China Monetary Policy Report

Quarter Three, 2010

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In Q3 2010, the Chinese economy developed in the direction as intended by the macroeconomic management policies and the momentum for stable and fairly rapid growth became stronger. Consumption continued to grow rapidly and steadily, the investment structure improved, and external trade recovered further. The contributions of consumption, investment, and exports to economic growth were more balanced. Agricultural sector performance was stable， and sales and production of the manufacturing industries was good. In the first nine months of 2001, the Gross Domestic Product (GDP) registered 26.9 trillion yuan, up 10.6 percent year on year, and GDP growth in Q3 was 9.6 percent year on year. The Consumer Price Index (CPI) rose year on year by 2.9 percent in the first nine months and by 3.5 percent in Q3.

In accordance with the overall arrangements of the State Council, the People's Bank of China (PBC) continued a relatively loose monetary policy, focused on making more targeted, flexible, and effective policies, strengthened liquidity management in the banking system, raised benchmark deposit and lending rates, and guided financial institutions to properly manage the aggregate, pace, and structure of credit provisions. The PBC further promoted the RMB exchange rate regime reform and improved foreign exchange administration to contribute to the stable and healthy development of the economy. In general, the performance of the financial sector was sound and the flexibility of the RMB exchange rate was further strengthened. At end-September, the growth of money and credit rebounded slightly.

At the end of September 2010, broad money supply M2 recorded 69.6 trillion yuan, up 19.0 percent year on year, representing an acceleration of 0.5 percentage points from the end of June. Narrow money supply M1 stood at RMB 24.4 trillion, up 20.9 percent from the same period of the last year, a deceleration of 3.7 percentage points from the end of June. Deposits at financial institutions expanded rapidly, with RMB and foreign currency deposits at financial institutions increasing by 19.8 percent year on year at the end of September, representing an acceleration of 1.2 percentage points from the end of June. Growth of lending by financial institutions accelerated. At end-September, RMB loans were up 18.5 percent year on year, an acceleration of 0.3 percentage points from the end of June, or an increase of RMB 6.3 trillion from the beginning of 2010, representing a deceleration of RMB 2.4 trillion year on year. Lending rates offered by financial institutions went up slightly, with the weighted average lending rate for non-financial enterprises and other sectors standing at 5.59 percent in September, up 0.02 percentage points from June. At end-September, the central parity of the RMB against the US dollar registered RMB 6.7011, an appreciation of 1.89 percent and 1.90 percent from June 19, 2010 and the end of 2009 respectively.

Going forward, the economy is expected to continue its momentum of stable and fairly rapid growth. The worst of the financial crisis is over and the global economy will continue its tepid recovery. In China the ongoing upgrading of consumption and urbanization provide a strong basis for sustainable economic growth. However, it is worth noting that uncertain factors will emerge from time to time in the world economy and as the recovery of the advanced economies has slowed, monetary conditions will remain loose. Some fast-growing emerging economies must address inflation and capital inflow pressures. At home, the recovery of domestic demand is not evenly based, private investment and endogenous growth drivers need to be reinforced, and the tasks of expanding consumption, improving income distribution, and restructuring the economy remain daunting. Given the significant uncertainties in price movements, it is necessary to strengthen management of inflation expectations.

The PBC will continue to follow the scientific outlook on development and implement the relatively loose monetary policy in line with the overall arrangements of the State Council. It will properly manage the intensity, pace, and focus of its policies and make policies better targeted and more flexible while also maintaining policy consistency and stability. It will continue to gradually bring monetary conditions back to a normal state in light of new developments. Efforts will be made to strike a balance between supporting sound and relatively rapid growth, restructuring the economy, and managing inflationary expectations. The PBC will employ a variety of policy tools to enhance liquidity management so as to maintain proper growth of money and credit and to optimize the credit structure, to keep general price levels stable, to strengthen the sustainability of financial support to economic development, and to make sure that the financial system performs in a sound manner. Moreover, the PBC will advance the market-based interest rate reform and the reform of the RMB exchange rate regime to promote the healthy development of the financial market. In addition, it will enhance the role of the market in allocating resources, improve policy coordination, optimize the policy mix, make full use of flexible market-based measures, and facilitate institutional reform and economic structural adjustments to contribute to a shift in the growth model and to stronger endogenous forces for economic development.

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Part 1 Monetary and Credit Performance

In the third quarter of 2010, growth of money and credit recovered modestly, liquidity in the banking system was generally adequate, the RMB exchange rate became more flexible, and the financial system performed well.

I. The growth of money supply rebounded

At end-September 2010, outstanding M2 registered RMB 69.6 trillion, up 19.0 percent year on year, an acceleration of 0.5 percentage points from the end of June. Outstanding M1 stood at RMB 24.4 trillion, an increase of 20.9 percent year on year, a deceleration of 3.7 percentage points from the end of June. Cash in circulation, i.e., outstanding M0, totaled RMB 4.2 trillion, up 13.8 percent year on year, a deceleration of 1.9 percentage points from the end of June. A total of RMB 295.2 billion of net cash was pumped into the system in the third quarter, RMB 19.5 billion less than that during the same period of the last year.

In general, aggregate money growth picked up. M2 growth in August and September remained at a high level of over 19 percent, faster than that registered at end-June, and the upswing in aggregate money growth deserved due attention. M1 growth decelerated gradually, which was mainly attributed to the high base data in the previous year, but it showed a noticeable slowdown in the third quarter. At present, M1 is still growing faster than M2.

II. Deposits in financial institutions grew rapidly

At end-September, outstanding loans in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, as throughout this report) totaled RMB 71.6 trillion, up 19.8 percent year on year, 1.2 percentage points higher than that at end-June, representing an increase of RMB 10.4 trillion from the beginning of 2010 but a deceleration of RMB 1.4 trillion year on year. Outstanding RMB deposits rose 20 percent year on year to RMB 70.1 trillion, 1.0 percentage points more than that at end-June, an increase of RMB 10.3 trillion over the beginning of the year but a deceleration of RMB 1.4 trillion year on year. Deposits increased by RMB 1.1 and RMB 1.5 trillion in August and September respectively, above the RMB 1 trillion threshold. Due to the rising RMB supply as a result of foreign exchange purchases and rapid credit extensions, liquidity was relatively abundant. Outstanding foreign currency deposits registered US$ 229.8 billion, up 13.1 percent year on year and an increase of US$ 21.2 billion over the beginning of 2010 and deceleration of US$ 10.7 billion in year-on-year terms.

In terms of the source and maturity of RMB deposits, growth of household deposits picked up, of which demand deposits accounted for a significantly larger share, while deposits of non-financial enterprises rose steadily, with considerable changes in the maturity structure. At end-September, outstanding household deposits at financial institutions totaled RMB 30.4 trillion, up 17.0 percent year on year, an acceleration of 1.9 and 1.8 percentage points from end-March and end-June respectively, representing an increase of RMB 3.9 trillion over the beginning of the year and an acceleration of RMB 143.8 billion year on year. Outstanding RMB deposits of non-financial institutions reached RMB 28.8 trillion, up 20.5 percent year on year, a deceleration of 6.1 percentage points from end-March and an acceleration of 1.0 percentage points from end-June, up RMB 3.6 trillion from the beginning of 2010 and RMB 2.5 trillion less than the growth during the same period of the last year. In particular, the increase of RMB 682.4 billion in the third quarter represented an acceleration of RMB 173.3 billion year on year. In the third quarter, demand deposits accounted for 55 percent of new household deposits, up 3.9 and 12.7 percentage points respectively from the previous two quarters and indicating an upward trend. In the third quarter, time deposits as a share of the total of deposits by non-financial enterprises reached 82 percent, up 30 percentage points from the first half of the year. This is mainly due to significant changes in the deposit structure of non-financial enterprises in September, when time deposits grew by RMB 682.6 billion, whereas demand deposits declined by RMB 316.7 billion. Compared to the corresponding period in previous years, the structural change in September was within the normal range and was a result of a combination of factors, such as seasonal holidays, advance payments of salaries and fringe benefits, and conversion from demand deposits to time deposits by some enterprises to increase interest returns. At end-September, outstanding fiscal deposits registered RMB 3.4 trillion, up 19.6 percent year on year, an increase of RMB 1.2 trillion over the beginning of the year and an acceleration of RMB 120.3 billion from the same period of the last year.

III. Growth of RMB loans was stable and accelerated

At end-September, outstanding loans in domestic and foreign currencies of all financial institutions reached RMB 49.1 trillion, up 18.7 percent year on year, representing a deceleration of 0.5 percentage points from end-June and an increase of RMB 6.5 trillion from the beginning of the year, but a deceleration of RMB 2.8 trillion from the same period of the last year. The major share of medium- and long-term loans in domestic and foreign currencies went to the infrastructure sector (transportation, warehousing and postal services, production and supply of electricity, gas, and water, and water conservation, the environment, and public utilities), the real estate sector, and the manufacturing sector. In the third quarter, medium- and long-term loans extended by major financial institutions (including the China Development Bank and policy banks, state-owned commercial banks, commercial shareholding banks, postal savings banks, and urban commercial banks) to the three sectors registered RMB 372.3 billion, RMB 154.7 billion, and RMB 93.5 billion, accounting for 45.6 percent, 18.9 percent, and 11.4 percent respectively of new medium- and long-term loans to all industries. Credit support to the agricultural sector, farmers, and rural areas intensified. At end-September, outstanding loans extended to the rural areas by major financial institutions and rural cooperative financial institutions, urban credit cooperatives, village and township banks, and finance companies stood at RMB 9.3 trillion, up 30.3 percent year on year, 11.6 percentage points higher than the average loan growth in all sectors. Outstanding loans to rural households registered RMB 2.6 trillion, up 29.8 percent year on year and about 11.1 percentage points higher than the average loan growth in all sectors. Outstanding loans to the agricultural, forestry, animal husbandry, and fishery industries totaled RMB 2.3 trillion, up 19.4 percent year on year and 0.7 percentage points higher than the average loan growth in all sectors.

The growth of RMB loans accelerated. At end-September, outstanding RMB loans went up by 18.5 percent from the same period of the last year to RMB 46.3 trillion, representing an acceleration of 0.3 percentage points from end-June and an increase of RMB 6.3 trillion from the beginning of the year. Though RMB loans in the first three quarters posted a deceleration of RMB 2.4 trillion year on year, from June growth tended to speed up on a stable trajectory, and growth of new loans accelerated in all three months of the third quarter on a year-on-year basis. Hikes in credit extensions in recent months were pushed up of demand by small- and medium-sized enterprises (SMEs), the real estate sector, and project investments on the one hand, and by a stronger willingness on the part of financial institutions to issue loans on the other hand; in particular, some banks that had reached the regulatory requirements, such as the deposit to loan ratio or the capital adequacy ratio before accelerating credit provision. Broken down by financial institutions, the four state-owned commercial banks extended more loans in the third quarter, which accounted for 40 percent of all the new loans, representing an acceleration of 1 percentage point from the first half of the year. Broken down by sectors, household loans maintained fairly rapid growth and growth of non-financial enterprise loans and other sectors rebounded. At end-September, household loans grew 42.2 percent year on year, down 7.1 percentage points over end-June. This figure represented continued high growth from the beginning of 2010 by about RMB 2.4 trillion, and an acceleration of RMB 527.7 billion from the same period of the last year. Among this increase, residential mortgage loans accounted for 45 percent of total household loans, registering a remarkable increase of RMB 1.1 trillion from the beginning of the year. In particular, new residential mortgage loans in September stood at RMB 80.4 billion, an increase of RMB 26.5 billion from the previous month and the first month-on-month increase since May. With the recovery of the housing market in some regions during the third quarter, the future development of housing loans should be closely followed. Loans to non-financial enterprises and other sectors rose 12.8 percent year on year, growing RMB 3.9 trillion from the beginning of this yea and a deceleration of RMB 2.9 trillion year on year. Among this total, medium- and long-term loans went up RMB 3.6 trillion over the beginning of the year, a deceleration of RMB 671.3 billion year on year. Bill financing dropped by RMB 809.8 billion from the beginning of the year, a deceleration of RMB 1.7 trillion year on year. RMB loans to SMEs continued to rise. Loans extended by banking institutions to SMEs grew by RMB 2.6 trillion from the beginning of the year, and the balance in September registered year-on-year growth of 20.5 percent. Among this total, loans to small enterprises increased by RMB 1.3 trillion from the beginning of the year, with the balance in September up 27.7 percent, about 12.0 and 15.2 percentage points higher than that for medium and large enterprises respectively.

Table 1: RMB loans of financial institutions in the first three quarters of 2010

Unit: 100 million RMB

	First three quarters of 2010	
	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	33339	-14542
Chinese-funded Small and Medium Banks Operating Nationwide②	16718	-6807
Chinese-funded Small and Medium Local Banks③	4412	-1894
Rural Cooperative Financial Institutions④	9922	399
Foreign-funded Financial Institutions	1109	1174

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

②Chinese-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 RMB 2 trillion.

③ Chinese-funded small and medium local banks refer to banks that operate within a single province with total assets in domestic and foreign currencies of less than RMB 2 trillion.

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

Source: The People's Bank of China.

At end-September, outstanding foreign currency loans of financial institutions registered US$ 422.7 billion, up 23.1 percent year on year and US$ 43.2 billion more than that at the beginning of the year, a deceleration of US$ 56.4 billion year on year. Broken down by quarters, foreign currency loans grew by US$ 29.2 billion in the first quarter, an acceleration of US$ 37.7 billion, but slowed down in the second quarter, which to some extent might be related to the tighter foreign currency liquidity of commercial banks. Growth in the second quarter declined significantly to US $3 billion, representing a deceleration of US$ 57.2 billion, but it picked up modestly in the third quarter to US$ 11 billion, still US$ 37 billion less than that in the same period of the last year. Overseas loans grew by US$ 18.7 billion from the beginning of the year, US$ 7.2 billion less than that in the same period of the last year. Overseas loans increased quarter after quarter since the beginning of 2010, recording US$ 1.7 billion, US$ 4.6 billion and US$ 12.4 billion, in the first three quarters respectively, with overseas loans in the second and third quarters exceeding the growth of foreign currency loans during the same period, representing greater support to enterprises that wish to “go global.”

IV. Liquidity in the banking sector was generally adequate

At end-September, outstanding base money registered RMB 16.1 trillion, up 20.9 percent year on year and an increase of RMB 1.7 trillion over the beginning of the year. At end-September, the money multiplier was 4.32, about 0.03 and 0.05 smaller compared with that at end-March and end-June respectively. At end-September, the excess reserve ratio of financial institutions stood at 1.7 percent, and that of large, medium-sized, and small domestic banks and rural credit cooperatives registered 1.4 percent, 1.1 percent, 2.4 percent, and 4.0 percent respectively.

