

MONETARY POLICY

In 2008, due to the shocks of global financial crisis, the economic and financial situation both at home and abroad changed dramatically, the PBC adjusted monetary policy stance accordingly. In the beginning of the year, the PBC implemented tight monetary policy in order to prevent economic overheating and inflation. Along with the evolvement of the global financial crisis, the PBC adjusted monetary policy stance, priority and intensity in a timely manner, especially implemented moderately loose monetary policy to maintain stable and relatively rapid economic development since September. Currently, the global financial crisis has not yet bottomed out and external environment is still very severe. Owing to the implementation of a series of domestic demand-boosting policies, some positive changes can be seen in China's economy in the beginning of 2009 but not yet on a solid basis. In the next stage, the PBC will continue to carry out the moderately loose monetary policy, maintain reasonable and sufficient liquidity in banking system, guide appropriate growth of money and credit aggregate and optimization of credit structure to promote stable and relatively rapid economic development.

In 2008, hit by the most serious global financial crisis since the Great Depression, global economic situation became complicated, and the increasing uncertainties brought unprecedented great challenges for policy makers worldwide. Under the correct leadership of the CPC Central Committee and the State Council, the monetary policy stance was adjusted with improved preemptiveness, targeting, and flexibility according to the changing situation.

Monetary Policy Measures in 2008

In the beginning of 2008, the PBC implemented tight monetary policy to prevent the rapid economic growth from becoming overheated and the structural price hike from turning into entrenched inflation, sterilized excess liquidity and guided financial institutions to make reasonable credit planning. From July, the US sub-prime crisis spread and deepened and as a result, China's export shrank and the general demand reduced. The PBC adjusted monetary policy stance, priority and intensity in a timely manner, guided financial institutions to expand credit and increasing

lending to support the earthquake-hit areas, agricultural sector and SMEs according to the requirements for maintaining stable and relatively rapid economic growth and preventing price hikes. After September, the international financial crisis deteriorated rapidly and took a heavy toll on China's economy. The Chinese government launched a demand-boosting and economic stimulus package. In line with the overall arrangement of the State Council, the PBC adopted moderately loose monetary policy, used a number of instruments, and took a series of flexible and effective measures to maintain sufficient liquidity provision in banking system to promote reasonably stable monetary and credit growth and beef up financial support for economic development.

Flexibly Conducting Open Market Operation

The PBC adjusted open market operation strategy according to the changing internal and external economic and financial situation. Firstly, the PBC flexibly adjusted central bank bill issuance pace to ensure ample liquidity in banking system. The PBC suspended preemptively the issuance of 3-year central

bank bills in the beginning of July and gradually reduced central bank bill issuance size and frequency since the fourth quarter. In the whole year of 2008, a total of 4.3 trillion yuan of central bank bills were issued, with 1.78 trillion yuan, 1.17 trillion yuan, 981 billion yuan and 371 billion yuan for each quarter respectively. At end-2008, the outstanding balance of such bills posted 4.65 trillion yuan. Secondly, the combination of operational tools was optimized. Short-term repurchase instrument was added in timely to gradually reduce the operational duration and further enhance the flexibility of banking system in offsetting short-term liquidity shocks. Thirdly, flexibility of interest rate in open market operation was enhanced. Supplemented by other monetary policy instruments such as deposit and lending rate and required reserves, the open market operational rate steadily declined, thus further guiding the movement of market interest rates and in turn playing their role in adjusting the demand and supply of funds. In December, the average weighted interest rate in the interbank market declined by 183 bps from June. Fourthly, the PBC strengthened the coordination with the fiscal policy. The PBC timely transformed central treasury funds from accounts in the central bank to time deposits in the commercial banks. A total of 170 billion yuan was transformed for the full year and the outstanding balance was 80 billion yuan at year-end.

