Government will exert positive impact on the stabilization of consumption though the moderation of economic growth might negatively affect households' income and consumption. Third, high savings ratio in China laid a solid foundation for maintaining relatively loose liquidity and huge domestic demand potential will give enough room for macro-adjustment. With effective implementation of proper policy measures in a timely manner, it is hopeful that China will realize an economic growth targeted at around 8 percent.

Downward Pressure on Price Will Gradually Ease

Due to the deceleration of economic growth and excess production capacity, price level will face downward pressure in the short-term, but attention should be given that monetary factor will finally lead pro-cyclical changes in price level along with economic cyclical movement. At present, on one hand, steady economic growth requires large increase in money supply; while on the other hand, excessively loose monetary condition may increase price upward risks in the next economic rising cycle. In general, in the first half of 2009, the CPI will continue the downward trend due to the base effect, but in the second half of the year, with gradual economic recovery, especially acceleration of investment growth, rising investment product price will bring the general price level gradually stabilized.

Restructuring Efforts Will Be Further Strengthened

Although some positive changes emerged in China as economic development stabilized, given the yet severe internal and external environment, efforts should be made to continue to implement the proactive and moderately loose monetary policy to promote steady and relatively rapid economic development in line with the requirement of boosting domestic demand to sustain economic growth and adjusting economic structure. Along with efforts in boosting demand, restructuring will be strengthened to expand expenditure in education, health care, social safety net, other vulnerable sectors and public service sector, to boost consumption in particular household consumption, to maintain stable agricultural development, to accelerate key industries' adjustment and revival, to foster the development of SMEs and job creation in various forms, to reform resources pricing mechanism and to promote structural optimization and transformation of economic development mode.

GLOBAL ECONOMIC AND FINANCIAL DEVELOPMENT

The U.S. subprime mortgage crisis developed into a major financial crisis in 2008, which had huge impact on the international financial market and the economies over the world, and gave rise to a severe global economic downturn.

The Serious Financial Crisis Ever Seen in A Century

Since the U.S. subprime mortgage crisis intensified and spread to the entire world, many institutions directly involved in the subprime mortgage business went bankrupt while the massive deleveraging made some major financial institutions incur huge loss. All these dragged the international financial market into heightening turbulence. Even more, many economies slid into recession. In April 2009, the IMF estimated that the loss of global institutions might hit as high as $4.1 trillion in the period from the burst of the crisis to 2010.

The development of this crisis can be divided into four stages as the financial crisis spread from the sub-prime products to the financial market, from the financial sector to the real economy, and from the U.S. to the whole world. The first stage was from March 2007 to July 2007, as the emerging stage. The second stage was from August 2007 to December 2007, when the crisis spread to the U.S. financial market and the real economy. The third stage was from January 2008 to September 2008, when the crisis and the deepened and affected developed economies widely. The fourth stage was from Sep 2008 till now, in which the crisis has been deteriorating rapidly, the hit on the emerging markets exacerbated and pulled the global market into a recession.

In the above mentioned evolution, the crisis has shown several features. First, the increasing sophistication of financial innovations has made the risk more risky than it appeared, which has given the crisis a feature of sudden outbreak. Second, the high leverage level has enlarged the extent of losses of financial institutions, accelerated the adjustment of asset prices, speeded up the spread of the crisis and even made the crisis more powerful. Third, the high degree of integration of the international financial market and a wide range of international operations of financial institutions has put the crisis on a track of growing globally and systemically. Fourth, the border of government rescue was constantly broken through, and their intervention in the market became increasingly powerful.

The causes of this on-going crisis are complicated. On the micro-level, the breakdown of the U.S. real estate bubble is the direct cause of the crisis; the "abuse" of excessively complicated financial derivatives encouraged speculation, pushed up the leverage level of the financial system and enlarged risks; the pro-cyclicality of the financial system exacerbated such risks. From a macro point of view, financial supervision of some developed economies has not had adequate oversight of financial innovation, which is one of the fundamental reasons for the on-going crisis. The incomplete supervision stimulated the excess accumulation of total liabilities including household debt, budget deficit, trade deficits together with over-consumption of households, which has trigged off the imbalance of the world economy and even this crisis. The excessively accommodating monetary policy of some developed economies before the crisis has bred a long-term asset bubble and credit bubble. In addition,

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the crisis also exposed some inherent defaults in the current international monetary system.