V. Lending rates of financial institutions inched up

Lending rates offered to non-financial enterprises and other sectors continued to crawl up. In September, the weighted average lending rate reached 5.59 percent, up 0.02 percentage points over June. The weighted average interest rate for general loans registered 6.09 percent, up 0.10 percentage points over June, and the weighted average bill financing rate posted 3.86 percent, up 0.09 percentage points over June. By September, the residential mortgage rate had edged up steadily to 5.03 percent on a weighted average basis, up 0.08 percentage points from June.

Compared to the benchmark interest rates, loans with interest rates below and at the benchmark accounted for a smaller share of the total, whereas the share of loans with interest rates above the benchmark increased. In September, the share of loans with interest rates below and at the benchmark stood at 25.54 percent and 30.19 percent respectively, down 2.18 and 0.70 percentage points respectively from June. Loans with interest rates above the benchmark accounted for 44.27 percent of the total, up 2.88 percentage points compared with that in June.

Affected by the changes in credit demand and supply in the domestic market and interest rate movements in the international financial market, the deposit rates of foreign currency generally climbed and lending rates edged down. In September, the weighted average rate of large-value US dollar deposits with a maturity of less than 3 months posted 1.93 percent, up 0.17 percentage points from June; the weighted average US dollar deposit rates with maturities of less than 3 months and between 3 (inclusive) and 6 months posted 2.30 percent and 2.46 percent respectively, down by 0.09 and 0.35 percentage points respectively from June.

Table 2: Shares of loans with rates at various ranges of the benchmark rate in the first three quarters of 2010

Unit：%

	Lower than the benchmark	At the benchmark	Higher than the benchmark					
	[0.9，1)	1	Sum	(1，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2]	Above 2
January	35.38	31.18	33.44	11.92	8.74	4.42	5.71	2.65
February	32.64	31.95	35.41	12.77	9.21	4.31	6.09	3.03
March	30.05	28.91	41.04	13.12	10.91	5.45	7.11	4.45
April	26.22	31.18	42.60	13.83	11.66	5.89	7.47	3.75
May	26.56	29.55	43.89	14.92	11.88	5.77	7.62	3.70
June	27.72	30.89	41.39	14.44	11.63	5.34	6.80	3.18
July	27.03	29.72	43.25	15.38	11.76	5.42	7.05	3.64
August	25.75	29.31	44.94	14.79	12.57	5.42	7.93	4.23
September	25.54	30.19	44.27	14.61	12.57	5.36	7.76	3.97

Source: The People's Bank of China.

Table 3: The average interest rate of large-value deposits and loans denominated in US dollars in the first nine months of 2010

Unit：%

	Large-value deposits						Loans				
	Demand Deposits	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year	Within 3-months	3-6 months	6-12 months	1-year	Above 1-year
January	0.12	0.62	0.88	1.07	1.88	2.96	1.55	1.91	2.07	2.09	3.04
February	0.15	0.70	0.85	1.50	1.65	1.75	1.68	1.88	1.90	2.16	2.79
March	0.15	0.76	0.81	1.34	2.32	0.82	1.69	1.82	2.03	2.32	2.87
April	0.15	0.92	0.87	1.69	1.99	3.83	1.94	2.12	2.14	2.53	2.50
May	0.16	1.41	1.65	1.72	3.09	2.82	2.39	2.88	2.63	2.96	3.02
June	0.21	1.76	1.44	2.32	1.60	3.94	2.39	2.81	2.88	3.10	3.33
July	0.22	1.99	2.20	2.66	3.02	2.89	2.48	2.99	3.18	3.22	3.07
August	0.31	2.04	2.18	2.65	3.42	2.19	2.37	2.72	3.03	2.78	2.12
September	0.26	1.93	1.85	2.12	3.48	2.16	2.30	2.46	2.94	2.83	3.82

Source: The People's Bank of China.

VI. The flexibility of the RMB exchange rate increased

From the beginning of the year to June 19, the RMB exchange rate was kept basically stable in order to deal with the global financial crisis. After furthering the RMB exchange rate reform on June 19, 2010, the RMB exchange rate moved in both directions and appreciated slightly with much stronger flexibility. At end-September, the central parity of the RMB exchange rate against the US dollar was 6.7011 yuan per US dollar, up 1264 basis points or 1.89 percent over that on June 19, 2010, and up 1271 basis points or 1.90 percent over that at end-2009. The central parity of the RMB exchange rate against the euro registered 9.1329 yuan per euro, an appreciation of 7.27 percent from end-2009, and the central parity of the RMB against the Japanese yen stood at 7.9999 yuan per 100 Japanese yen, a depreciation of 7.77 percent from end-2009. From the reform of the RMB in July 2005 to end-September 2010, cumulatively the RMB appreciated 23.51 percent against the US dollar, 9.65 percent against the euro, and depreciated 8.68 percent against the Japanese yen. According to estimates of the Bank for International Settlements (BIS), the nominal effective RMB exchange rate appreciated 14.8 percent and the real effective exchange rate appreciated 22.3 percent from the start of the RMB exchange rate reform to September 2010.

In the first three quarters of the year, the central parity of the RMB against the US dollar peaked at 6.6936 yuan per dollar and bottomed out at 6.8284 yuan per dollar. Among the 118 trading days, the inter-bank foreign exchange market saw an appreciation of the RMB against the dollar on 97 days, flat movement on 6 days, and a depreciation on 78 days. The largest appreciation on a single day was 295 basis points (or 0.43 percent) whereas the largest depreciation on a single day was 247 basis points (or 0.36 percent).

Box 1: Effective exchange rates

Exchange rates usually refer to bilateral exchange rates measuring the relative prices between the currencies of two countries. For example, the bilateral exchange rate of the RMB against the US dollar was 6.7011 yuan per US dollar on September 30, 2010. However, when the relative price of a given currency to several other currencies is measured, the concept of the effective exchange rate should be introduced. The effective exchange rate is an average exchange rate usually weighted by trade shares. It is a very important economic index, which is usually used to measure the comprehensive international competitiveness of the tradable goods of a given country, or as an early warning indicator in the study of a monetary crisis, or as an indicator of the living standards of the people in the country under study relative to those of other countries.

In practice, effective exchange rates in most cases are divided into nominal effective exchange rates and real effective exchange rates. The nominal effective exchange rate is the weighted average of the bilateral nominal exchange rates of the currency vis-à-vis the currencies of the country's major trading partners, and the real effective exchange rate is obtained by excluding inflation. The real effective exchange rate not only takes into account the relative movements of the bilateral exchange rates of the given currency against the currencies of all the country's trading partners, but also eliminates the influence of inflation on the purchasing power of the currency per se, so it can comprehensively reflect the value of the currency abroad and its relative purchasing power. When calculating the effective exchange rates, researchers usually design the methods for the calculation of the weighted average, the scope of the sample currencies, the trade weights, and other relevant parameters according to their specific purposes; therefore, their outcomes may be different.

All the major economies in the world measure their own currency's effective exchange rates. For example, for a long time the U.S. Federal Reserve released its measure of the nominal and real effective exchange rates of the US dollar. There are three indices for the nominal and real exchange rates respectively based on different currency baskets, such as the Broad Index that includes the currencies of all the trading partners, the Major Currencies Index which includes only the major currencies in the basket, and the Other Important Trading Partners Index. The indices, which are widely referred to globally, are intended to reflect the competitiveness of the US dollar to different groups of trading partners.. In another example, the market presumes that the Monetary Authority of Singapore selects about 19 currencies and puts them in the basket for the calculation of the effective exchange rates based on the importance of trade and the competitive economic relationship with the currency issuing countries, and the nominal effective exchange rate is used as an indicator for monetary policy operations. Unlike Singapore, Russia only puts the US dollar and the euro into the basket for the calculation of the effective exchange rates in order to reflect in a simple and straightforward way the relative competitiveness of the ruble vis-à-vis its major trading partners.

Several international organizations use the same basket of currencies for the calculation of the effective exchange rates of several major currencies for the sake of comparing the value changes of the currencies. For example, the International Monetary Fund (IMF) in the International Financial Statistics (IFS) releases as a package the effective exchange rates of its member countries' currencies, but they are updated rather slowly. The more widely used data are from the Bank for International Settlements (BIS), which releases on its official Web site the nominal and real effective exchange rates of 58 currencies (including the euro and the 17 currencies of the euro zone members) as of the end of the previous month on the 15th of every month. The nominal and real effective exchange rates of the RMB, according to the BIS estimation, appreciated in cumulative terms by 34.9 percent and 57.5 percent respectively between 1994 and September 2010. According to the BIS, the RMB is among the top 10 appreciating currencies in real effective terms.

As effective exchange rates are more scientific than bilateral rates in measuring exchange rate levels, they can play a more effective role in the adjustment of imports and exports, the current account balance, and the balance of payments. At present, China's major trading partners are becoming more diversified, with trade with the U.S. only accounting for 13.0 percent of China's total foreign trade in the first three quarters of 2010, and trade with the EU, Japan, and the ASEAN countries accounting for 16.3 percent, 10.0 percent, and 9.8 percent respectively. Apart from the diversified trading partners, the currencies that are used to price trade are also diversifying. Although the US dollar is still the dominant settlement currency, some trade transactions have been priced in the euro, the Japanese yen, and other currencies before conversion into the US dollar. Compared to the bilateral exchange rates, the effective exchange rates represent the real exchange rate levels at which businesses price and settle their transactions; hence they are more relevant as a reference for businesses to make financial and operational decisions.

Part 2 Monetary Policy Conduct

In line with the overall arrangements of the State Council, the PBC continued to implement a moderately loose monetary policy in the third quarter of 2010, with the focus on making the policies better targeted, more flexible, and more effective. Specifically, the PBC strengthened liquidity management in the banking system, raised the benchmark deposit and lending interest rates with appropriate timing, and guided financial institutions to properly manage the aggregate, pace, and structure of credit provisions. It continued to promote reform of financial enterprises, further reform of the RMB exchange rate regime, and improve foreign exchange administration, with a view to promoting steady and healthy economic and financial development.

I. Open market operations were conducted with appropriate timing and with proper intensity

Closely monitoring and analyzing global, economic, and financial developments at home and abroad as well as liquidity movements in the banking system, the PBC conducted open market operations in a flexible manner during the third quarter of 2010 in accordance with the overall requirements of macroeconomic management and intensified liquidity management in the banking system, which helped maintain liquidity in the banking system at a reasonably adequate level. First, the PBC properly managed the size and pace of open market operations. Based on analysis and monitoring of liquidity supply and demand in the banking system and the market environment, the PBC conducted open market operations in a flexible manner, which balanced supply and demand of liquidity and kept adequate liquidity in the banking system. In the third quarter, the PBC issued RMB 1.2 trillion of central bank bills and conducted RMB 343 billion of repurchase operations. Outstanding central bank bills stood at RMB 4.1 trillion at end-September. Second, the PBC continued to improve the mix of tools employed in open market operations. Based on scientific analysis and forecasts of liquidity demand and supply, the PBC improved the package of sterilization tools according to the requirements for aggregate monetary management. The toolkit was dominated by central bank bills and included short-term repurchase operations as an auxiliary tool. With an improved maturity structure for open market operations, liquidity management has become more forward-looking and effective. Third, the PBC kept the interest rates of open market operations basically stable. In the context of the slowdown in the global economic recovery and uncertain factors in domestic economic development, better coordination between open market operations and other monetary policy instruments and keeping the operating interest rates of products with varying maturities basically stable will help stabilize market expectations. At end-September, the issuing interest rates of 3-month and 1-year central bank bills stood at 1.5704 percent and 2.0929 percent respectively, both at a par with the levels at end-June; the interest rate for 3-year central bank bill operations posted 2.65 percent, down 3 basis points from end-June. Fourth, the PBC duly conducted state treasury cash management operations, depositing state treasury funds as time deposits with commercial banks. With a view to coordinating with fiscal policy, the PBC deposited RMB 100 billion of state treasury funds in commercial banks in 3 separate operations, including RMB 40 billion in 3-month deposits, RMB 30 billion in 6-month deposits, and RMB 30 billion in 9-month deposits.

II. The reserve requirement ratio was raised with the proper timing

In an effort to manage inflation expectations and consolidate achievements in regulating the real-estate market, on October 20, 2010 the PBC raised the RMB deposit rates in financial institutions. Specifically, the benchmark 1-year deposit interest rate was raised by 0.25 percentage points from 2.25 percent to 2.50 percent; the benchmark 1-year lending interest rate was raised by 0.25 percentage points from 5.31 percent to 5.56 percent.

III. Window guidance and credit policy guidance were strengthened

The PBC continued to improve window guidance of financial institutions. It encouraged financial institutions, in accordance with the differentiated credit policy requirements, to properly adjust the credit structure and manage the pace of credit provisions, to beef up support for weak links in the economy and society, employment, energy savings, and environmental protection, the drive to develop the West, strategic new industries, and industrial shifts, to improve rural financial services, to make financial services to earthquake-afflicted regions better targeted and more effective, and to promote reform and innovation in the management system for credits to small- and medium-sized enterprises (SMEs), with a view to effectively solving the financing difficulties of the SMEs. The PBC also made efforts to ensure adequate lending to key projects under construction, strengthened management of lending activities of local government financing platforms, and tightened lending to heavily energy-consuming industries, highly polluting industries, and industries at overcapacity. The PBC also carried out well the policy of differentiated interest rates for mortgage loans to promote healthy and stable development of the real-estate market. Efforts were made to guide financial institutions to enhance their performance evaluation mechanism and the PBC encouraged financial institutions to properly pace credit extensions to avoid sharp lending fluctuations between months and quarters.

Box 2:Make solid efforts in providing financial services to SMEs

Healthy development of SMEs is of great importance to economic restructuring, job creation, and improvements in the people’s well-being. In recent years, in particular after the outbreak of the international financial crisis, the financial sector has attached great importance to the provision of financial services to SMEs. As a move to implement the economic stimulus package announced by the central government to deal with the international financial crisis, the PBC issued the *Opinions on Improving Financial Services to SMEs (PBC Document 193 [2010])* jointly with the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC), requiring financial institutions to strengthen their sense of responsibility and adopt an overall perspective in providing financial services to SMEs and to earnestly adjust their business philosophy. Banking financial institutions are required to regard the provision of financial services to SMEs and the expansion of credit and loans to SMEs as an important strategy in their lending business, making sure that SMEs loans grow faster than all other types of loans and at an accelerated speed compared to that in the previous year. The PBC made efforts to further diversify the financing channels available for SMEs, with a view to supporting their healthy development. A mix of monetary policy instruments were flexibly combined to strengthen the guiding role of credit policies and to promote innovation in financial products in order to improve financial services to SMEs, and this has yielded good results.

At end-September, outstanding loans of financial institutions to SMEs[1] (including bill discounts) rose 20.5 percent year on year to RMB 17.0 trillion; outstanding loans to SMEs accounted for 56.4 percent of the total lending to enterprises and 36.7 percent of all loans combined; new loans to small enterprises constituted 34.0 percent of the new loans to the corporate sector, up 11.7 percentage points from the same period of the last year. At end-September, a total of 13 SMEs had issued 14 short-term financing bills, raising about RMB 600 million; 57 SMEs had issued 11 collective notes, raising about RMB 3.74 billion. In addition, the PBC actively supported financial institutions in conducting pilot programs for the securitization of credit assets of the SMEs.

