Chapter Ⅰ

Macroeconomic Developments

The year 2009 witnessed gradual stabilization and turnaround of the global economy in the wake of the full-scale international financial crisis. The Chinese economy, severely affected by the shock of the finance crisis, staged a fast recovery in the year. Globally, supported by the large unconventional stimulus measures in major economies, the financial crisis was largely brought into control. With uncertainties and systemic risks in financial markets falling markedly, major economies saw gradual recovery since the mid of the year. Domestically, thanks to the proactive fiscal policy and moderately loose monetary policy as well as the package of policy measures on dealing with the international financial crisis, the Chinese economy reversed the evident growth downturn relatively fast and achieved a general recovery.

Looking ahead, the main trend of global economic recovery is expected to remain unchanged despite uncertainties around a full and sustainable recovery. Constrained by debt sustainability and potential asset bubble risks, the room for additional stimulus in major economies is limited. Phasing out stimulus measures could also add uncertainties to economic recovery. On the domestic front, the foundation of upturn in domestic demand is not solid and balanced yet, and private investment and other internal driving forces of growth are to be strengthened. Inflation expectation has risen somewhat. The tasks of continuing to boost household consumption and adjusting economic structure are still arduous.

Global Economic and Financial Developments in 2009

The world economy slid into deep recession after the full-scale outbreak of the financial crisis, contracting by 0.6 percent in 2009. The large unconventional stimulus policies adopted by major economies and broad coordination and cooperation among them in response to the financial crisis supported rally of global demand and reduced uncertainties and systemic risks in financial markets. The financial crisis was largely brought under control for the year as a whole. Major economies showed signs of recovery since the mid of 2009. However, the recovery is not solid yet and expected to be a slow process.

Economic Developments in Major Economies

The US economy showed signs of recovery, but the strength for sustaining recovery seemed not robust. In 2009, GDP contracted by 2.4 percent, the first contraction since 1991 and the largest decline since 1946. But GDP expanded in a row in the third and fourth quarters of 2009, with the annualized growth of the fourth quarter reaching 5.6 percent, 3.4 percentage points higher than that recorded in the third quarter. Trade deficits fell by 45 percent to USD 380.7 billion. CPI was −0.2 percent, 1.8 percent and 2.7 percent in October, November and December respectively. However, the strength for sustaining recovery seemed not robust. Household consumption remained sluggish, with retail sales declining by 6.2 percent y-o-y in 2009, the largest fall since collecting this indicator in 1993. Unemployment rate stayed at a lofty level, reaching 10.1 percent, 10 percent and 10 percent in the last three months of 2009 respectively. Fiscal deficits continued to climb up, with fiscal deficits growth hitting USD 91.9 billion for the single month of December 2009, marking the 15th consecutive month of fiscal deficits and a record high for monthly growth. Deficits for the fiscal year of 2009 (as of September 30, 2009) amounted to a historical high of USD 1.42 trillion, or 10 percent as a percentage of GDP, the highest level since the Second World War.

The Euro Zone saw a slow recovery, but employment remained grim. The Euro Zone economy worsened sharply into recession after the financial crisis. GDP fell by 3.9 percent in 2009. The Euro Zone saw signs of recovery in the second half of 2009. Reversing negative growth of five consecutive quarters, the Euro Zone economy started a slow recovery beginning from the third quarter of 2009, with GDP growth in the third and fourth quarters being 0.4 percent and 0 percent, better than −2.5 percent and −0.1 percent in the first and second quarters. Large trade surpluses were recorded except EUR 2.3 billion of deficits in August. In particular, trade surpluses in July reached EUR 12.3 billion, the highest level since July 2002, and the total surpluses for the year of 2009 reached EUR 22.3 billion. Deflation was generally brought into control. Inflation was zero in May, then saw decline in the following consecutive months. But HICP rose by 0.5 percent and 0.9 percent respectively in November and December. Driven by large stimulus plan of the governments together with consumption, economic activity turned around gradually. However, the employment remained grim, with unemployment rate hitting 9.8 percent, 9.9 percent and 10 percent in the last three months of 2009. Sovereign debts of five European countries including Greece, Ireland, Italy, Portugal and Spain are great risks, which may have spillover effects and drag the pace of the recovery, if not properly dealt with.

