gradually decline. Moving the growth rate in the direction of a stable and moderate range will help contain excessive price spikes and will contribute to economic restructuring and sustainable development in the medium and long term.

With the adoption of a series of policy measures, the momentum for excessive price hikes has been checked as the effects of these measures have gradually unfolded. At present, the relative stable aggregate demand, gradually normalizing monetary conditions, expected bumper autumn grain harvest at home, tepid global growth, and stable commodity prices are factors conducive to price stability. Month-on-month CPI growth has shown signs of moderating since August and judging from the current situation there is a possibility of continued moderation in the year-on-year CPI. If domestic and global growth slow down further, moderation in CPI growth is likely to accelerate. But it is necessary to note that uncertainties remain with respect to future price movements and a basis for price stability has yet to be consolidated. First, current price levels are elevated and it will be difficult to alter inflationary expectations in the short run given the likely continuation of extremely loose global monetary conditions and the rapid expansion of domestic consumption over the past two years. Second, endogenous pressures for economic expansion remain, thus efforts to manage price hikes should continue and it will be necessary to manage the pace and intensity of macroeconomic management. In addition, labor costs and prices in the services and non-tradable sectors may go through a process of continued and rigid increases, and pricing mechanisms for resource products have yet to be reformed. These factors may exacerbate inflation expectations and make prices more sensitive to the expansion of aggregate demand. According to the PBC's survey of urban depositors in Q3, households still have strong expectations of price hikes, as indicated in the climb of 2.6 percentage points from the last quarter in the future price expectation index and the expansion of 4.1 percentage points in the group that expects higher prices next quarter. The percentage of respondents who believed housing prices are too high increased by 1.3 percentage points, the largest increase since 2009 when the item was first included in the survey.

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, closely watch developments in the economic and financial situations 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, and conduct fine-tuning and preemptive adjustments with proper timing in response to changes in the economic situation, in order to consolidate the good momentum for steady and relatively rapid economic growth, to keep price levels stable, and to strengthen prevention of systemic risks.

First, a combination of multiple policy tools will be used and the macro-prudential framework will be improved to maintain a proper volume of all-system financing aggregates. Liquidity management will be strengthened to keep liquidity at reasonable levels. In line with the changes in the economic and financial situations and in capital flows, a combination of policy tools with a proper maturity structure and an intensity of operations will be used to keep liquidity in the banking system at reasonable levels and to guide money market interest rates at appropriate levels. Price instruments such as interest rates will be used to adjust demand for funds as well as investment and savings behavior 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, and to properly adjust the measures in line with the macroeconomic changes and the soundness of the banking system. Based on the operations of financial institutions and the implementation of credit policies, the relevant parameters will be fine-tuned. Adjustments of the differentiated reserve requirement ratio will continue to encourage financial institutions to maintain sound operations, to adjust lending, and to boost their risk-prevention capability. Monitoring of and adjustments to the all-system financing aggregates will be intensified to keep them at appropriate levels.

Second, measures will be taken to optimize the credit structure, improve financial services, and enhance credit support for structural adjustments, in particular to the agricultural sector and small enterprises. Coordination of credit and industrial policies will be improved. The PBC will guide financial institutions to manage the pace of lending, to implement the differentiated credit policy, to insure that fund demands of ongoing and follow-up projects are satisfied, to focus on supporting SMEs that are compatible with the industrial policies, to support projects that enhance the people's welfare especially government-subsidized housing projects, and to strictly control lending to high-energy-consuming, highly-polluting industries and industries with excess capacity. It is necessary to make innovations in financial products and services, to increase effective credit inputs to micro and small enterprises, to strive to achieve the goal that lending to micro and small enterprises will grow no more slowly than that of total lending and with a larger increment than that during the corresponding period of the last year. The qualified small financial institutions will continue to be subject to relatively lower required reserve ratios. In addition, efforts will be made to build a system of financial organizations to service micro and small enterprises and the agricultural sector, rural areas, and farmers, and to promote the development and reform of small financial institutions. In order to issue risk warnings and to prevent systemic risks, risk management will be further strengthened with respect to lending to local government financing platforms, off-balance-sheet businesses, and real estate sector financing, and monitoring and analysis of informal lending will be enhanced.

Third, the market-based interest rate reform and the RMB exchange rate regime will be advanced. Efforts will continue to develop benchmark interest rates in the financial market, 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 of 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, allowing market demand and supply to play a fundamental role in the exchange rate regime, increasing the flexibility of the RMB exchange rate, keeping the exchange rate basically stable at an adaptive and equilibrium level, and promoting 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 will expand channels for cross-border flows of RMB. Measures will be adopted to promote trading between RMB and currencies of the emerging markets based on directly quoted rates on the interbank foreign exchange markets to provide better services for the development of RMB settlement of cross-border trade. 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. Measures will be taken to develop financial markets, to optimize the financing structure, to encourage financial innovation, to expand financing channels for small and micro enterprises, to improve the institutional framework and infrastructure-building in the financial market, to improve laws and regulations governing market behavior, and to facilitate the opening of an interbank bond market in an active and prudent manner for the purpose of enabling the financial market to serve the real economy. Follow-up monitoring and guidance will be given to the Agricultural Bank of China in its reform of its Agricultural and Rural Business Department in order to provide financial services for the agricultural sector, the rural areas, and farmers. Focusing on the nation's development strategy, study and analysis of the reform program of the Export-Import Bank of China will continue. Efforts will be made to facilitate implementation of the reform program of the China Export and Credit Insurance Corporation so that it will play a role in supporting trade development and the "going-global" strategy. Studies will be conducted to review the reform program of the Agricultural Development Bank of China to enable it to play a role in supporting agricultural and rural development.