However, it should be noted that there are still some factors constraining the provision of financial services to SMEs. First, some SMEs do not have a streamlined governance structure, sound financial reporting, or verifiable data, and information about their operations is highly internalized, with a large amount of non-economic information not easily accessible; therefore, banks are more cautious when lending to them. Second, it is more difficult for SMEs to access the capital market than it is to have access to bank loans; therefore, over 98 percent of their financing is indirect, and less than 2 percent is direct. Third, there is a shortage of socialized intermediation services. Institutions providing socialized intermediation services such as guarantees, wealth management, and auditing and training are not well developed, and these institutions prefer to work for big businesses rather than for SMEs, resulting in

[1] Criteria for classifying big, medium-sized, and small enterprises are compiled by the Department of Financial Statistics and Survey of the PBC based on the *Tentative Regulations on Standards for Classifying SMEs (Guo Jing Mao Document No. 143 [2003])*, the *Notice of the National Bureau of Measures on Statistical Classification of Big, Medium-sized, and Small Enterprises (Tentative) (NBS Document No. 17 [2003])*, and the *Classification of Big, Medium-sized, and Small Enterprises of Some Non-industrial Enterprises (Tentative) (Guo Zi Ting Ping Jia Document No. 327 [2003]).*

inadequate services for SMEs. Fourth, the credit information system for SMEs needs to be improved. The credit information collection system in China began rather late, and credit information collected by this system is mainly on those SMEs borrowing money from banks. It is difficult at present to provide comprehensive information on SMEs that have not borrowed from banks.

Going forward, the PBC will work with other relevant authorities to make solid efforts to improve financial services to SMEs in line with the overall arrangements of the State Council to promote the healthy and steady development of SMEs. First, the PBC will use a mix of monetary policy instruments to keep reasonably adequate liquidity in the banking system and will guide the appropriate growth of money and credit in order to create a benign monetary and financial environment for the development of SMEs. Second, the PBC will strengthen credit policy guidance at the macro level to encourage financial institutions to improve their credit structure by boosting lending to SMEs. The PBC will also urge banking financial institutions to better serve SMEs on all fronts by promoting reform and innovation of the SME credit management system, setting up and improving the multi-layer organizational structure of financial institutions providing services to SMEs, diversifying financing channels available for and catering to SMEs, developing a stronger SME credit information system, and using various measures to support SMEs to “go global.” Third, the PBC will continue to build a multi-layer direct financing market that caters to the financing needs of SMEs. More short-term financing bills will be issued at a steady pace to encourage SMEs to receive financing by issuing collective notes according to their characteristics. The PBC will work in coordination with the efforts of other relevant agencies to regulate various property trading markets, conduct pilot programs of regional property trading markets, and provide a service platform for the registration and trading of property rights, equity rights, and creditorship for various SMEs. Fourth, the PBC will improve the credit information service system for SMEs and optimize the financial ecology for SMEs.

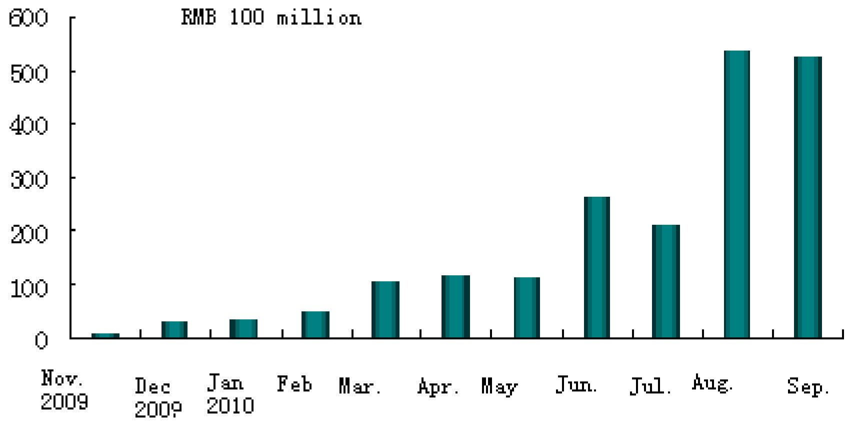
IV. The pilot program for RMB settlement of cross-border trade transactions made steady headway

Since June 2010 when the pilot program was expanded, the volume of cross-border trade transactions using RMB as the settlement currency rose substantially. In the third quarter of 2010, RMB settlement of cross-border trade transactions reached RMB 126.48 billion, expanding 1.6 times quarter on quarter. From the start of the program to end-September 2010, cross-border trade transactions settled in RMB posted RMB 197.08 billion, including RMB 17.73 billion in goods exports, RMB 157.09 billion in goods imports, and RMB 22.26 billion in services trade and other items under the current account. Agent banks in the mainland opened 493 inter-bank RMB transfer accounts for participating overseas banks, with a total balance of RMB

19.14 billion.

In the third quarter, 107 cross-border trade transactions of RMB settlement were completed on a case-by-case and trial basis, totaling RMB 27.4 billion. At end-September, the pilot regions had conducted a total of 166 cross-border trade transactions of RMB settlement, worth RMB 30.5 billion. Among this total, overseas projects using RMB were granted about RMB 22.4 billion in loans.

In October, in order to implement the arrangements made at the meeting of the CPC Central Committee in the Xinjiang Autonomous Region, Xinjiang launched a pilot program for RMB settlement of cross-border trade transactions and investment activities, becoming the first province to launch a pilot program for direct cross-border RMB investments.



Source: The People's Bank of China.

Figure 1 Value of RMB settlements for cross-border trade transactions by month

In August 2010, the PBC announced two supporting policies for the pilot program on RMB settlements of cross-border trade transactions. The first is the *Notice on Issues Related to the Pilot Program on Allowing Overseas RMB Settlement Banks and Two Other Types of Institutions to Use RMB to Invest in the Inter-bank Bond Market*, allowing overseas central banks or monetary authorities, Hong Kong and Macao RMB clearing banks, and overseas participating banks to use legally obtained RMB funds to invest in the inter-bank bond market. The second is the *Administrative Measures on RMB Bank Settlement Accounts of Overseas Institutions*, which specifies that overseas institutions can apply to open RMB bank settlement accounts with banks within the territory of the People's Republic of China for carrying out various cross-border RMB businesses.

V. The reform of financial institutions continued

Reform of the large commercial banks and policy financial institutions saw further progress. The five publicly listed large commercial banks, namely the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), the China Construction Bank (CCB), and the Bank of Communications further improved their corporate governance structure and corporate core competitiveness. At the end of the third quarter, the capital adequacy ratio of these five banks stood at 11.57 percent, 11.38 percent, 11.73 percent, 11.64 percent, and 12.53 percent respectively; their non-performing loan (NPL) ratios posted 1.15 percent, 2.08 percent, 1.10 percent, 1.14 percent, and 1.22 percent respectively, whereas their before-tax profits registered RMB 166.3 billion, RMB 89.2 billion, RMB 107.4 billion, RMB 143.8 billion, and RMB 37.9 billion respectively. The ABC continued to explore ways to combine its agro-linked businesses with commercial operations. It continued a multi-divisional structural overhaul program and built a division dedicated to rural finance, which was launched on a trial basis in eight provinces (autonomous regions), including Sichuan, Chongqing, Hubei, Guangxi, Gansu, Jilin, Fujian, and Shandong. The purpose of the program is to set up institutional mechanisms and operational patterns that are different from those in the urban areas, to bring the decision-making core closer to the rural borrowers, to provide incentives to county-level sub-branches to provide for agro-linked businesses, and to provide a strong institutional mechanism as a guarantee for the development of agro-linked businesses and businesses at the county level. The China Development Bank proceeded with its market-oriented reform to better support the major national medium- and long-term economic development strategies. On August 25, 2010, China Development Bank Securities was incorporated in Beijing, and its organizational structure has since been continuously improved. At the same time, reforms tailored to policy financial institutions were advanced. The PBC continued to study and improve the reform plan for the Export and Import Bank of China. Moreover, the PBC pushed ahead with the listing of China Everbright Bank, whose stocks began trading on the Shanghai Stock Exchange on August, 18, 2010.

Meanwhile, major achievements were made in the reform of the rural credit cooperatives (RCCs). The liquidity-provision policy went well. At end-September, a total of RMB 169.9 billion of targeted central bank notes was issued to RCCs in 2,408 counties (county-level cities), and the PBC redeemed RMB 165 billion of targeted central bank notes to RCCs in 2,366 counties (county-level cities), accounting for over 97 percent of the total amount issued. At the same time, a total of RMB 1.9 billion of designated loans was issued to RCCs within the jurisdiction of Xinjiang and a number of other provinces (autonomous regions). As such, financial support was basically delivered, helping to solve the historical burdens on the RCCs and to promote the reform of the RCCs. The asset quality of the RCCs also improved notably. Based on the four-category loan classification, at end-September the outstanding NPLs of RCCs stood at RMB 349.3 billion, accounting for 6.1 percent of their total lending, about 1.3 percentage points less than that recorded at end-2009. According to the five-category loan classification system, at end-September the capital adequacy ratio of the RCCs reached 7.2 percent, up 1.2 percentage points from end-2009. The RCCs granted more loans to support the agro-linked sectors. At end-September, outstanding loans of RCCs reached RMB 5.7 trillion, accounting for 12.3 percent of the total lending by financial institutions, up 0.6 percentage points from end-2009. Outstanding agro-linked loans and loans to rural households stood at RMB 3.8 trillion and RMB 2.0 trillion respectively, an increase of RMB 735.3 billion and RMB 396.2 billion from end-2009. Furthermore, reform of the RCCs' property system made progress. As of end-September, a total of 2,014 RCCs, 64 rural commercial banks, and 212 rural cooperative banks had been established, all with legal person status at the county (city) level.

VI. Reform of the foreign exchange administration system was deepened

In the third quarter of 2010, the foreign exchange administration authority continued to deepen the foreign exchange administration system in line with the overall arrangements of the State Council and the scientific outlook on development in order to promote steady and rapid economic development. First, reform of the foreign exchange receipt system from exports was deepened. On October 1, 2010, the pilot program on overseas deposits of foreign exchange-denominated export proceeds was inaugurated in Beijing, Shandong, and two other provinces (municipalities), allowing domestic enterprises to open accounts with overseas banks to deposit export proceeds from real and legal trade transactions in order to improve the efficiency of capital utilization. Second, the management of guarantees to external institutions was improved. On July 28, 2010, the *Circular of the State Administration of Foreign Exchange (SAFE) on Issues Related to Overseas Guarantees Provided by Domestic Institutions* was issued in order to satisfy the financing needs of domestic institutions that wish to "go global." Third, direct overseas investments by domestic banks were streamlined. On June 30, 2010, the *Circular of the SAFE on Relevant Issues Concerning Foreign Exchange Management of Overseas Direct Investments by Domestic Banks* was promulgated, regulating issues related to outbound direct investments, such as foreign exchange registration, purchases and sales of foreign exchange, and equity transfers, and it took effect on September 1, 2010.

Part 3 Financial Market Analysis

In the third quarter of 2010 China's financial market continued to perform in a stable and sound way. The money market traded briskly and interest rates fluctuated up after a depressed period. Indices on the bond market were mainly stable and went up slightly and bond issuances grew steadily. Stock indices went up slightly amidst fluctuations, whereas financing on the stock markets rose substantially. In the first three quarters of 2010, aggregate financing by the domestic non-financial sector (including the household, corporate, and public sectors) stood at RMB 8.6 trillion, down 23.3 percent year on year. Broken down by financing instruments, loans still dominated the financing structure but their share of total financing declined. The share of financing via the stock markets rose notably, enterprise bond financing continued to increase, and treasury bond financing maintained its momentum. Direct financing played a more important role in allocating funds and the financing structure improved notably.

Table 4: Financing by domestic non-financial sectors in the first three quarters of 2010

	Volume of financing (RMB 100 million)		As a percentage of total financing (%)	
	First Three Quarters of 2010	First Three Quarters of 2009	First Three Quarters of 2010	First Three Quarters of 2009
Financing by domestic non-financial sectors	85865	111930	100.0	100.0
Bank loans(1)	65444	93458	76.2	83.5
Equities(2)	4142	2513	4.8	2.2
Government securities (3)	7288	7218	8.5	6.4
Enterprise bonds(4)	8991	8741	10.5	7.8

Notes: 1. Bank loans in this table include domestic currency and foreign currency loans.

2. Equity financing in this table includes convertible bond financing and excludes additional share offerings tailored for designated investors and financing by financial institutions on the stock markets.

3. The financing volume of government securities includes municipal bonds issued by the Ministry of Finance on behalf of local governments.

4. Enterprise bonds include enterprise bonds, corporate bonds, bonds with detachable warrants, collective bills, short-term financing bills, and medium-term notes.

Source: The People's Bank of China.

I. Financial market analysis

1. The money market traded briskly and interest rates moved up after a depressed period

Repo transactions on the money market increased steadily while inter-bank borrowing rose remarkably. In the first three quarters of 2010, the turnover of bond repos on the inter-bank market totaled RMB 65.0 trillion, with an average daily turnover of RMB 345.8 billion, up 22.4 percent year on year. The turnover of inter-bank borrowing reached RMB 20.3 trillion, with an average daily turnover of RMB 107.7 billion, an increase of 48.4 percent year on year. In terms of the term structure, the maturity of transactions showed an obvious shortening tendency, and overnight repo products and overnight inter-bank borrowing transactions accounted for 80.0 percent and 87.7 percent of total turnovers respectively, up 3.0 and 4.9 percentage points from the same period of the last year. The total turnover of government securities repos on the stock exchanges soared to RMB 4.5 trillion, with the daily average turnover increasing by 82.6 percent year on year.

The financing structure on the money market showed the following characteristics. First, net lending of state-owned commercial banks on the inter-bank market increased rapidly. As the impact of the global financial crisis on China's financial markets gradually waned, credit-based inter-bank lending became more and more active. In the first three quarters of 2010, net lending of state-owned commercial banks increased 35.4 percent year on year. Second, other commercial banks became net borrowers in the first three quarters of 2010, after being net lenders during the same period of the last year. Due to strengthened balance sheet management and rapid and continuous asset expansion, net borrowing of other commercial banks registered RMB 7.8 trillion, RMB 8.0 trillion more than during the same period of the last year. Third, funding demand by non-banking financial institutions declined markedly. Due to heightened fluctuations on the domestic stock market and uncertainties about a number of factors, non-banking financial institutions traded more cautiously, and their funding demand declined substantially from the previous year. Net borrowing of securities and fund management companies and insurance companies saw a year-on-year decline of 23.4 percent and 67.5 percent respectively in the first three quarters of 2010. The declining funding demand of insurance companies to a large extent was related to their rapid increase in premium income.