The crisis will have a significant impact on the global economy and the financial system. On the one hand, the crisis has cut down the leverage ratio significantly and pulled the global economiy into a slowdown. On the other hand, it will have profound impact on the architecture of international financial organizations, the international monetary system, the financial supervision system and even on the concept of free market.

To combat the crisis, major economies took a great number of unconventional economic policies including cutting interest rates consecutively, pumping liquidity into the market through various channels, handing out various bailout aids to troubled financial institutions, and launching massive economic stimulus packages. At the "Financial Market and the World Economy Summit" in November 2008, the leaders of the G-20 nations pledged to strengthen international cooperation, coordinate crisis resolution, and reform the international financial system. After the Summit, a number of policies were issued by countries and relative international organizations to implement the declarations and action plans of the Summit.

World Economic Development in 2008

The U.S. Slid into Recession

Affected by the persistently bearish property market, shrinking asset price and rapid worsening balance sheet of households and enterprises, the U.S. consumption and investment were lower, and the year-on-year GDP growth was merely 1.1 percent, 0.9 percentage points lower than that in 2007, with annualized quarter-on-quarter GDP growth registering 0.9 percent, 2.8 percent, -0.5 percent, and -6.3 percent respectively (the biggest decline since the second quarter of 1982). The employment situation continued to deteriorate, with the unemployment rate soaring from 4.9 percent at the beginning of the year to 7.2 percent in December, the highest level in the past 16 years. Foreign trade contracted notably, and trade deficit decreased by $19.13 billion from 2007 to $681.13 billion in 2008. Under the combined influence of the economic slowdown and the massive fiscal plan, fiscal deficit of the U.S. Federal Government rose substantially. The federal budget deficit reached a historical high of $454.8billion in the 2008 fiscal year ending on September 30, an increase of 181.6 percent year on year, and the fiscal deficit to GDP ratio climbed from 1.2 percent in the 2007 fiscal year to 3.2 percent. Inflationary pressures first built up and then eased. The CPI grew year-on-year from 4.3 percent at the beginning of the year to an 18-year-high of 5.6 percent in July, and dropped rapidly thereafter to 0.1 percent in December, which is the smallest single month rise since September 1955.

The Euro Zone Slid into Its First Recession since Inception

Affected by the financial crisis, consumption, investment and exports in the euro zone slowed down simultaneously, with GDP in the first three quarters growing at 2.1 percent, 1.4 percent and 0.6 percent respectively. The annualized quarterly GDP growth rate of the second and third quarter posted -1 percent, which features its first recession since inception. Since then, as the recession continued to deepen, the GDP growth in the fourth quarter declined 1.5 percent from the same quarter of the previous year and 6.3 percent on the annualized quarter by quarter rate, the highest drop since the establishment of the euro zone. The employment situation in the first half of 2008 remained stable but worsened in the second half of the year, with unemployment rate rising from 7.2 percent in March to 8.1 percent in December. Trade deficit increased, and the annual import and export growth rate increased by 3.7 percent and 7.1 percent year-on-year respectively, amounting to 33.2 billion euros cumulatively over the whole year, compared to 15.8 billion euros surplus in the same period of the previous year. The price level first edged up and then declined. The year-on-year Harmonized Index of Consumer Prices (HICP) grew from 3.2 percent at the beginning of the year to a historical high of 4.1 percent in July, but rapidly decreased starting from August and dropped to 1.6 percent in December, within the 2 percent target set by the European Central Bank.

The Japanese Economy Slumped into Recession

The shrinking export exerted an increasing impact on the export-dependent Japanese economy. Due to weakening investment and contraction of industrial production, the annualized quarter-on-quarter real GDP grew by 1.4 percent in the first quarter but decreased by 4.5 percent and 1.4 percent respectively in the next two quarters, and dropped by 12.1 percent in the last quarter, the steepest fall in the past 35 years. The unemployment rate increased from 3.8 percent at the beginning of the year to a two-year high of 4.1 percent in August. Following a slight decline in the next few months, the unemployment rate climbed to 4.3 percent in December. The trade surplus shrank significantly. The second half of 2008 even witnessed a trade deficit for six months in a row. The cumulative trade surplus in 2008 registered 2.16 trillion yen, a drastic decrease of 80.9 percent from that in 2007. Price indices dropped from an elevated level. The year-on-year CPI growth, after climbing from 0.7 percent at the beginning of the year to a ten-year high of 2.3 percent in July, slid rapidly in the fourth quarter and fell to 0.4 percent in December.