The Japanese economy was yet to shake off deflation in spite of improvement. After the financial crisis Japan launched stimulus plans many times with the total spending reaching around USD 300 billion. In addition, the Bank of Japan kept the benchmark interest rate at the very low level of 0.1 percent, and injected large liquidity to the market. Seasonally adjusted GDP contracted for six consecutive quarters beginning from the second quarter of 2008, and was reversed to positive growth in the second quarter of 2009. GDP growth was −12.4 percent, 0.7 percent, 1.2 percent and 1.1 percent quarter-on-quarter for the four quarters of 2009 respectively, and −5.2 percent for the whole year. Labor market started to turn around in the second half of 2009, with unemployment rate declining for five consecutive months to 5.1 percent in December from the peak of 5.7 percent in July. External trade stabilized, posting positive growth for several consecutive months since the beginning of 2009. Imports and exports fell by 34.9 percent and 33.1 percent to JPY 51.4 trillion and JPY 54.2 trillion respectively, bringing the trade surpluses to JPY 2.8 trillion an increase of 36.1 percent, marking the first growth in two years. Prices continued to drop. CPI declined by 1.7 percent y-o-y in December 2009, which was the 11^{th} consecutive month of price fall, suggesting the economy was yet to shake off deflation.

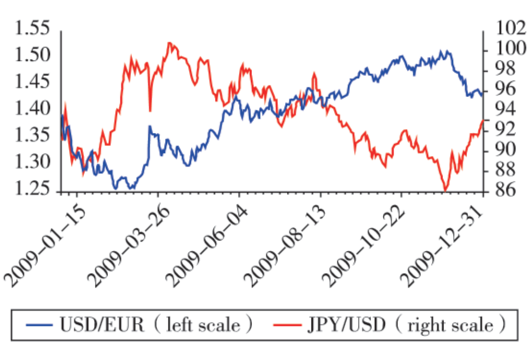
Emerging economies were recovering at varying speeds. Asian economies enjoyed strong growth momentum. The recovery was slower in Middle East and Eastern European economies and uneven in Latin American economies. Timely large stimulus packages launched in response to the crisis and strengthened regional cooperation among major Asian economies resulted in recovery signals in the region even when advanced economies were still at the trough of the financial crisis. In particular, for the year of 2009, GDP grew by 8.7 percent and 5.7 percent in China and India respectively. Four industrial economies including Korea, Singapore, Hong Kong SAR and Chinese Taipei, which were heavily hit by the financial crisis, all saw gradual narrowing of growth decline. GDP growth was 0.2 percent, −2.0 percent, −2.7 percent and −1.9 percent in the four economies respectively in 2009. The recovery in Middle East was bumpy. Marginal growth was recorded in a few economies. In particular, GDP grew by 0.2 percent and 1.6 percent respectively in Saudi Arabia and Iran in 2009. However, the outbreak of the Dubai debt crisis on November 25, 2009 aroused turbulence in global financial markets and had direct spillover effects on Greece, Spain and Baltic countries etc., highlighting uncertainties around the global recovery. The alarm bell was also ringing for asset bubbles, alerting risks of short term capital flows to emerging economies. The recovery in East European countries was slow due to heavy fiscal burdens, weak financial sectors and declining attractiveness to foreign capital. Most East European Economies, except Poland, were still in recession and had a long way to turn around. GDP grew by 1.7 percent in Poland in 2009, driven by private sector and household consumption. Latin American and Caribbean economies were facing contraction after six consecutive years of growth. The Economic Commission for Latin American and Caribbean estimated that GDP growth was −1.7 percent in 2009. The financial crisis had uneven impacts on Latin American Economies in terms of scope and intensity, hitting most hardly Mexico and some Central American and Caribbean economies. As a result, the region was facing a distinctly uneven recovery. Signals of recovery emerged since the second quarter of 2009. In particular, the pace of recovery was brisk in South American countries including Argentina, Brazil, Columbia, and Peru.

Global Financial Market Developments

International Foreign Exchange Markets

The exchange rates among the major currencies experienced wide fluctuations. The exchange rate of the US dollar against the euro and yen saw ups and downs for the year of 2009. As of December 31, 2009, the exchange rate of the dollar against the euro and yen closed at 1. 4332 USD/EUR and 93. 08 JPY/USD. The dollar depreciated by 2. 77 percent against the euro during the year, peaking at 1. 2547 USD/EUR on February 18, 2009 and falling to the lowest level of 1. 5029 USD/EUR on October 23, 2009. The dollar appreciated by 2. 15 percent against the yen for the whole year, peaking at 100. 71 JPY/USD on April 7, 2009 and falling to the lowest level of 86. 12 JPY/USD on November 30, 2009 (Figure 1. 1).