Table 5: Fund flows among financial institutions in the first three quarters of 2010

Unit: RMB 100 million

	Repo	Inter-bank borrowing

	First three quarters of 2010	First three quarters of 2009	First three quarters of 2010	First three quarters of 2009
State-owned commercial banks	-182021	-206565	-22842	-16876
Other commercial banks	70866	-7351	6791	5274
Other financial institutions (1)	84319	189689	13313	5790
Of which：Securities and fund management companies	57981	77137	2274	1475
Insurance companies	10414	32013	—	—
Foreign-funded financial institutions	26835	24226	2738	5812

Note: (1)"Other financial institutions" in this table include policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, fund management companies, and so forth. (2) A negative sign indicates net lending; a positive sign indicates net borrowing.

Source: The People's Bank of China.

After a depressed period, interest on the money market moved up. Since the beginning of 2010, due to a number of factors, such as the increase in IPOs, additional fund-raising of large commercial banks, strengthened regulation, and heightened inflation expectations, interest rates on the money market generally rose from the same period of the last year along with increased volatility. After the monthly weighted average interest rate of bond-pledged repo and inter-bank borrowing rose to 2.38 percent and 2.31 percent respectively in June, both rates declined somewhat in July and August. In September, due to large deposit withdrawals before the Mid-Autumn Festival and the National Day holiday, as well as the quarter-end evaluation of regulatory indicators, the monthly weighted average interest rate of bond-pledged repo and inter-bank borrowing rose from that in July and August to 1.98 percent and 1.90 percent respectively, down 40 and 41 basis points from June and up 72 and 65 basis points from end-2009. In the third quarter of 2010, the Shibor of all maturities moved up, and the Shibor with maturities of less than 3 months showed relatively larger fluctuations.

Trading of RMB interest rate swaps grew rapidly quarter by quarter, while the turnover on the forward interest rate market declined somewhat. In the first three quarters of 2010, the turnover of RMB interest rate swaps increased month by month and a total of 6,984 transactions in RMB interest rate swaps conducted, with an aggregate nominal principal of RMB 798.15 billion, up 146 percent year on year. In particular, trading of RMB interest rate swaps with a maturity of less than 1 year were the most buoyant, with an aggregate nominal principal of RMB 414.65 billion, accounting for 52.0 percent of the total turnover. In terms of the reference interest rates, the reference interest rates of RMB interest rate swaps included 7-day fixing repo rates, the Shibor and 1-year time deposit interest rates, and their related nominal principal, accounting for 65.8 percent, 29.7 percent, and 4.5 percent of the total In the first three quarters of 2010, there were 731 bond forward transactions with a total turnover of RMB 255.17 billion, down 46.6 percent year on year. In terms of underlying bonds, policy financial bonds dominated bond forward transactions, accounting for 55.8 percent of the total. In terms of the maturity structure, transactions of products with a maturity of 2 to 7 days accounted for the lion's share at 73.7 percent. Interest rate forward products traded sluggishly and there were only 10 transactions conducted in the first three quarters of 2010, with an aggregate nominal principal of RMB 1.95 billion. All interest rate forward agreements were based on the 3-month Shibor.

Table 6: Transactions of interest rate derivatives

	Bond forwards		Interest rate swaps		Forward rate agreements	
	Transactions	Volume[2] (RMB 100 million)	Transactions	Volume of nominal principal (RMB 100 million)	Transactions	Volume of nominal principal （RMB 100 million）
2006	398	664.5	103	355.7	—	—
2007	1238	2518.1	1978	2186.9	14	10.5
2008	1327	5005.5	4040	4121.5	137	113.6
2009	1599	6556.4	4044	4616.4	27	60.0
Q1 2010	552	1951.4	1872	2098.1	0	0.0
Q2 2010	92	404.2	2390	2758.2	2	5.0
Q3 2010	87	196.2	2722	3125.3	8	14.5

Source: China Foreign Exchange Trade System.

2. Indices on the bond market went up slightly and bond issuances grew steadily

Spot trading on the inter-bank bond market was stable. In the first three quarters of 2010, the turnover of spot bond trading on the inter-bank bond market totaled RMB 44.7 trillion, with a daily average turnover of RMB 237.8 billion, up 23.1 percent year on year. Net bond sales of other commercial banks on the inter-bank spot market posted RMB 911.4 billion, while bond purchases by state-owned commercial banks, foreign-funded financial institutions, and other financial institutions posted RMB 829.1 billion, RMB 50.7 billion, and RMB 31.6 billion respectively. The turnover of spot government securities trading on the exchanges posted RMB 132 billion, down RMB 37.4 billion from the same period of the last year.

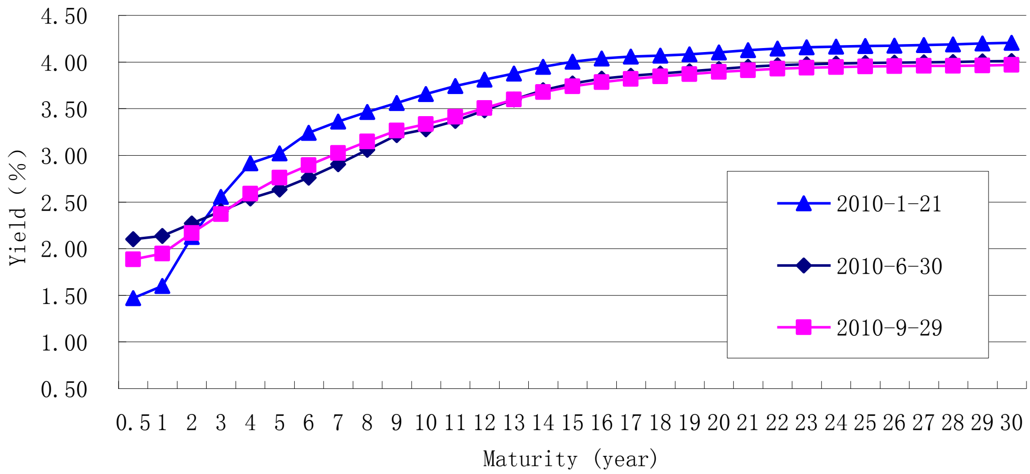
The bond indices on both the inter-bank bond market and the stock exchanges rose slightly. In the first three quarters of 2010, the index of total returns on the inter-bank bond market rose 4.3 percent, from 130.2 points at the beginning of 2010 to 135.8

[2] Since 2009 the statistics on transactions of bond forwards have been changed to the settlement accounts of the transaction.

points at end-September. The index of government securities on the stock exchanges rose 3.6 percent, from 122.3 points at the beginning of 2010 to 126.7 points at end-September.

The yield curve of government securities flattened. Taking the yield curves of government securities on the inter-bank market on January 21 and September 29 as examples, the yields of six-month and 1-year government securities increased by 41 basis points and 34 basis points respectively, whereas the yields of 5-year, 10-year, and 30-year government securities declined by 26 basis points, 32 basis points, and 24 basis points respectively.

Figure 2. Yield curve of government securities on the inter-bank market in the first three quarters of 2010



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

Bond issuances grew steadily. In the first three quarters of 2010, a total of RMB 3.9 trillion of bonds (excluding central bank bills) was issued on the primary bond market, up 6.9 percent year on year. In particular, bonds issued by policy banks and short-term financing bills grew significantly, by 26.3 percent and 81.6 percent respectively. At end-September, outstanding bonds deposited with the China Government Securities Depository Trust and Clearing Co. Ltd. totaled RMB 20.0 trillion, up 21.4 percent year on year, among which there were RMB 18.8 trillion of bonds deposited with the inter-bank bond market and RMB 275.4 billion of bonds deposited with the stock exchanges.

Table 7: Issuance of bonds in the first three quarters of 2010

Type of bonds	Total volume (RMB 100 million)	Year-on-year growth (%)
Government securities (1)	14907	3.9

Of which: Municipal bonds	1693	-15.4
Financial bonds and policy financial bonds issued by the China Development Bank	9064	26.3
Bank subordinated bonds and hybrid capital bonds	796	-67.2
Bank ordinary bonds	10	-80.0
Enterprise bonds (2)	12801	7.2
Of which: short-term financing bills	5628	81.6
medium-term notes	4273	-25.7
corporate bonds	349	-3.3
Government-backed institutional securities	1090	—

Note: (1) Including municipal bonds. (2) Including enterprise bonds, corporate bonds, SMEs' collective bills, short-term financing bills, and medium-term notes.

Source: The People's Bank of China.

Bond issuance rates showed an upward trend amidst fluctuations, whereas bond issuance rates of medium- and long-term bonds declined somewhat. Affected by the general increase in interest rates on the money market since the beginning of 2010 and the heightened inflation expectations, the issuance rates of short-term bonds edged up amid fluctuations. Taking 1-year government securities as an example, the fixed interest rate of 1-year book-entry government securities issued in September 2010 was 1.87 percent, 43 and 38 basis points higher than that of the same products issued in March and April respectively. Due to the abundant market liquidity and the high demand for bonds by financial institutions, the issuance rates of medium- and long-term bonds declined somewhat. For example, the fixed interest rate of 30-year government securities issued in August 2010 was 3.96 percent, 12 and 7 basis points lower than that for the same products issued in February 2010 and June 2010 respectively.

The Shibor played a greater role in bond pricing. In the first three quarters of 2010, 18 floating-rate bonds based on the Shibor were issued on the inter-bank bond market, with a total issuance volume of RMB 21.4 billion. In addition, 113 fixed-rate enterprise bonds were issued based on the Shibor, with a total issuance volume of RMB 251.9 billion; 120 short-term financing bills were issued based on the Shibor, with a total issuance volume of RMB 205.1 billion, accounting for 36 percent of the total volume of short-term financing bills.

3. Bill financing declined slightly and bill market interest rates moved up amid fluctuations

In the first three quarters of 2010, commercial drafts issued by enterprises totaled RMB .8.6 trillion, an increase of 10.3 percent year on year. Cumulative discounted bills amounted to RMB 18.1 trillion, at par with that in the same period of the last year. Cumulative rediscounted bills totaled RMB 97.9 billion, RMB 88.5 billion more than that in the same period of the last year. At end-September, the total value of outstanding commercial drafts increased 16.3 percent to RMB 5.0 trillion; outstanding discounted bills registered RMB 1.6 trillion, down 43.9 percent year on year; and outstanding rediscounted bills registered RMB 56.1 billion, RMB 48.3 billion more than that in the same period of the last year.

In the third quarter of 2010, transactions on the bills market were generally buoyant. However, as financial institutions adjusted the mix of credit assets by reducing bill financing to increase loan extensions, bill financing continued its decline since the beginning of 2010. At end-September 2010, outstanding bill financing declined by RMB 157.4 billion from end-June 2010, accounting for 3.4 percent of all sorts of loans, a decrease of 3.8 percentage points year on year. Affected by a number of factors, such as the interest rates on the money market as well as the demand and supply situations on the bill market, bill market interest rates fluctuated within a narrower range, with the overall rates slightly higher than those in the previous quarter.

4. Stock indices went up while the volume of financing on the stock markets surged

Turnover on the stock markets declined slightly. In the first three quarters of 2010, the turnover on the Shanghai and Shenzhen Stock Exchanges totaled RMB 35.1 trillion, RMB 3.7 trillion less than during the same period of the last year, and the daily turnover declined 8.0 percent year on year to RMB 193.7 billion. At end-September 2010, market capitalization had increased 0.8 percent from end-2009 to RMB 15.2 trillion.

The stock indices went up. After much volatility during the first quarter, the stock indices showed a rapidly downward movement in the second quarter and began to move up in the third quarter. At end-September, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index dropped 19.0 percent and 2.7 percent respectively from end-2009 to close at 2656 points and 1169 points, but rose 10.7 percent and 23.7 percent respectively from end-June 2010. The average P/E ratios on the A-share markets in Shanghai and Shenzhen posted 20 times and 40 times, lower than the 29 times and 47 times at end-2009, and higher than the 19 times and 32 times at end-June 2010.

Funds raised from the stock market increased remarkably. In the first three quarters of 2010, a total of RMB 765.1 billion was raised by non-financial enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, secondary offerings, rights issuances, stock vesting, and convertible bond issuances, a surge of RMB 498.6 billion or up 1.9 times from that during the same period of the last year. Among this total, RMB 583.5 billion was raised on the A-share markets, up 1.7 times from that during the same period of the last year. In particular, RMB 232.8 billion was raised in the third quarter of 2010, an acceleration of RMB 51.4 billion and RMB 63.5 billion from that during the first and second respectively quarters.

5. Premium income of the insurance industry continued fairly rapid growth

Premium income in the first three quarters of 2010 amounted to RMB 1.1 trillion, larger than the total income for the entire year of 2009, with annual growth of 32.0 percent. In particular, premium income of the life insurance business grew 31.9 percent to RMB 836.9 billion. Premium income of the property insurance business rose 32.3 percent to RMB 295.5 billion. Total claim and benefit payments declined RMB 8 billion from the same period of the last year to RMB 226.2 billion.

Total assets of the insurance industry continued fairly rapid growth. In terms of the asset structure, growth of investment-type assets increased, while growth of bank deposits declined. At end-September 2010, the total assets of the insurance industry were RMB 4.8 trillion, an increase of 26.7 percent year on year. Among this total, investment-type assets grew 29.0 percent year on year, an acceleration of 17.4 percentage points. Bank deposits grew 29.9 percent, a deceleration of 13.0 percentage points.

Table 8: Use of insurance funds at end-September 2010

	Outstanding balance (RMB 100 million)		As a share of total assets (%)	
	End-September 2010	End-September 2009	End-September 2010	End-September 2009
Total assets	47995	37880	100.0	100.0
Of which: Bank deposits	13070	10058	27.2	26.6
Investments	31253	24232	65.1	64.0

Source: China Insurance Regulatory Commission.

6. The foreign exchange market traded briskly

The foreign exchange spot market developed soundly and the volume of swap and forward transactions increased by a large margin. In the first three quarters of 2010, the turnover of spot RMB foreign exchange swaps increased 12.4 percent year on year. The turnover on the OTC market accounted for 99 percent of the total. The total turnover of RMB foreign exchange swaps registered RMB 950.7 billion and the daily average turnover soared 78.8 percent year on year. Among this total, overnight swap transactions accounted for 59.5 percent, 4.9 percentage points less than that during the same period of the last year. The turnover on the RMB foreign exchange forward market totaled US$ 7.2 billion, and the daily average turnover rose 38.5 percent from the same period of the last year. The turnover of 8 foreign currency pairs in the first three quarters amounted to US$ 44.8 billion, and their daily average turnover increased 61.2 percent year on year. In particular, the USD/HKD and EUR/USD currency pairs accounted for 81.5 percent of the total. Participants on the foreign exchange market increased further. In the third quarter, eleven new members were accepted on the spot market and four financial companies of enterprise groups were permitted to trade on the foreign exchange market.