Flexibly Using the Reserve Requirement Ratio

In the first half of 2008, given the widening “dual surplus” and the continuous rapid inflows of foreign exchange, and in order to sterilize the excess liquidity, the PBC increased the reserve requirement ratio cumulatively by 3 percentage points on five consecutive occasions. In the meantime, a lower reserve requirement ratio was applied to the RCCs and the financial institutions in the quake-hit areas. In the second half of the year, with the heightened international financial turmoil and in order to ensure ample liquidity in the

banking system, the PBC cut the RMB reserve requirement ratio of financial institutions on September 25, October 15, December 5 and December 25 respectively. Specifically, the reserve requirement ratio of large financial institutions was cut by 2 percentage points cumulatively, whereas that of small financial institutions was cut by 4 percentage points cumulatively. By the end of 2008, according to dynamic calculations, a total of 800 billion yuan of liquidity was released. The PBC continued to apply preferential reserve requirement ratios to rural financial institutions and to financial institutions in the quake-hit areas. In addition, in July the PBC adjusted the recipients of the differentiated reserve requirement ratio. Those financial institutions whose capital adequacy ratio reached the required level could revert to the normal reserve requirement ratio and thus the number of financial institutions enjoying the differentiated reserve requirement ratio declined notably.

The Leveraging Role of Interest Rate Was Brought into Play

To carry out the moderately loose monetary policy, the PBC cut the RMB benchmark deposit and lending rate for financial institutions on five occasions since September. In particular, the 1-year benchmark deposit rate was cut from 4.14 percent to 2.25 percent, cumulatively down 1.89 percentage points, and the 1-year lending rate was shaved cumulatively by 2.16 percentage points, from 7.47 percent to 5.31 percent. The deposit and lending rates applied to financial institutions by the PBC were cut twice; in particular, the deposit rates of required reserve and excess reserve with the PBC were cut by 0.27 percentage points each to 1.62 percent and 0.72 percent respectively. The 1-year central bank liquidity lending rate was cut from 4.68 percent to 3.33 percent, down 1.35 percentage points.

The PBC ratcheted up financial support for disaster relief and post-disaster reconstruction. First, preferential interest rates were applied to agro-linked central bank loans in the quake-hit areas for

reconstruction. Interest rates were adjusted downward by 0.99 percentage points on the basis of the central bank lending rate to RCCs. Second, the preferential interest rates were applied to quake-hit area residents who bought housing for their own use after the earthquake or rebuilt their houses. For the affected people who bought housing for their own use, the floor lending rate was adjusted to 60 percent of the benchmark lending rate, and the proportion for the down payment was lowered to 10 percent.

The PBC extended the downward floating range of interest rates on commercial individual housing loans. In order to improve financial services for residents who bought houses for their own uses, the PBC lowered the floor interest rate on commercial individual housing loans to 70 percent of the benchmark lending rate and reduced the minimum downpayment ratio to 20 percent effective on October 27. Effective on December 3, the floor interest rate for construction of low-rent housing was lowered by 10 percent from the benchmark lending rate.

The Role of Rediscount in Guiding the Direction of Credit Fund Was Appropriately Brought into Play

First, the amount of rediscounts was increased by times. In the beginning of 2008, for those provinces (regions and municipalities) hit by the heavy snow and sleet disaster and the disastrous earthquake, an additional rediscount quota of 25.6 billion yuan was timely arranged to inject liquidity into the financial institutions located in the disaster-hit areas so as to increase their credit inputs for post-disaster reconstruction. In December, 34.6 billion yuan of the rediscount quota was added to 16 provinces (regions and municipalities) so as to increase agro-linked loans and financing of small- and medium-sized enterprises. Second, the rediscount rate was lowered twice. In light with the market interest rate movement and adjustment requirement, the rediscount rate was cut cumulatively by 2.52 percentage points from 4.32 percent to 1.8

percent. Third, efforts were made to perfect the institutional building of the rediscount system through appropriately increasing the rediscount windows and expanding the scope of recipients and the institutional coverage, utilizing the rediscount tool to expand the use of commercial bills and granting preference treatment to commercial accepted draft, note rediscount related to the agricultural sector and small- and medium-sized enterprises.

Strengthening Window Guidance and Credit Policy Guidance

In early 2008, the PBC guided financial institutions to carry out annual credit programming in a down-to-earth manner, reasonably arrange the pace and frequency of credit extensions, appropriately control loans to medium- and long-term projects including basic construction projects, restrict loans to enterprises with high-energy consumption, high emissions, and excess capacity, and strengthen credit support to priority areas and vulnerable enterprises such as the agricultural sector, small- and medium-sized enterprises. In the second half of the year, according to the changed situation, the PBC timely eliminated the rigid constraints on credit programming of commercial banks, guided financial institutions to reasonably extend loans in accordance with the effective demands of the real economy in the principle of “differentiated treatment for different sectors” and to strive to optimize the credit structure, improve and strengthen credit services, and increase credit inputs for civil well-being projects, the agricultural sector, major project construction, small- and medium-sized enterprises, the services industry, energy-conservation and emission-reduction, scientific and technological innovation, increased employment, technological upgrading, mergers and acquisitions, coordinated regional development and so forth on the premise of controllable risks. Financial institutions were encouraged to strengthen financial services for the disaster-hit areas

and the PBC arranged an additional 19.4 billion yuan of central bank lending in 2008 to support the post-disaster reconstruction.