Major Emerging Markets and Developing Countries Witnessed Obvious Slowdown

As reported by the IMF, the economic growth of major emerging market economies and developing countries was 6.1 percent in 2008. In the first half of the year, emerging market economies as a whole maintained a momentum of stable growth, however, under the combined influence of rising energy and food prices, capital inflows, and strong domestic demand, inflation also surged. In light of the build-up of price hike pressures, most emerging market economies frequently raised interest rates by small margins. After mid- and late September, due to the unwinding of the weakening external demand and sharp decline of commodity prices as a result of the intensifying financial crisis, the situation of emerging markets and developing countries deteriorated rapidly. The deleverage of the financial market and the decrease of risk preference among investors caused accelerating capital outflows, stock index declined, currency devaluation and decrease of foreign exchange reserves. The sluggish exports severely affected some economies that are highly dependent on exports.

Global Financial Market Development in 2008

The Exchange Rates of Major Currencies Fluctuated within Broad Bands. The U.S. Dollar Weakened and then Revalued, and the Japanese Yen Appreciated amidst Fluctuations

As a result of the downbeat forecast by investors about the U.S. economy, the dollar depreciated rapidly against the euro and the yen at the beginning of the year. As the crisis worsened and massive deleveraging of financial institutions continued, combined with the flight-to-safety effects of the dollar when the financial crisis spread to Europe and the entire world, the dollar appreciated against the euro, pound and Australian dollar in the second half of 2008. At end-2008, the euro-to-dollar and the pound-to-dollar exchange rates closed at 1.3919 dollar per euro and 1.4619 dollar per pound, with the dollar revaluing by 4.9 percent and 35.7 percent against the euro and the pound respectively from the beginning of the year. Moreover, affected by the squaring of carry trade positions due to interest rate cuts and capital flow-backs, the yen appreciated amidst fluctuations and closed at 90.79 yen per dollar at end-2008, revaluing by 23.0 percent from the beginning of the year and reaching a record high for the past 16 years (Figure 5).

Figure 5 The U. S. Dollar Exchange Rate Movement in 2008

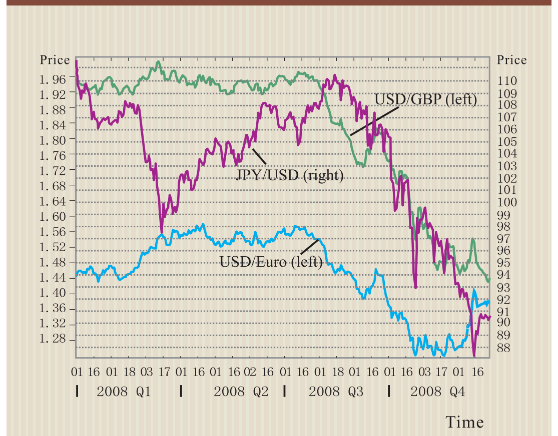
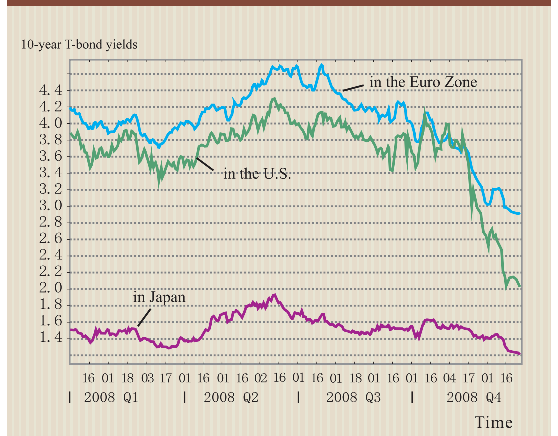