7. The gold market operated soundly

In the first three quarters of 2010, a total of 4613.4 tons of gold was traded on the Shanghai Gold Exchange, and the total turnover posted RMB 1.2 trillion. In the third quarter in particular, a total of 1438.9 tons of gold was traded, representing year-on-year growth of 25.1 percent and the total turnover increased 58 percent year on year to RMB 384.78 billion. The trading volume of silver surged 173.9 percent over the same period of the last year to 13,000 tons and its turnover soared 234.3 percent year on year to RMB 55.07 billion. The trading volume of platinum declined 18.8 percent year on year to 12.6 tons and its turnover rose 0.9 percent year on year to RMB 4.42 billion.

In the first three quarters of 2010, the price of gold showed an upward trend. The movement in the price of gold on the domestic market was basically consistent with that on international gold markets and reached a record high. At end-September, the price of gold reached a peak of US$ 1307.5 on the international market and RMB 282.4 per gram on the domestic market.

II. Institutional building of the financial market

1. Parallel with the cross-border pilot RMB trade settlement program, efforts were made to strengthen institutional building on the inter-bank market

To support the cross-border RMB trade settlement pilot program and to broaden the channels for overseas RMB funds to return to China, on August 16 the PBC released a notice on a pilot scheme for three types of eligible institutions outside Mainland China, including the RMB clearing bank, to invest their RMB funds in the Mainland's inter-bank bond market. Under the pilot scheme, RMB clearing banks in Hong Kong and Macao, participating banks outside the Mainland, and foreign and central banks and monetary authorities can apply to invest in the Mainland's inter-bank bond market. Upon approval by the PBC, the eligible institutions outside the Mainland can, within a specified quota, use RMB funds resulting from central bank monetary cooperation, cross-border trade, and RMB investments to invest in the Mainland's inter-bank bond market. Furthermore, the notice also put forward some specific requirements regarding operation modes, related trading, market supervision, and so forth to prevent risks and to promote stable market operations. The entry of relevant overseas institutions on the inter-bank bond market has opened a channel for legitimate overseas RMB funds to preserve their value, and it is a necessary arrangement to support the cross-border RMB trade settlement scheme.

2. Strengthening institutional building of the gold market

On July 26, 2010, the PBC, jointly with the National Development and Reform Commission, the Ministry of Industry and Information Technology, the Ministry of

Finance, the State Administration of Taxation, and the China Securities Regulatory Commission released *Several Opinions on Promoting Gold Market Development*, highlighting the roadmaps and main tasks to be completed in gold market development. The *Opinions* emphasized that the significance of promoting the healthy development of the gold market should be taken fully into account and the role of the gold market should be defined. The *Opinions* urged the Shanghai Gold Exchange, the Shanghai Futures Exchange, and commercial banks to do their jobs in their respective areas. Efforts should be made to enrich transaction modes and improve the standard accreditation system, the warehousing and transportation system, the clearing services system, and so forth. Continued efforts should be made to improve relevant policies for the gold market. In terms of tax policy, the Shanghai Gold Market and the Shanghai Futures Market will continue to apply the current tax regulations, while research will be conducted on improving tax regulations on investment-type gold businesses and commercial bank gold businesses. Efforts should be made to broaden the channels of gold supply and to continue to improve the foreign exchange policy and financing policy regarding the gold market. A number of measures should be taken to strengthen investor education and rigorously crack down on illegal underground gold trading activities so as to protect the legitimate rights and interests of investors.

3 Strengthening institutional building of the securities market

Efforts were made to strengthen supervision of listed securities companies and to standardize information disclosures by companies listed on the GEM board. The China Securities Regulatory Commission (CSRC) required that listed securities companies establish a sound internal declaration system and a firewall system, disclose regulatory ratings in their regular publications, publicly release their monthly operational situations and main financial information, and so forth. In addition, the CSRC also specified the contents and formats for the semi-annual reports of companies listed on the GEM board.

Efforts were made to strengthen anti-money laundering in the securities and futures industry. In September 2010, the CSRC issued the *Administrative Measures on Anti-money Laundering in the Securities and Futures Industry*. The measures stipulate that the CSRC should cooperate with the relevant State Council authorities responsible for anti-money laundering and perform its duties in supervising anti-money laundering activities in the securities and futures industry; the CSRC branch offices should perform their duties in supervising anti-money laundering activities in their respective jurisdictions; and the Securities Association of China and the China Futures Association should perform their self-regulating duties regarding anti-money laundering.

In August 2010, the CSRC publicly solicited opinions on the *Guidelines on Deepening the Reform of the IPO Mechanism (Draft)* and the *Decision on Adjusting the Administrative Measures on Securities Issuances and Underwriting (Draft)*. The main content of the two documents include further improving the quotation and application for new shares and improving the constraint mechanism for price quotations, subscriptions, and allotments; broadening the scope of book-building participants and expanding off-line institutional investors; enhancing the transparency of pricing information and the claw-back and suspension mechanism. On October 11 2010, the CSRC released the *Guidelines on Furthering the IPO Mechanism Reform* and the *Decision on Adjusting the Administrative Measures on Securities Issuance and Underwriting*.

4. Strengthening basic institutional arrangements on the insurance market

Supervision over insurance funds was strengthened. In order to broaden the investment channel for insurance funds and alleviate allocation pressures of insurance funds, in August 2010 the China Insurance Regulatory Commission (CIRC) issued the *Tentative Measures on the Use of Insurance Funds* and the *Notice on Adjusting the Investment Policies for Insurance Funds*. The two aforementioned documents consolidate the previous regulations on the use of insurance funds and make detailed arrangements and adjustments on the use of insurance funds regarding the investment market, products and percentage requirements, and so forth. In September, the CIRC issued the *Interim Measures for Insurance Capital Investment in the Real Estate Sector* and the *Interim Measures for Equity Investment of Insurance Funds*, specifying the condition, scope, and upper limits for insurance funds to invest in the real estate sector and equities of unlisted companies.

Efforts were made to strengthen internal control of insurance companies. In order to improve the insurance companies' capacity to prevent risks and to manage operations, and to promote compliance and sound and effective operations, in August the CIRC issued the *Basic Rules for Internal Control of Insurance Companies*, requiring that insurance companies establish an internal control system featuring "the board of directors having the final responsibility, the management team exercising direct leadership, the internal control department making overall arrangements, the internal auditing department responsible for checks and supervision, and the relevant business departments having the primary responsibilities."

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

In Q3 2010, although downside risks still existed, the world economy maintained the momentum for recovery. Unemployment conditions in the United States saw no obvious improvement. The extent of growth differed across member countries in the euro area. The Japanese yen appreciation and sluggish domestic demand resulted in tepid economic activities in Japan. The emerging market and developing economies continued to lead the global recovery but with a moderate growth rate. At the same time, the major financial markets fluctuated. The major advanced economies continued to keep their monetary stance accommodative while countries with strong growth and rising inflationary pressures began a gradual tightening of monetary policy.

1. Economic developments in the major economies

Growth slowed in the U.S., but the possibility for a “double dip” diminished. In Q2 2010, the economy grew at an annualized rate of 1.7 percent, a slower pace than the 3.7 percent growth rate posted in the first quarter, reflecting that the economy was falling back from its previous fast rebound. The employment situation saw no improvement. The seasonally adjusted unemployment rates registered 9.5 percent, 9.6 percent, and 9.6 percent in the three Q2 months to September, staying above 9 percent for 17 months in a row, a record-long duration in the recent 30 years. Trade picked up gradually and the trade deficit increased. In Q2 imports and exports gained 6.3 percent and 3.4 percent respectively compared with that in Q1, leading to a US$ 123.3 billion trade deficit, an increase of 12.9 percent from Q1. Due to the recovery and the rising tax income, the U.S. Federal Government’s expenditure for the financial bailout declined notably. In August, the budget deficit stood at US$ 90.53 billion, down by 12.6 percent YOY. Price levels continued to rise but at a slower pace, with the YOY CPI edging up by 1.1 percent, 1.2 percent, 1.1 percent, and 1.1 percent in the four months to September, and the CPI growth in the five months to May all surpassing 2 percent.

Economic recovery in the euro area was better than expected but the momentum might wane. The YOY GDP growth in Q2 was 1.9 percent while the MOM figure was 1 percent, much higher than the 0.3 percent in Q1 and the largest increase in the past four years. Trade continued rebounding, with the surplus registering 2.2 billion and 6.7 billion euro respectively in June and July, still lower than that during the same period of the last year. Employment conditions remained gloomy, reflected in a 10.1 percent unemployment rate for both July and August. Price levels went up slightly with the YOY HICP rising 1.7 percent, 1.6 percent, and 1.8 percent respectively for the three months of Q3. In Q2, Germany's manufacturing industry and exports enjoyed strong growth, which partly offset the weak performance of other member countries and served as a major engine for economic growth in the euro area. In Q2 the MOM economic growth of Germany was 2.2 percent (the annualized figure was 9.1 percent), while the YOY growth was 3.7 percent, the largest since 1990, leading the recovery of the euro area. However, financial consolidation and uneven growth across the euro area might put a drag on its growth.

The Japanese economy recovered slowly, but the continuous appreciation of the Japanese yen and the persistent deflation posed substantial challenges. Supported by better-than-expected capital expenditures and inventory investments, the annualized real GDP after seasonal adjustments stood at 1.5 percent in Q2, higher than the initial projection of 0.4 percent. However, exports were dampened by the shrinking global demand and the currency appreciation. In August, exports dropped by 2.3 percent MOM, but edged up by 15.8 percent YOY, registering a decline for six months and a record low since December 2009. The current account surplus for August was 1.1 trillion yen, down 5.8 percent YOY, and the trade surplus declined for the first time in the past 15 months. The unemployment rate remained high, standing at 5.2 percent, 5.1 percent, and 5.0 percent respectively for the three months of Q3, and further pulling down the consumer confidence index. In the three months of Q3, the CPI decreased by 1.1 percent, 0.9 percent, and 0.6 percent respectively, continuing its downward movement for 19 successive months and showing that deflation was still lingering. Amid the stalled global growth and the large appreciation of the Japanese yen, it will be a challenge for Japan to boost its recovery in the future by expanding exports.

The economies of the emerging market and developing countries expanded faster than that of the advanced economies. In order to realize stable growth, some emerging economies initiated a tightening of their policy stance. Some emerging economies including the BRIC countries experienced a strong rebound, becoming the driving power for global economic growth. In Q2, the GDP of India, Brazil, and Russia increased YOY by 8.8 percent, 8.8 percent, and 5.2 percent respectively. The growth rates of these three countries during the period all reached new historical highs since 2008. Due to the robust domestic demand and the strengthening of commodity prices, the major developing economies in Latin America, ASEAN, and Africa witnessed a more vigorous recovery than the advanced economies. But the speed of their recovery might be moderated because, on the one hand, some emerging market economies started to tighten their policy stances since Q3 to prevent the economy from overheating, and on the other hand, global demand was falling. Meanwhile, against the backdrop of excessive global liquidity and the disappointing performance of the advanced economies, capital for arbitrage purposes swarmed into those emerging market economies with better economic outlooks and larger interest rate spreads, putting upward pressures on their asset prices, such as stocks and real estate, as well as their currencies.

2. Global financial market development

The exchange rates of the major currencies saw large fluctuations. Although weak economic indices published by the U.S. in Q3 caused market concern, the broadly positive recovery momentum in the advanced economies and the easing of the European sovereign debt crisis eventually reduced risk aversion in the market. At the same time, the specter of a cheap dollar flooding global markets due to the quantitative easing also lent support to the major currencies to appreciate against the US dollar. At the end of September, the exchange rates of the euro and the yen against the US dollar closed at 1.3623 dollar per euro and 83.76 yen per dollar, up by 11.8 percent and 5.8 percent respectively compared with end-June. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, depreciated cumulatively by 4.8 percent in Q3.

International money market rates fluctuated within an enlarged range. Due to slow U.S. growth and stronger expectations that the U.S. would roll out further quantitative-easing measures, the US dollar Libor slid back after reaching a year high on May 25, 2010. On September 30, the 1-year US dollar Libor registered 0.78 percent, down 0.39 percentage points compared with end-June. The Euribor fluctuated upward due to the influence of the European sovereign debt crisis. On September 30, the 1-year Euribor posted 1.433 percent, up 0.127 percentage points compared with end-June.

The yields of government securities of the major countries fluctuated downward. In July and August, the yields of government securities of the major economies drifted lower. Starting from September, declining market concerns about a global double dip, technical adjustments of treasury securities after an earlier rally, the redeployment of assets by investors, and the flow of capital from the bond market to the stock market spurred a temporary rebound of the government securities yields of the major economies. On September 30, the yield of 10-year treasury bonds of the United States, euro area, and Japan closed at 2.51 percent, 2.26 percent, and 0.94 percent, down 0.43, 0.31, and 0.15 percentage points respectively compared with end-June, or down 1.28, 1.12, and 0.35 percentage points from the end of the last year.

The major stock markets went up amid fluctuations. In Q3, the share markets of the major advanced economies witnessed ups and downs due to the complicated and changing global economic developments. In July, in response to the easing of the European sovereign crisis, the publication of the U.S. Financial Regulatory Reform Bill, and the results of the stress test of the European banks,[3] stock markets in Europe and the U.S. rallied. However, weak economic data released by Europe and the U.S. in August made the major stock markets fluctuate downward. Starting from September, market expectations that the U.S. Fed would launch a fresh round of quantitative-easing added to investors' worries about a global double-dip, which spurred a strong rebound of the share markets in the U.S. and Europe. At end-September, the Dow Jones Industrial Average, the NASDAQ, and the STOXX50 closed at 10788, 2369, and 2482, up by 10.4 percent, 12.3 percent, and 5.2 percent respectively compared with end-June. Due to the sharp appreciation of the Japanese yen and the continuous deflation, the Nikkei 225 slid to 9369, down 0.1 percent compared to that at end-June.

3. Housing market development in the major economies

Recovery of the U.S. housing market was sluggish. Factors such as the expiration of the homebuyer's tax credit caused the sales of existing homes to go down by 27.2 percent, the largest fall since 1968. In August, seasonally adjusted new home sales stood at 288,000, the same as the previous month but down by 28.9 percent compared with the same period of the last year. The NAHB Housing Market Index in September still remained at a historical low since March 2009.

The European housing market remained sluggish. In response to fiscal consolidation by the government and the increase in housing supply, the British housing market cooled after a year's rebound. In September, the Halifax Housing Index plummeted by 3.6 percent, the biggest monthly fall since the launch of the index. Housing prices remained stable in Germany, whereas the drop in housing prices in the other euro area countries such as France, Italy, and Spain was somewhat arrested.

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[3] On July 23, the results of the stress test showed that among the 91 participating European banks, only 7 failed the health check, indicating that the European banking system was generally in good shape.

Housing prices receded further in Japan. Stimulated by the government subsidies and tax reductions for energy-conserving homes, starts of new homes increased by 20.5 percent YOY in August, the third consecutive monthly increase and the biggest gain in the three months. In contrast, housing prices continued to slide. By July 1, land prices had dropped by an average of 3.7 percent for the year, among which the price of residential land declined by 3.4 percent and that of commercial land declined by 4.6 percent.