Improving RMB Exchange Rate Formation Mechanism and Deepening Institutional Innovation in Foreign Exchange Administration System

The PBC continued to improve the managed floating exchange rate reform based on market demand/supply with reference to a basket of currencies and to maintain the RMB exchange rate broadly stable in a self-initiated, controllable and gradual manner. At the same time, the PBC promoted the facilitation of trade and investment and perfected the balanced management of cross-border capital flows. First, facilitation of trade and investment made progress. Pilot projects of licensed small-value currency exchange business were launched. Eligible financial companies of enterprise groups were allowed to conduct spot sales and purchases of foreign exchange. Foreign exchange business procedures were streamlined in order to provide financial services for the Beijing Olympics and for anti-quake and disaster relief projects. In line with the changing situation, the percentage of exchange settlement quota of sales revenues received in advance of ordinary enterprises was increased. Second, supervision over cross-border capital flows was further strengthened. *The Regulations on the Foreign Exchange System of the People's Republic of China* were amended to strengthen administration on foreign exchange inflow and sale. The systems of online verification of collection and settlement of foreign exchange from exports and trade credit registration and management were implemented in order to improve examination of the authenticity and consistency of export transactions and the collection and settlement of foreign exchange. Management of the external debt was reformed to adjust the size of short-term foreign debts of financial institutions in a rational manner. The information system for direct investment foreign exchange business and the registration system

for trade credit were established and the verification and management system for foreign exchange revenue and payment from export and import was improved so as to enhance statistical monitoring and management skills in cross-border capital movement. Efforts were made to crack down illegal activities and crimes of underground banking. Third, efforts were made to prudently cope with the widespread global financial crisis, strengthen risk management and internal supervision, and maintain and increase the value of foreign exchange reserves. Fourth, the early warning system over the BOP was further improved.

Money and Credit Conditions Remained Generally Stable

With the comprehensive effects of financial macro-adjustment measures, money and credit maintained relatively rapid growth in general with ample liquidity in banking system and further improved credit structure in 2008 so as to support the stable and relatively rapid economic development.

Money supply remained large. At end-2008, broad money M2 increased by 17.8 percent year-on-year to 47.5 trillion yuan, representing an increase of 1.1 percentage points from the previous year. Narrow money M1 was up 9.1 percent year-on-year to 16.6 trillion yuan, a deceleration of 13 percentage points from the previous year. M0 grew by 12.7 percent year-on-year to 3.4 trillion yuan. Net cash injection in 2008 reached 384.4 billion yuan, 54.1 billion yuan more than that in 2007.

Deposits remained relatively rapid growth. At end-2008, the outstanding balance of various RMB deposits grew by 19.7 percent year-on-year to 46.6 trillion yuan, up 3.7 percentage points from 2007. New Deposits tilted in the direction of time deposits. In 2008, enterprises' deposits increased by 1902.8 billion yuan, 700.1 billion yuan less than the increase in the previous year, including a deceleration of 1147.7 billion yuan in demand deposits, an acceleration of 447.6 billion yuan

in time deposits. Savings deposits grew by 4535.3 billion yuan, 3438.6 billion yuan more than the increase in a year before, including an acceleration of 195.4 billion yuan in demand deposits and an acceleration of 3243.2 billion yuan in time deposits. Fiscal deposits increased by 26.9 billion yuan, a deceleration of 635.4 billion yuan.