Figure 6 The Chang of the Major Bond Yields in 2008



The Major Bond Yields in the International Market Fluctuated downward

Following the substantial slump from the beginning of the year, the major bond yields rallied from end-March and edged down marginally in June. After the bankruptcy of Lehman Brothers in September, there was more demand for safety. After the frequent interest rate cuts, a large amount of capital flowed into the bond market, pushing down the yields of the major T-bonds. At end-2008, 10-year T-bond yields closed at 2.061 percent, 2.944 percent and 1.168 percent in the U.S., the euro zone, and Japan respectively, a drop of 2.026, 1.398, and 0.334 percentage points respectively from the beginning of the year (Figure 6)

The Major Stock Markets Plunged Considerably

Affected by the financial crisis, the major stock markets tumbled amidst fluctuations, and the retreat accelerated after September when the financial crisis deteriorated. At end-2008, the Dow Jones Industrial Average, the Nasdaq, the STOXX50, and the Nikkei 225 closed at 8776.4 points, 1577.0 points, 2447.6 points, and 8859.6 points respectively, down 33.8 percent, 40.5 percent, 44.3 percent, and 42.1 percent respectively from the beginning of the year.

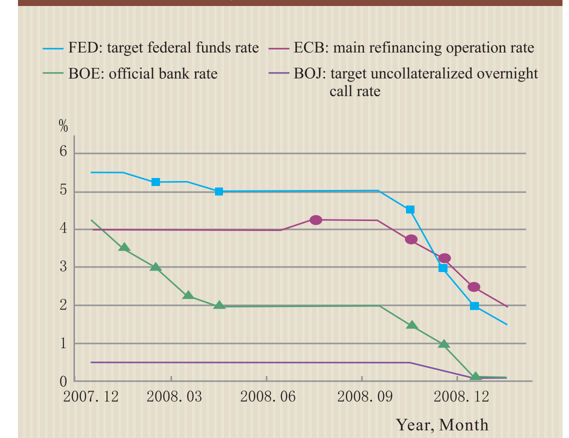
The Price of International Crude Oil Soared during the First Half of 2008 and Fell Rapidly in the Second Half

Affected by geo-political tensions, the U.S. dollar depreciation and intensified speculation, the price of international crude oil accelerated from the beginning of 2008. WTI closed at historical high of $147.27 per barrel on 11 July. Then, with rapid decline in demand due to world economic slowdown, the U.S. dollar appreciation and the rapid withdraw of speculative money, price of commodities represented by crude oil plunged. At the end of 2008, WTI and Brent crude oil futures prices closed at 44.6 dollar and 45.6 dollar per barrel respectively, down 55.3percent and 51.4 percent respectively from the beginning of the year.

Monetary Policies of the Major Economies

In the first half of 2008, monetary policy was in dilemma due to worsening crisis of the international financial market on the one hand and inflationary pressures due to soaring commodities prices such as energy and grain on the other. The central banks of major economies tried to inject massive liquidity to the market from all channels and through coordinating policies and conducting currency swaps to strengthen co-operations while adjusting the interest rate modestly in order to deal with the crisis (Figure 7).With global inflationary pressures easing due to the declining commodities price in the third quarter and growing risks of economic recession, the major central banks chose to cut interest rates successively and substantially, which turned the global monetary policy into an expansionary nature. In order to promote financial market stability and recovery of the credit market, the U.S. Federal Reserve not only cut the federal funds target rate to nearly zero, but also adopted a series of unconventional monetary policy. The U.S. Federal Reserve pumped liquidity directly into banks, securities companies, government agencies, insurance companies, non-banking financial institutions and the broader business sector through the expansion of its own balance sheet and over 10 innovative liquidity management instruments, which had a wide coverage of asset-backed securities, commercial papers and various types of bonds.