4. The monetary policies of the major economies

The central banks of the major economies continued to rely on low interest rates and quantitative-easing to spur economic growth. Since Q3 2010, the U.S. Fed, the ECB, and the Bank of England had kept their policy rates unchanged at 0-0.25 percent, 1 percent, and 0.5 percent respectively, while the Bank of Japan again cut its policy rate to near zero after a lapse of about four years. On October 5, the Bank of Japan announced that it would encourage the uncollateralized overnight call rate to remain at about 0 to 0.1 percent, which could be interpreted as a measure to arrest the further appreciation of the yen and the economic slack. The U.S. Fed stated on many occasions that when necessary it would adopt unconventional measures, such as increasing the purchase of treasury bonds, to further relax its monetary policy so as to support the economic recovery and to bring inflation back to the target level. Recently, the Bank of Japan also decided to expand fixed-rate fund-supplying operations and to set up a new asset purchase program totaling about 5 trillion yen. However, the ECB was relatively cautious in utilizing quantitative-easing.

The central banks of some emerging and advanced economies again raised their policy rates. In order to prevent overheating, inflation pressures, and asset bubbles, the central banks of Brazil, India, Malaysia, Peru, and Korea increased their policy rates. Canada and Sweden became the first advanced economies to raise their interest rates. To cope with large speculative inflows, Brazil lifted the financial transaction tax on foreign investments in fixed income; Korea enhanced its control on capital inflows; and some emerging market economies including India, Thailand, and Malaysia warned that control measures in some form or another would be tried.

Some central banks lowered the benchmark rates. On August 18, the Central Bank of

Iceland decided to cut its benchmark rate by 100 basis points to 7 percent.

Table 9. Monetary Policies of Several Economies since 2010

Central Bank	Current Target Interest Rate	Policy Measures since 2010
U.S. Fed	Target range for federal funds 0-0.25%	On August 10, the U.S. Fed announced that it would reinvest principal payments from agency debts and agency mortgage-backed securities in longer-term treasury securities so as to support the economic recovery.
Bank of England	Official Bank Rate 0.5%	On August 5, the Bank of England decided to maintain the stock of asset purchases under the unconventional quantitative-easing policy at ￡200 billion.
Bank of Japan	Uncollateralized overnight call rate 0-0.1%	On August 30, the Bank of Japan decided to further enhance monetary easing to drive market rates down. Apart from maintaining the outstanding amount of funds provided by the existing three-month term operations at 20 trillion yen, it would start providing additional funds with a six-month term in an amount of approximately 10 trillion yen. On October 5, the Bank of Japan announced that it would encourage the uncollateralized overnight call rate to remain at 0 to 0.1 percent, rather than at the former 0.1 percent, so as to arrest a further yen appreciation and economic slack.
Banco Central do Brasil	Selic target 10.75%	On July 21, the Central Bank of Brazil decided to increase the Selic target by 50 basis points to 10.75 percent.
Reserve Bank of India	Repo rate 6%	On July 2, July 27, and September 16, the Reserve Bank of India increased its repo rate three times by 25 basis points each time to 6 percent.
Bank Negara Malaysia	Overnight Policy Rate 2.75%	On July 8, the Bank Negara Malaysia decided to raise the overnight Policy Rate by 25 basis points to 2.75 percent.
Bank of Korea	7-day Repo Rate 2.25%	On July 9, the Bank of Korea raised the base rate by 25 basis points to 2.25 percent. It was the first rate increase since the outbreak of the financial crisis.
Bank of Thailand	1-day repo rate 1.75%	On July 14 and August 25, the Bank of Thailand increased the policy interest rate by 0.25 percentage points each time to 1.75 percent.
Sveriges Riksbank	Repo rate 1.0%	On September 2 and October 26, the Riksbank raised the repo rate by 0.25 percentage points each time to 1 percent.
Bank of Canada	Overnight rate 1%	On July 20 and September 8, the Bank of Canada raised its target for the overnight rate by 25 basis points each time to 1 percent, becoming the first G7 country to increase the interest rate.
Reserve Bank of New Zealand	Official Cash Rate 3%	On July 29, the Reserve Bank of New Zealand increased the official cash rate by 25 basis points to 3 percent.
Central Bank	Key interest rate 7.0%	On August 18, the Central Bank of Iceland lowered the bank's 7-day

of Iceland		collateralized lending rate by 100 basis points to 7 percent.

Data source: Websites of the relevant central banks.

5. World economic outlook

Looking ahead, the global economic recovery is likely to proceed as broadly expected, although downside risks remain elevated. According to the IMF forecast, global activity will expand by 4.8 percent in 2010, an upward adjustment of 0.2 percent from the July 2010 update. Growth in the United States, euro area, Japan, and the emerging market and developing economies is expected to grow at 2.6 percent, 1.7 percent, 2.8 percent, and 7.1 percent respectively, up by 5.2 percentage points, 5.8 percentage points, 8.0 percentage points, and 4.6 percentage points from their real growth rates in 2009. Global inflationary pressures are projected to stay generally low, but conditions might be different in the advanced and developing economies. It is expected that in 2010 price levels will increase by 6.2 percent in the developing economies and by 1.4 percent in the advanced economies, and in 2011 they will slow to 5.1 percent in the developing economies and 1.3 percent in the advanced economies . It should be pointed out that increased demand in the emerging market economies cannot offset the gap caused by shrinking demand in the advanced economies. Global growth is unlikely to bounce back to the pre-crisis level in the near future. Furthermore, problems such as the public debt, fragile banking system, high unemployment rate, recurrence of trade protectionism in the major advanced economies, and rising inflationary pressures and the inflow of capital faced by the emerging market economies might hamper global growth. The macroeconomic policies of the various countries should be coordinated to facilitate structural reform and a firm recovery.

Box 3: Developments in global financial reform

The global financial crisis exposed a number of defects and flaws in the financial sector. First, financial institutions were weak. The global financial system entered the crisis with an insufficient level of capital and provision coverage and a lack of information disclosure. In addition, the business of shadow banks was beyond the reach of supervision. Second, current macroeconomic policy could not fully prevent systemic financial risks. The lack of macro-prudential tools made it difficult to adopt a counter-cyclical macroeconomic policy to counter the pro-cyclicality of the economy. Meanwhile, when institutions with systemic importance encountered trouble, there were few methods to prevent the shocks from spilling over into the real economy or to keep the market stable. Third, the financial infrastructure needed improvement. Effective supervision over the financial market and information disclosure needed to be enhanced whereas counterparty risks needed to be reduced.

In 2010, at the request of the G20 Leaders Summit, the FSB and the relevant international standard-setters proposed important financial reform initiatives, including the “Basel III” (raising the quality of capital, introducing harmonized standards, strengthening transparency, and setting up minimum global liquidity standards) and policy suggestions for reducing the moral hazard posed by financial institutions with systemic importance. The major countries achieved substantial progress in this regard. In July 2010 the United States adopted its financial reform bill. At the same time, the European Union is accelerating the legislative process in this field; Japan has amended relevant laws and regulations; and the new British government is sparing no efforts to facilitate financial sector reform.

First, raising capital and liquidity requirements. In Q1 2010, the supervisory authority of the United States published a guide on financing and liquidity management. The European Commission is amending its *Capital Requirements Directive*, which is expected to complete the legislative process by the end of 2011.

Second, establishing a macro-prudential policy framework. The United States will establish up the Financial Stability Oversight Council. At the same time, capital requirements and leverage standards for financial institutions with systemic importance will be tightened. The European Union established the European Systemic Risk Board to preside over supervision and evaluation of systemic risks and implementation of macro-prudential management. In May 2010, the Japanese Parliament passed an amendment to the *Financial Instruments and Exchange Act*, which enhanced supervision over financial institutions with systemic importance. On May 20, the British coalition government released a plan to give the Bank of England responsibility for macro-prudential management.

Third, solving the problem of “too big to fail” and cross-border disposals. According to the U.S. financial reform bill, the Financial Stability Oversight Council has the right to require a large complex company to divest some of its holdings if it poses a grave threat to the financial stability of the United States and the FDIC is in charge of the liquidation process. The European Commission strengthened regulations over the "too big too fail" institutions, as well as relevant emergency dissolution principles. In February 2009, the British government enacted the *Bank Law*, which set up a special dissolution regime, bestowed the relevant authorities with policy tools to dispose of insolvent banks, and prescribed new bank insolvency and administration procedures.

Fourth, improving OTC derivative transactions. The new U.S. financial reform bill requires central clearing and exchange trading for most derivatives, and the separation of derivatives with high risks such as CDS from banks to specific affiliates. It also limits the proprietary business of large financial companies by requiring that investments by a banking entity in a hedge fund or a private equity fund shall not exceed 3 percent of the total ownership interests of the fund, as well as 3 percent of the Tier 1 capital of the banking entity. The European Commission proposed that standard OTC derivative contracts should be cleared through central counterparties and relevant information should be reported to trade repositories. In Japan's *Amendment to the Financial Instruments and Exchange Act*, there are requirements for central clearing of OCT derivatives, as well as requirements for the storage and reporting of transaction information.

Fifth, sharing of the costs of financial reform. The U.S. financial reform bill allows the FDIC to increase its reserve ratio in the deposit insurance fund from 1.15 percent to 1.35 percent. At the beginning of 2011, the European Commission will allow its member countries to levy a tax on financial institutions and is planning to raise legislative proposals for crisis management and tools, as well as to establish a bank dissolution fund. In June 2010 the British government announced it would levy a bank tax beginning from January 1, 2011.

Sixth, strengthening accounting rules. In 2011, the U.S. SEC will decide whether, when, and how the current U.S. financial reporting system should be transitioned to a system incorporating the International Financial Reporting System (IFRS). In June 2009, the Financial Services Agency of Japan released the *Opinions on Revision of*

Audit Standards (Mid-term) at a meeting of the business accounting council to establish a blueprint for adopting the IFRS in Japan. With regard to compensation reform, the U.S. financial reform bill allows shareholders a non-binding vote on executive compensation and golden parachute arrangements. At the beginning of 2010, the British Financial Services Authority published a new rule requiring that up to 60 percent of the income of those who earn more than 1 million pounds annually should be deferred in the subsequent three years.

Seventh, enhancing supervision of hedge funds. The U.S. financial reform bill requires that hedge funds and private equity funds register with the U.S. Securities and Exchange Commission and companies with more than US$ 150 million must be supervised. In April 2009, the European Commission proposed a *Directive on Alternative Investment Fund Managers*, aimed at creating a comprehensive and effective regulatory and supervisory framework for hedge funds in the European Union. According to the *Financial Instrument and Exchange Act*, the Financial Services Agency of Japan requires registration by a larger range of hedge funds and specifies the reporting of information pertaining to fund risk management. Since July 2010, hedge funds must register with the Financial Services Authority of Britain and must be supervised.

Eighth, tightening supervision over credit rating agencies. The U.S. financial reform bill requires the creation of an office of credit rating agencies within the SEC to oversee the rating agencies. In July 2010, the European Commission proposed a revision of the *Credit Rating Agencies Regulation* to introduce centralized EU oversight of credit rating agencies, granting the European Securities and Markets Authority with exclusive supervisory power over the credit rating agencies registered in the EU. The Japanese Parliament passed the *Financial Instrument and Exchange Act*, requiring registration by credit rating agencies. Starting from July 2010, the Financial Services Authority of Britain demands that all credit rating agencies be registered and supervised by the FSA.

Learning from the financial reform plans of the advanced economies and taking into consideration the national conditions of our country, we should pay special attention to the following issues. First, a macro-prudential management framework should be put into place so as to prevent and mitigate systemic risks. The focus of the current financial supervisory regime is on micro-prudential management, making it difficult to monitor systemic risks in a timely and effective manner or to take prompt action when necessary. Therefore, a macro-prudential management framework needs to be established and relevant policy tools and methods need to be developed. Second, supervision over financial institutions with systemic importance should be enhanced. The first step is to determine how to measure the systemic importance of financial institutions, markets, and tools. Thereafter, the relevant regulatory regime should be properly arranged in a synergy. Third, a framework for the dissolution of large financial institutions should be established, especially the deposit insurance system, so that market discipline will be improved and the central bank will better perform its role as lender of last resort rather than passively paying the final bills for the dissolution of financial institutions. As a result, the financial safety network will be more resilient to risks. Fourth, supervision over the credit rating agencies should be enhanced. On the one hand, laws and regulations on credit rating industry should be stipulated and, on the other hand, studies on how to establish an oversight framework for the industry should be encouraged.

II. Analysis of China's macroeconomic performance

In the third quarter of 2010, the Chinese economy developed in the direction intended by the macroeconomic management policies and the momentum for stable and fairly rapid growth became stronger. Consumption continued to grow rapidly, the structure of fixed-asset investments improved, and external trade recovered further. Performance of the agricultural sector was good, and sales and production in the manufacturing industries were stable. In the first nine months of 2001, the Gross Domestic Product (GDP) registered 26.9 trillion yuan, up 10.6 percent year on year based on comparable prices and an acceleration of 2.5 percentage points from the previous quarter; the CPI was up 2.9 percent year on year, an acceleration of 0.4 percentage points from the first half of 2010; the trade surplus posted US$120.6

billion, representing a decline of US$14.9 billion from the same period of the last year.

1. Consumption grew steadily, the investment structure improved, and external trade recovered further

Supported by the income gains of urban and rural residents, domestic consumption remained stable. In the first nine months of the year, the per capita disposable income of urban households posted 14,334 yuan, representing year-on-year growth of 10.5 percent and real growth of 7.5 percent. The per capita cash income of rural households registered 4,869 yuan, up 13.1 percent year on year, or 9.7 percent in real terms. In the first nine months of the year, retail sales of consumer goods totaled RMB 11.1 trillion yuan, representing an increase of 18.3 percent year on year and an acceleration of 3.2 percentage points from the corresponding period of the last year. Price-adjusted real consumption growth was 15.2 percent, a deceleration of 1.7 percentage points from the corresponding period of the last year. The gap between real and nominal consumption growth was due to the effect of the price hikes in recent months. Broken down by urban and rural areas, consumption in the urban areas grew faster than that in the rural areas, but the gap remained basically the same. In the first nine months of the year, retail sales in the urban areas registered 9.6 trillion yuan, up 18.7 percent, or 15.8 percent in real terms, whereas retail sales in the rural areas posted 1.5 trillion yuan, up 15.8 percent, or 12.2 percent in real terms. The survey of urban depositors in the third quarter reveals that the income sentiment indicator climbed 2.1 percentage points to 51.6 percent, the savings sentiment and consumption sentiment indices both declined, whereas the investment sentiment index shifted from a downward movement to an upward movement.