Growth of lending increased steadily. At end-2008, the outstanding balance of RMB loans grew by 18.8 percent year-on-year to 30.3 trillion yuan, representing an increase of 2.7 percentage points from the previous year. In 2008, new loans grew by 1.3 trillion yuan from that in 2007 to 4.9 trillion yuan. Quarterly distribution of loans became more balanced, with the new loans in each quarter registering at 1.33 trillion yuan, 1.12 trillion yuan, 1.03 trillion yuan and 1.43 trillion yuan respectively. Break down by destinations, short-term credit and paper financing grew by 2273.9 billion yuan, 1135.2 billion yuan more than the growth in 2007, including a growth of 1627.9 billion yuan of short-term lending or an acceleration of 47.8 billion yuan, and a growth of 646.1 billion yuan in paper financing or an acceleration of 1087.5 billion yuan. Medium and long-term loans grew by 2521.1 billion yuan, representing an acceleration of 11 billion yuan from a year ago.

RMB exchange rate movement remained stable. In the first half of 2008, the exchange rate of RMB against the U.S. dollar appreciated by 6.5 percent. The spot rate of RMB against the U.S. dollar fluctuated broadly in the band of 6.81~6.85 since July. In 2008, the RMB cumulatively appreciated by 6.88 percent against the U.S. dollar, and 10.43 percent against the Euro, but depreciated by 15.32 percent against the Japanese Yen.

Monetary Policy Outlook for 2009

Maintaining stable and relatively rapid economic growth was highlighted as the top priority of economic work in 2009 at the Central Economic Work Conference. At present, the global financial crisis has not yet bottomed out and external environment is rather

severe. In the beginning of 2009, with the implementation of a series of demand-boosting measures, the relatively rapid decline momentum of Chinese economy was contained with the emerging of some positive changes but the foundation was not solid yet. In the next stage, in accordance with the overall arrangements of the CPC Central Committee and the State Council, and thoroughly carrying out the scientific approach to development, the PBC will continue to carry out the moderately loose monetary policy and policy measures formulated by the State Council on how does the financial sector support the economic growth, maintain policy consistence and stability, guide a proper increase of money and credit aggregate and optimization of credit structure to promote steady and relatively rapid economic development.

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

Second, the PBC will promote moderate money and credit growth. Taking into account the changes in the domestic and international economic and financial situations and the need for macroeconomic management, the PBC will properly employ various instruments to ensure that money and credit grow in a reasonable and stable manner so as to meet the need for bank lending as the economy develops. The aggregate money supply will target at a 17 percent growth in M2. The PBC will guide financial institutions to establish correct management philosophy, scientifically define performance evaluation system to prevent negative impact on long-term sound operation from excessively pursuing short-term profits and continue to lend on a balanced and reasonable basis.

Third, the PBC will guide financial institutions to optimize the destinations of credit funds. Following the principle of “differentiated treatment to different sectors,” the PBC will ensure qualified central-government investment projects to obtain supplemental loans in a timely manner, earnestly encourage credit supports to agriculture, small- and medium-sized enterprises, employment, students, reconstruction in the post-disaster areas and projects for improving the people's livelihood. Efforts will be made to develop consumer credit, implement real estate credit policy and strengthen finance support to industry relocation, self-initiated innovation and coordinated regional economic development. The PBC will strictly control lending to enterprises with high-energy consumption, heavy pollution or excess production capacities. Financial institutions will be guided to innovate and improve financial services, strengthen financial support to economic development while effectively ward off credit risks.

Fourth, the PBC will steadily advance the market-based interest rate reform and the reform of the RMB exchange rate formation mechanism. The PBC will accelerate the establishment of the benchmark interest rate system in the money market, improve the central bank interest rate system, enhance the pricing capabilities and expertise of financial institutions, and give greater play to the market in determining interest rate levels. The PBC will closely watch the movement in the exchange rates of the major currencies in the international market, and, following the principle of “self-initiated, controllable, and gradual” to improve the

formation mechanism of the RMB exchange rate, make the exchange rate more flexible, and keep it basically stable at an adaptive and equilibrium level. The PBC will also vigorously promote development of the foreign exchange market and develop more tools to manage exchange rate risks.

Fifth, the PBC will continue to deepen the reform of the foreign exchange administration system. The PBC will further facilitate trade and investment, support export and strengthen support to domestic companies' overseas strategic investment. The PBC will improve the QDII system and the QFII system, strengthen the balanced management of cross-border capital flows, and improve BOP statistics and monitoring and research on policy measures in coping with the abnormal changes in BOP. The PBC will closely follow movements of the international financial market to effectively control foreign reserve operational risks.

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