Figure 7 Interest Rate Adjustments of Central Banks of the Major Economies



World Economic Outlook in 2009

In light of the current adjustment in the international financial market, developed economies might slide into an even bigger recession, and the emerging markets and developing economies will further slow down. The

Table The Real GDP Growth and Projections of the Major Economies

	2008	2009 (Projections)
World	3.2	−1.3
Developed Economies	0.9	−3.8
United States	1.1	−2.8
Euro Zone	0.9	−4.2
Germany	1.3	−5.6
France	0.7	−3.0
Italy	−1.0	−4.4
Japan	−0.6	−6.2
United Kindom	0.7	−4.1
Canada	0.5	−2.5
Emerging & Developing Economies	6.1	1.6
Russia	5.6	−6.0
China	9.0	6.5
India	7.3	4.5
Brazil	5.1	−1.3
Africa	5.2	2.0
Economies in Central & East Europe	2.9	−3.7

Source: *The World Economic Outlook*, the IMF, April 2009 world economy would be in the deepest recession since World War II. The IMF predicted in April 2009 that world economic growth would drop from 3.2 percent in 2008 to -1.3 percent in 2009, the lowest level since World War II, with the U.S., the euro zone, and Japan slowing to -2.8, -4.2, and -6.2 percent respectively in 2009 and that of the emerging market economies slowing from 6.1 percent in 2008 to 1.6 percent (Table). According to the World Bank forecast in March 2009, the growth rate of world GDP will be -1.7 percent and that of developing economies will decline to 2.1 percent in 2009. At the same time, growth rate of world trade will fall to -6.1 percent.

With these uncertainties, the adjustment of the global economy will take longer. The recovery of the U.S. real estate market and the credit and other financial markets in major economies will play a crucial role in the recovery of the global economy. Meanwhile, different contents and approaches in the stimulus packages of various economies will influence the speed and timing of the recovery. The time lag of polices and even some of beggar-thy-neighbor policies may delay the recovery significantly. If the huge liquidity can't be retrieved after the recovery, the extremely lax monetary policy of major central banks may also provoke mid- or long-term inflation. In addition, given the widespread and deepening risk of recession, vigilance is needed against trade, investment, and financial protectionism and anti-globalization sentiment that might be on the rise. Global trade and investment liberalization should be promoted by resisting trade and investment protectionism decisively and increasing coordination among international macroeconomic policies.

BOX 1

The G-20 Summit on Financial Markets and World Economy

With the continuous deepening of the financial crisis, the international community called for enhancing cooperation and working together to deal with the crisis. At the proposal of U.S. President George W. Bush, the leaders of the G-20 held the Summit on Financial Markets and World Economy in Washington ("Washington Summit" for short) on November 14-15, 2008. Participants from United Nations, the World Bank, the IMF, Financial Stability Forum and other international institutions also joined the Summit. The meeting discussed the root causes of the crisis, evaluated the actions taken by the G-20 countries, and came to some common principles for financial regulation and reform of international financial system. And the leaders of the G-20 also discussed the impact of the financial crisis on the emerging economies and developing countries. The meeting released the *Declaration from the G-20 Summit on Financial Markets* and *World Economy ("Declaration from the G-20 Summit")* and the *Action Plan to Implement Principles for Reform (Action Plan* for short).

Chinese President HU Jintao was invited to the Summit and delivered an important speech entitled "Tide Over Difficulties Through Concerted Efforts", elucidating China's efforts to restore the economy growth and maintain financial stability. The speech also tried to lead the direction of future reform on international financial system to stick up for the interests of China and other developing countries. This meeting brought together the top leaders of major developed powers and emerging economies, discussing how to cope with the crisis, which played a positive role to promote confidence in the international financial markets and stimulate the world economy. Washington Summit had a very special historical significance when the world economy and international markets were facing unprecedented challenges.

According to the *Declaration from the G-20 Summit* and the *Action Plan,* and pushed by the United Kingdom —the chair of the next G-20 summit, four working groups including Group 1—Enhancing sound regulation and strengthening transparency, Group 2—Reinforcing international cooperation and promoting integrity in financial markets, Group 3—Reforming the IMF, and Group 4 —Reforming the World Bank and other multilateral development banks were established right after the Washington Summit and had begun to carry out the research work. Each group planed to make a report on its preliminary research production to the G-20 Minister Meeting being intended to be held in the middle of March 2009, and submit its final report to the second G-20 summit being intended to be held in London on April 2, 2009.

Following the coordinated instruction of the CPC Central Committee and the State Council and cooperating with other departments closely, the PBC took work in the areas of the above four working groups. The PBC also actively participated in the preparation for the second G-20 financial summit, trying to set up China's image of a responsible great power and stick up for the China's interests on the rules formulation in international financial field.