Growth of fixed-asset investments was rapid, in particular growth of investments in the tertiary sectors. In the first three quarters of the year, fixed-asset investments totaled 19.2 trillion yuan, up 24.0 percent year on year, or 21.4 percent in real terms, representing a deceleration of 1.0 percentage points from the previous two quarters. Private investment continued to outpace total investment, but investment in highly polluting and energy-consuming industries was contained. Broken down by urban and rural areas, completed fixed-asset investments in the urban areas totaled 16.6 trillion yuan, up 24.5 percent year on year and an acceleration of 1.0 percentage points from the previous two quarters; completed fixed-asset investments in the rural areas registered 2.6 trillion yuan, up 20.5 percent year on year and a deceleration of 1.6 percentage points from the previous two quarters. Broken down by regions, urban fixed-asset investment growth in the eastern, central, and western regions registered 21.5 percent, 27.1 percent, and 26.5 percent respectively, with the central and western regions obviously higher than the eastern region. Broken down by industries, urban fixed-asset investments in the primary, secondary, and tertiary industries grew 17.7 percent, 22 percent, and 26.7 percent respectively, and growth in the tertiary industry was much higher than that in the other two industries. In the first nine months of the year, the total planned investment in projects under construction in the urban areas registered 45.8 trillion yuan, up 26.2 percent year on year. A total of 389,487 projects were under construction, 12,961 more than during the same period of the last year.

External trade recovered further and the export structure improved, presenting an increasingly diversified trade pattern. In the first nine months of the year, imports and exports totaled US$2.1 trillion, up 37.9 percent year on year, representing an acceleration of 58.7 percentage points from the same period of the last year but a deceleration of 5.1 percentage points from the previous two quarters. In particular, exports posted US$1.1 trillion, up 34.0 percent year on year, an acceleration of 55.4 percentage points and a deceleration of 1.1 percentage points from the corresponding period of the last year and the first half of 2010 respectively; imports posted US$1.0 trillion, up 42.4 percent year on year, an acceleration of 62.7 percentage points from the same period of the last year and a deceleration of 10.3 percentage points from the previous two quarters. The trade surplus stood at US$120.6 billion, representing a decrease of US$13.9 billion from the same period of the last year. Exports of machinery and electronic products and high- and new-technology products grew rapidly, by 34.5 percent and 36.1 percent respectively year on year, both exceeding the growth of exports. In the long run, we expect that the U.S. and Japan will remain the major destinations for Chinese exports, but their share in our total exports will decline, which shows that China's trade is becoming increasingly diversified. In the first nine months of the year, actually utilized foreign investment reached US$74.3 billion, up 16.6 percent and an acceleration of 30.8 percentage points from the corresponding period of the last year.

2. Agricultural production remained stable and in general industrial production grew rapidly

In the first nine months of the year, the added value of the primary, secondary, and tertiary industries reached 2.6 trillion, 12.9 trillion, and 11.4 trillion respectively, up 4.0 percent, 12.6 percent, and 9.5 percent. The share of the three industries in GDP was 9.5 percent, 48.1 percent, and 42.4 percent respectively.

The performance of the agricultural sector was good, and the output of the autumn harvest was expected to post a large increase and another year of a bumper grain harvest was anticipated. The total output of meat (including pork, beef, mutton, and poultry) posted 54.39 million tons, up 2.6 percent year on year. In particular, the output of pork totaled 35.89 million tons, up 2.7 percent year on year.

Industrial growth was generally fast, with corporate profits remaining good. In the first three quarters of the year, the added value of statistically large enterprises grew 16.3 percent year on year, representing an acceleration of 7.6 percentage points from the same period of the last year. Production and sales of industrial products were well connected, and 97.8 percent of manufactured goods were sold, up 0.4 percentage points from the same period of the last year. Industrial enterprises were generally profitable. In the first eight months, the pre-tax rate of return on sales of industrial enterprises was 6.0 percent, an acceleration of 0.9 percentage points from the same period of the last year. The survey of 5,000 industrial enterprises in the third quarter conducted by the PBC reveals that the corporate business index has registered growth for six successive quarters, reaching 70.3 percent and close to the record-high level at the beginning of 2008. Market demand continued to pick up, with the market demand index posting 62 percent, flat with that in the previous quarter, but up 1.4 percentage points from the previous quarter, representing its fifth consecutive quarter in the positive zone. The inventory index was basically stable, a reduction of 0.2 percentage points from the previous quarter to 48.5 percent. Profitability of the corporate sector was stable with the profitability index at 60.3 percent, representing an acceleration of 5.2 and 0.2 percentage points from the same period of the last year and the previous quarter respectively.

3. CPI growth was up further

The CPI rose notably year on year. In the third quarter of the year, the CPI gained 3.5 percent year on year, an acceleration of 0.6 percentage points compared to the previous quarter, and the monthly CPI was up 3.3 percent, 3.5 percent, and 3.6 percent respectively. Broken down by food and non-food items, significant food price increases were the major driver for the CPI hike, whereas non-food price hikes were generally stable. In the third quarter of the year, food prices increased by 7.4 percent year on year, an acceleration of 1.5 percentage points from the previous quarter, whereas non-food prices were up 1.5 percent year on year, on par with the previous quarter. Broken down by consumer goods and services, the prices of consumer goods grew faster than the prices of services, with the prices of consumer goods up 3.8 percent in the third quarter or accelerating 0.5 percentage points from the previous quarter, and the prices of services up 2.4 percent year on year or accelerating 0.6 percentage points. In terms of the base period factor and the new price-rising factor, in the third quarter the base period factor and the new price-rising factor averaged 1.8 percent and 1.7 percent, respectively, flat from the previous quarter and representing an acceleration of 0.6 percentage point.

Growth of producer prices moderated. In the third quarter of the year, ex-factory producer prices of industrial products grew 4.5 percent year on year, a deceleration of 2.3 percentage points from the previous quarter, or up 4.8 percent, 4.3 percent, and 4.3 percent in the three months respectively; the purchasing prices of raw materials, fuel, and power grew 7.7 percent year on year, representing a deceleration of 4.0 percentage points from the previous quarter, or up 8.5 percent, 7.5 percent, and 7.1 percent respectively in the three months. In the first nine months of 2010, the producer’s price of agricultural produce (the price at which farmers sell their products) was up 8.9 percent year on year, whereas the price of agricultural capital goods grew 1.9 percent year on year. In Q3, the Corporate Goods Price Index (CGPI) monitored by the PBC gained 6.0 percent year on year, a deceleration of 0.8 percentage points from the previous quarter, or up 5.9 percent, 6.0 percent, and 6.1 percent in the three months respectively. Broken down by categories within the basket of the CGPI, prices of agricultural produce, mineral products, and coal, oil, and electricity were up 12.8 percent, 12 percent, and 7.6 percent respectively year on year.

The import price hike decelerated further. In the third quarter, import prices went up 10.9 percent year on year, representing a deceleration of 7.8 percentage points from the previous quarter, or up 12.8 percent, 10.5 percent, and 9.5 percent respectively in the three months; export prices grew by 5.1 percent year on year, an acceleration of 3.5 percentage points from the second quarter, or up 4.0 percent, 6.5 percent, and 4.9 percent year on year respectively in the three months. In the third quarter, the average price of crude oil futures traded on the New York Mercantile Exchange dropped 2.4 percent from the previous quarter, up 11.7 percent from the same period of the last year. The average spot prices of copper and aluminum traded on the London Metal Exchange rose by 3.0 percent and fell by 0.2 percent respectively from the previous quarter, up 23.8 percent and 15.4 percent from the same period of the last year.

Labor compensation continued to grow rapidly. In the first nine months, the monthly average salary of urban employees grew 16 percent year on year, faster than the growth in the first half of 2010. In particular, the salary of urban employees in state-owned and collective enterprises grew faster than that of employees in other economic entities (excluding private enterprises).

The GDP deflator rebounded rapidly. The GDP totaled 26.9 trillion yuan in the first nine months of the year, representing real growth of 10.6 percent. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 5.1 percent, up 6.6 percentage points from the same period of the last year and at par with the first half of 2010.

The price reform of resource goods advanced further. First, the prices of refined oil products were adjusted. Based on the current refined oil pricing mechanism, and in light of recent international price movements, the National Development and Reform Commission (NDRC) hiked the prices of petrol and diesel by 230 yuan and 220 yuan per ton respectively, effective as of October 26. Second, there has been a process of consulting with households regarding their views on a possible progressive electricity tariff mechanism.[4]On October 9, the NDRC released the *Draft of Guiding Opinions on a Progressive Electricity Tariff Mechanism for Household Power Use* to solicit responses from the entire society. The period of solicitation has now ended. The NDRC noted that the views of the entire society will be carefully studied to improve the design of the progressive tariff mechanism.

4. Fiscal revenue growth accelerated year on year and expenditures expanded rapidly

[4] The progressive tariff mechanism is designed to have three categories of power demand, subsistence needs for electricity, normal needs for electricity, and electricity needs for higher living standards. The tariff is progressive based on the three categories.

In the first three quarters, fiscal revenue (excluding debt income) surged. Fiscal revenue increased 22.4 percent year on year to 6304 billion yuan, representing an acceleration of 17.1 percentage points from the corresponding period of 2009 and a deceleration of 5.2 percentage points from the previous two quarters, whereas fiscal expenditures grew 20.6 percent to 5450.5 billion yuan, representing a deceleration of 3.5 percentage points from the corresponding period of 2009 and an acceleration of 3.6 percentage points from the first half of 2010. Revenue exceeded expenditures by 853.5 billion yuan, representing an expansion of 221.8 billion yuan from the corresponding period of 2009.

As for the structure of fiscal revenue, in the first three quarters tax revenue was up 30.8 percent year on year, an acceleration of 6.6 percentage points from the first half of the year. In particular, domestic VAT, business tax, and consumption tax revenue were up 12.1 percent, 26.2 percent, and 32.3 percent respectively year on year. Within the expenditure basket, the three largest items were education (749.2 billion yuan, or 13.7 percent of total spending), social security and employment (604.0 billion yuan, or 11.1 percent of total spending), and general public services (580.9 billion yuan, or 10.7 percent of total spending). Among all items in the basket, expenditures on commercial and other services, on transportation and communications, and on science and technology registered relatively rapid growth at 73.6 percent, 46.7 percent, and 45.2 percent respectively.

5. The balance of payments account

In the first half of 2010, the world economy continued to recover but the recovery was not firmly based and international financial markets experienced large fluctuations. During this period, China's BOP account transactions were brisk, with the volume of transactions exceeding that in the first half of 2009 and approaching the level in the pre-crisis corresponding period of 2008. The current account surplus declined 6 percent year on year to US$126.5 billion; and the financial and capital account surplus was up 48 percent to US$90 billion. The BOP position improved, as indicated by a current account surplus to GDP ratio of 5 percent, representing a reduction of one percentage points from 2009. Meanwhile, the BOP account fluctuated, as evidenced by the faster growth of goods imports than goods exports, a current account surplus that was smaller than that during the corresponding period of the last year, a large surplus in the capital and financial account in the first quarter, and recovery of the current account surplus in the second quarter that exceeded the surplus in the first quarter. As a result of the sovereign debt crisis in Europe, net current and capital account inflows to China slowed.

In the second quarter of 2010, China had a twin surplus under the current account and the capital and financial accounts. The current account surplus was up 35 percent to US$72.9 billion, including a surplus of US$59.5 billion in trade in goods, a deficit of US$4.5 billion in trade in services, a surplus of US$8 billion in returns, and a surplus of US$9.9 billion in current transfers. The capital and financial account surplus was down 68 percent year on year to US$25.8 billion, including US$21.5 billion in net inflows of direct investment, US$9.5 billion in net inflows of portfolio equity investment, and US$12.4 billion in net inflows of other investments.

Going forward, the global economy is expected to recover slowly. With the Chinese economy continuing its stable growth, a fairly large BOP surplus, a continued surplus in trade in goods, and a large inflow of direct foreign investment are expected. Cross-border capital flows are still seeking arbitrage opportunities and may heighten China's BOP fluctuations through various channels, such as external trade, foreign investment, and the financial sectors.

At end-June 2010, the size of China's external debt had expanded by 19.9 percent from end-2009 to US$513.8 billion, including US$343.8 billion in short-term debt (remaining maturities) that accounted for 66.9 percent of the total external debt. With respect to the structure of the short-term external debt (remaining maturities), trade credits and trade financing (such as credit support provided by banks for exporters and importers) accounted for 60.1 percent and 18.5 percent respectively, totaling 78.6 percent. This can be attributed to the rapid development of external trade in recent years.

6. Sectoral analysis

Growth of industrial profits was relatively fast but then moderated. In the first eight months, statistically large industrial enterprises[5]registered a total profit of 2.6 trillion yuan, up 55 percent year on year, representing an acceleration of 65.6 percentage points from the corresponding period of the last year but a deceleration of 26.6 percentage points from the first five months of this year. Among all 39 sectors, 36 sectors (including the non-ferrous metal smelting and rolling industry, the ferrous metal mining and dressing industry, the chemical fiber manufacturing industry, the ferrous metal smelting and rolling industry, the petroleum and natural gas extracting industry, and so forth) reported year-on-year growth in profits, whereas two industries (i.e., the tobacco industry and the petroleum processing, coking, and nuclear fuel processing industry) saw a year-on-year decline in profits. From January through September, statistically large enterprises in 38 out of the 39 sectors reported a year-on-year growth in profits. The demand and supply situation for coal, power, and oil was generally relaxed. In the first seven months of 2010, a total of 23.304 billion tons of freight volume was handled, up 14.5 percent year on year; power generation increased 16.1 percent year on year to 3090.6 billion kilowatts per hour; and the output of crude oil increased 5.8 percent to 150.30 million tons.

(1) The Real Estate Sector

In the first three quarters of 2010, the sales volume of commercial real estate declined, and the growth of real estate prices moderated and subsequently the growth of real estate loans of major financial institutions also moderated.

Sales of commercial real estate decelerated. In the first nine months, the sold floor

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[5] Any enterprise that in its main business makes more than RMB 5 million per year in profits.

area of commercial real estate was up 8.2 percent year on year to 630 million square meters, representing a deceleration of 7.2 percentage points from the first two quarters and 33.9 percentage points from 2009. In the period under review, the sale of commercial real estate was up 15.9 percent year on year to 3.2 trillion yuan, representing a deceleration of 9.5 percentage points from the first half of 2010 and a deceleration of 59.6 percentage points from 2009. The sold floor area and sale value of office real estate and real estate for commercial use both grew faster than that of commercial housing. In July and August, monthly sales were down year on year, but in September were up year on year.

The surge in real estate prices moderated after April, but month-on-month growth again became notable in September. In September 2010, the index of housing prices in 70 large and medium cities was up 9.1 percent year on year, representing a deceleration for five months in a row and a deceleration of 3.7 percentage points from April; on a month-on-month basis, the hike was 0.5 percent, representing a deceleration of 0.9 percentage points from April, but an acceleration of 0.5 percentage points from August. In September, the price of newly built homes was up 11.3 percent year on year and 0.5 percent month on month, whereas the price of pre-owned homes was up 6.2 percent year on year and 0.5 percent month on month. In the 70 large and medium cities, 20 and 15 cities respectively saw a month-on-month decline in real estate prices in July and August respectively, but only one city had a month-on-month decline in real estate prices in September. In Q3, land price were up 21.3 percent year on year, representing a deceleration of 0.8 percentage points from Q2; rent was up 7.4 percent year on year, an acceleration of 1.0 percentage points from Q2.

Growth of investment in real-estate development moderated but remained relatively high. In the first three quarters of 2010, real estate investment totaled 3.4 trillion yuan, up 36.4 percent year on year, representing a deceleration of 1.7 percentage points from the first half of 2010 but an acceleration of 20.3 percentage points from 2009. The floor area of newly started real estate projects was up 63.1 percent year on year to 1.2 billion square meters, representing a deceleration of 4.8 percentage points from the first half of 2001 but an acceleration of 50.6 percentage points from 2009. Land purchases by real-estate development companies were up 35.6 percent year on year to 290 million square meters, on par with that in the first half of 2010, representing a deceleration of 18.9 percentage points from 2009.

The expansion of real estate loans decelerated. With the implementation of various austerity measures and changes in the real-estate market, growth of outstanding real estate loans moderated since May. At end-September, outstanding real estate loans of major financial institutions were up 32.9 percent year on year to 9.1 trillion yuan, representing a deceleration of 7.3 percentage points from end-June. In particular, outstanding land development loans were up 36.0 percent year on year to 828.1 billion yuan, representing a deceleration of 9.6 percentage points from end-June; outstanding real-estate development loans were up 21.5 percent year on year to RMB 2.3 trillion, representing an acceleration of 1.2 percentage points from end-June; outstanding mortgage loans were up 37.3 percent year on year to 6.0 trillion yuan, representing a deceleration of 11.5 percentage points from end-June. At end-September, outstanding real estate loans accounted for 20.5 percent of total outstanding loans, an acceleration of 1.3 percentage points from end-2009. In September, new real estate loans posted 138.5 billion yuan, a reduction of 92.9 billion year on year.

After the April release of the *State Council Notice on Resolutely Containing the Excessive Real Estate Price Hikes in Certain Cities*, positive changes took place in the real-estate market. In order to further implement the above-mentioned *Notice*, to consolidate the results of the real estate austerity measures, and to promote the healthy development of the market, in September the Ministry of Land Resources, the Ministry of Housing and Urban-Rural Development, the Ministry of Finance, and the PBC adopted relevant real-estate market austerity measures. In particular, on September 29 the PBC and the China Banking Regulatory Commission released the *Notice on Matters Related to Improving the Differentiated Housing Credit Policy*, requiring commercial banks to more strictly implement the relevant policies on the downpayment ratio for the purchase of commercial housing and on lending rates, clarifying the moratorium on lending to purchase of third homes by households in an effort to contain speculation. In addition, the *Notice* requires commercial banks to continue to support loan demand for welfare housing construction and to support construction of low and medium-priced and small floor area housing projects, for the purpose of guiding the real-estate market to develop in a sound manner.

(2) The Automobile Industry

As an important pillar industry in the national economy, the auto sector plays a significant role in economic and social development because it involves a variety of sectors, provides a large variety of job opportunities, and helps boost domestic demand.

In recent years, the auto industry has expanded rapidly in China. In 2000, auto sales exceeded 2 million. Since then, auto sales have been growing by about one million every year. In the first nine months of 2010, the output and sales of autos posted 13.08 million and 13.14 million respectively (already approaching total output and sales in 2009), up 36.1 percent and 36 percent respectively. The auto consumption market developed rapidly. In 2009, out of the total of 76.19 million autos (including 13.31 million three-wheelers) in the country, 52.18 million were private vehicles. Private citizens have become the major consumers in the auto market. The efficiency of the auto industry was good. From January through August, the output of statistically large auto enterprises totaled 2754.8 billion yuan, up 42 percent year on year, and their income from their main business totaled 2748.7 billion yuan, up 47 percent year on year; new product output totaled 892.9 billion yuan, up 43 percent.

As a result of the macroeconomic policies adopted by the government, mergers and reorganization of the auto industry accelerated, the structure of the industry gradually improved, and the concentration ratio was up step by step, albeit relatively low compared with international counterparts. According to the statistics of the China Auto Industry Association, the country's top 10 auto makers accounted for 84 percent of both the total output and total sales in 2004. In 2009, the top 10 selling auto makers sold 11.89 million automobiles, about 87 percent of the total auto sales in China. At end-2009, there were 361 auto makers in China, indicating serious duplicate construction and waste of resources. According to the statistics of the International Organization of Motor Vehicle Manufacturers (OICA), production of self-owned-brand vehicles by 7 Chinese auto makers was among the top 25 world auto makers in 2009. The combined production of self-owned-brand vehicles by these 7 auto makers was 4.704 million, only 65 percent of the production of Toyota, the world's number one auto maker.

Chinese brands are growing steadily and taking a larger market share. But they face the problem of a lack of sophisticated technology and a lack of innovative capacity. In 2009, the sale of Chinese brand passenger vehicles posted 4.577 million, about 44.3 percent of total sales of passenger vehicles, an acceleration of 2.8 percentage points from 2006; sales of local Chinese brand autos totaled 2.217 million, about 29.7 percent of auto sales, an acceleration of 4.0 percentage points from 2006. Chinese-brand cars mainly target the low-end market and do not have a large share of total output and sales. In addition, due to the low ratio of research and development inputs to sales income and the small share of research and development teams in the total employment in the industry,[6] Chinese automakers do not have strong innovative abilities and their key technology and auto development capacity are yet to be improved.

Supported by energy conservation subsidies and policies, auto consumption is moving in favor of more economic and energy-saving vehicles. Compact and mini vehicles are becoming increasingly popular and energy-saving and environmentally friendly low-emission vehicles are gaining market shares. In 2005, the sale of passenger vehicles with an engine displacement below 1.6 liters accounted for 63.5 percent of the total sales of passenger vehicles and 43.8 percent of the total auto sales, but in 2009 grew to 69.7 percent and 52.7 percent respectively. The demand structure has also improved.

The auto industry chain has yet to be improved. The auto industry involves a long chain of industries. Currently, the relatively weak front-end and basic research in the auto industry does not provide sufficient support for independent innovation and future development. The core part of the industrial cluster and the supporting facilities and equipment that are closely related to the manufacturing of finished automobiles are not advanced, and the research and development of key technology and finished automobiles need to be improved. The pre-owned vehicle market, auto financing, and auto service industry have just begun in China. The total number of automobiles is increasing rapidly, posing challenges to fuel supplies, urban traffic, and environmental protection.

[6] According to the EU Auto Industry Association, its members invest about 5 percent of sales income in R&D activities. In China, the industry average is between 1 and 2 percent.

Given the rapid economic growth and income gains in China, the external and domestic environments are quite favorable for the auto industry. It is necessary for the industry to speed up restructuring and upgrading and to achieve balanced development of the auto making and auto services sectors; to build independent innovation abilities and to make Chinese brands more competitive; and to achieve breakthroughs in energy conservation and in new energy-savings automobiles and to upgrade products. At the same time, it is also necessary to build urban road systems and to improve the efficiency and modernization of urban transportation management so as to promote sustained, healthy, and stable expansion of the auto industry.

Part 5 Monetary Policy Stance to Be Adopted in the Next Period

I. Outlook for the Chinese economy

The Chinese economy is developing in the direction as intended by the macroeconomic management policies and it is expected to continue its momentum of stable and fairly rapid growth. In terms of the international environment, given the apparent lack of new growth sources in the global economy, rapid growth is unlikely. Yet the worst of the financial crisis is behind us and the tepid global recovery is expected to continue, presenting a relatively stable external demand environment for China. On the domestic front, after the adoption of the crisis response package the Chinese economy recovered quickly. The moderation of the economic indicators in Q2 2010 was against a low relatively high base and attributable to the macroeconomic management policies. This was conducive to stable and sustainable growth. Since the beginning of August, a good momentum of stable growth has emerged. The various policy measures adopted earlier, such as the boosting of new strategic industries, the building of welfare housing and the rebuilding shanty towns, the encouraging and guiding of private investment, and the implementation of local development strategies will help promote economic restructuring and nurture more sustainable economic growth points. Currently, the localities are enthusiastic about promoting development and have strong incentive to invest. The ongoing consumption upgrading and urbanization provide a strong basis for sustainable economic growth. According to the business survey, banker survey, and urban depositors' survey conducted by the PBC in Q3, the major indices have either gone up or have stabilized and remained high. The household income sentiment index and employment sentiment index were up 2.1 percentage points and 1.6 percentage points from Q2, the market demand index was up 1.2 percentage points, but the export orders index slid a bit.

However, it is worth noting that the current economic development environment is quite complicated and because uncertain factors occasionally emerge in the global economy, the recovery of the advanced economies has slowed, monetary conditions remain loose, and some fast-growing emerging economies have to address inflation and capital inflow pressures. At home, the recovery of domestic demand is not evenly based, private investment and endogenous growth drivers need to be reinforced, and the tasks of expanding consumption, improving income distribution, and restructuring the economy remain daunting. It is necessary to combine the two tasks of promoting short-term stable and rapid growth and creating favorable conditions for long-term development and to make every effort to speed up transformation of the economic growth mode.

The uncertainties in price trends remain significant and warrant stronger measures for the management of inflation expectations. Recovery of the global economy is still slowing. In China, growth is fairly strong and thus inflation expectations and upward price pressures should not be ignored. Given the uncertainties in recovery, various economies have been prudent in exiting their stimulus policies. As the stimulus policies adopted earlier on have expired, the major advanced economies have moved to release new measures. Globally, abundant liquidity and loose monetary conditions are likely to remain, there is a strong expectation that the major economies will keep in place their accommodative monetary policies to support economic growth, and massive capital inflows into the emerging economies with higher growth rates are quite possible. Against the backdrop of abundant liquidity and strong inflation expectations, it is inevitable that idle money will look for investment opportunities and potential inflationary pressures will require attention. In addition, there are structural upward price pressures. At home, increasing labor and service prices, growing resource and environmental protection costs, and the pending resource price reform all might have an impact on inflation expectations. According to the urban depositors' survey conducted by the PBC in Q3, the household future price sentiment index rose to 73.2 percent, relatively high compared with the corresponding period in past years, and more households expect higher housing prices in the future compared with the previous quarter.

Ⅱ. Monetary policy in the next stage

Since the beginning of 2010, as the momentum of stable and fairly rapid growth became stronger, the PBC, following the overall arrangements of the State Council, has adjusted the focus, strength, and pace of policy operations in a forward-looking and flexible way while maintaining monetary policy continuity and stability in order to gradually bring monetary conditions back from their anti-crisis status to a normal state, playing an important role in preserving stable and fairly rapid economic growth and managing inflation expectations. Going forward, the PBC will continue to follow the scientific outlook on development, continue to implement a moderately loose monetary policy in accordance with the overall arrangements of the State Council, and properly manage policy intensity, pace, and priorities, maintain policy consistency and stability, make policy better targeted and more effective, and continue to gradually shift monetary conditions from an anti-crisis to a normal state in light of new developments. The PBC will properly handle the relationship between maintaining stable and relatively rapid economic development, adjust the economic structure and manage inflation expectations, improve the sustainability of using financial measures to support economic development, and safeguard the healthy and stable development of the financial system. More efforts will be made to strengthen policy coordination and optimize the policy mix, to make full use of flexible market-based measures, and to focus on the institutional reform and economic restructuring so as to speed up the transformation of the economic growth pattern and to enhance endogenous dynamics for economic development.

First, the PBC will strengthen liquidity management and guide money and credit to grow at a proper pace. In view of economic and financial developments and changes in foreign exchange flows, the PBC will deploy a wide range of monetary policy tools and carefully arrange the mix and terms of the policy tools and manage the intensity of monetary policy operations to enhance liquidity management, so that liquidity in the banking system will remain at a reasonable level and money and credit will grow properly to satisfy credit demand for economic development and to create a sound monetary environment for keeping the general price level basically stable and for managing inflation expectations. It is necessary to guide financial institutions to properly pace the provision of loans in line with the macroeconomic management policies and the credit needs of the real economy.

Second, the PBC will step up financial support to promote the transformation of the development pattern and economic restructuring. It will continue to implement differentiated credit policies and to improve the credit structure. Specifically, the PBC will enhance credit policies to support the weak links in the economy, employment, energy conservation and environmental protection, the Western development drive, emerging industries of strategic importance, industrial relocation and post-disaster rebuilding; address the financing difficulties of small enterprises effectively, and ensure that loans to ongoing key projects are granted; and rein in lending to high energy-consuming and polluting industries and industries with overcapacity. Efforts will be made to speed up innovation in rural financial products and services and to improve and upgrade rural financial services. Measures will be adopted to implement differentiated mortgage policies to promote the healthy and stable development of the real-estate market. Measures will be adopted to improve risk warnings to financial institutions and to enhance the management of risks of loans extended to local financing platforms. Moreover, the establishment and improvements in the macro-prudential management framework will be explored to take advantage of a framework that works against the wind, including studying imposing stronger capital and liquidity requirements for systemically important banks, so as to maintain the soundness of the financial system, prevent systemic risks, and improve the sustainability of financial support to economic development.

Third, the PBC will steadily advance the market-based interest rate reform and improve the RMB exchange rate regime. The role of price levers in economic management will be strengthened. The PBC will continue to promote the establishment of a benchmark interest rate system on the money market to improve pricing ability and to strengthen the role of price levers. The PBC will, in accordance with the principles for reforming the RMB exchange rate regime, further improve the RMB exchange rate regime based on market supply and demand with reference to a basket of currencies. The exchange rate floating bands will remain the same as previously announced in the inter-bank foreign exchange market so as to keep the RMB exchange rate basically stable and at an adaptive and equilibrium level. The PBC will promote the development of the foreign exchange market and introduce more tools for managing exchange-rate risks. It will steadily advance the pilot program for RMB settlement of cross-border trade transactions to facilitate trade and investment and the use of RMB in trade and investment activities, and will support the going-global initiative. It will deepen reform of the foreign exchange administration system to promote balanced capital flows. It will also improve cross-border capital flow management and step up the monitoring and management of irregular and abnormal fund flows.

Fourth, the PBC will promote the healthy development of the financial market. The PBC will continue to deepen the reform of financial institutions, speed up the establishment of a modern financial enterprise system, and improve the system for organizations providing financial services. Efforts will be made to accelerate innovation in financial products and to strengthen the building of market infrastructure. The PBC will broaden the channels for enterprises to access direct financing, accelerate the development of the bond market, and actively and prudently promote the opening-up of the inter-bank bond market.

In addition, it will be necessary to strengthen coordination among fiscal, industrial, and monetary policies, with a focus on promoting reform and economic restructuring, so as to enhance the endogenous growth dynamics in the economy. Continued efforts should be made to reform the fiscal and tax systems, to relax further restrictions on investments and financing, to improve the income distribution structure, to strengthen the dynamism of the private sector, and to increase the disposable income of households. The market mechanism should be improved as well so that the market fully plays a fundamental role in resource allocations.