Figure 1. 1 Exchange Rate Movements of Major Currencies



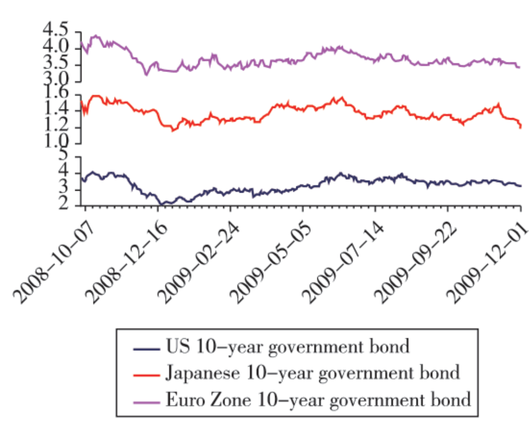
Source: CEIC.

International Bond Markets

The government bond yields of the major economies hiked and then fell back gradually. Following the large interest rate cut of the US Federal Reserve at end-2008, a wave of rate cut was seen around the globe, bringing bond yields to low levels. In the first half of 2009, with investor fears of the global financial crisis abating and increasing consensus about bottoming of the global recession, the demand for long term government bonds in the international bond market declined markedly, leading to rebound of long-term government bond yields. During the course, market concerns over rising fiscal deficits as a result of large economic stimulus in Western governments put some upward pressure on long term government bond yields. In the second half of the year, major government bond yields fell back gradually, as market expected inflation to be contained and major central banks to keep interest rates at low levels. As of end-2009, 10-year government bond yields in the US, the euro zone and Japan closed at 3. 85 percent, 3. 63 percent and 1. 3 percent respectively, a fall of 0. 13, 0. 4 and 0. 26 percentage point from the peak levels during the year (Figure 1. 2).

Figure 1. 2 Government Bond Yields in Major Economies

(*percent*)

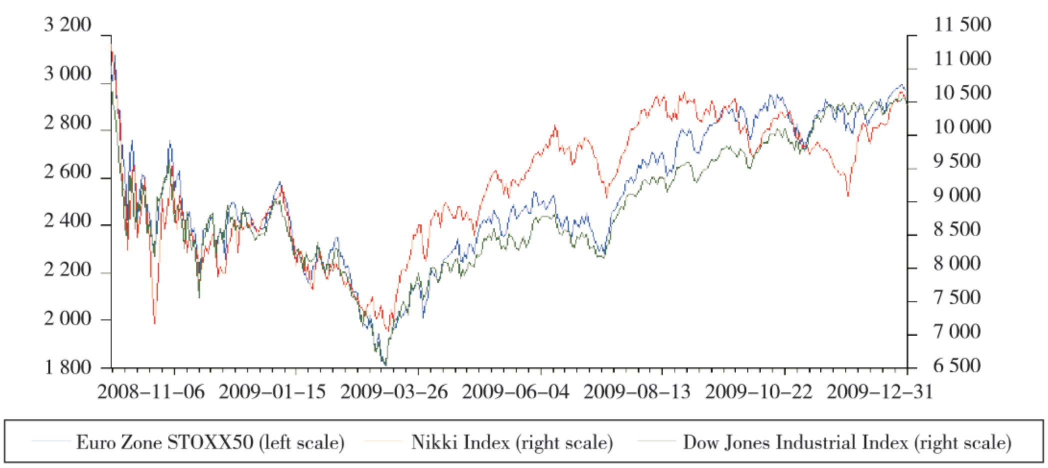


Source: CEIC.

International Equity Markets

The stock indices bottomed out and then rebounded substantially in the major markets in 2009. Since the mid of March 2009, market confidence was boosted by frequent launch of strong unconventional rescue measures and easing of global economic and financial conditions. After the outbreak of the Dubai Debt Crisis on November 25, 2009, the major indices fell once, but rallied upward momentum very fast. As of end-2009, Dow Jones Industrial Index, NASDAQ Index, Euro Zone STOXX50 Index, and Nikkei Index closed at 10 428.05, 2 269.15, 2 966.24 and 10 546.44, rising by 15.4 percent, 39 percent, 16.9 percent and 16.6 percent respectively from the beginning of the year (Figure 1.3).

Figure 1.3　Stock Indices in Major Economies



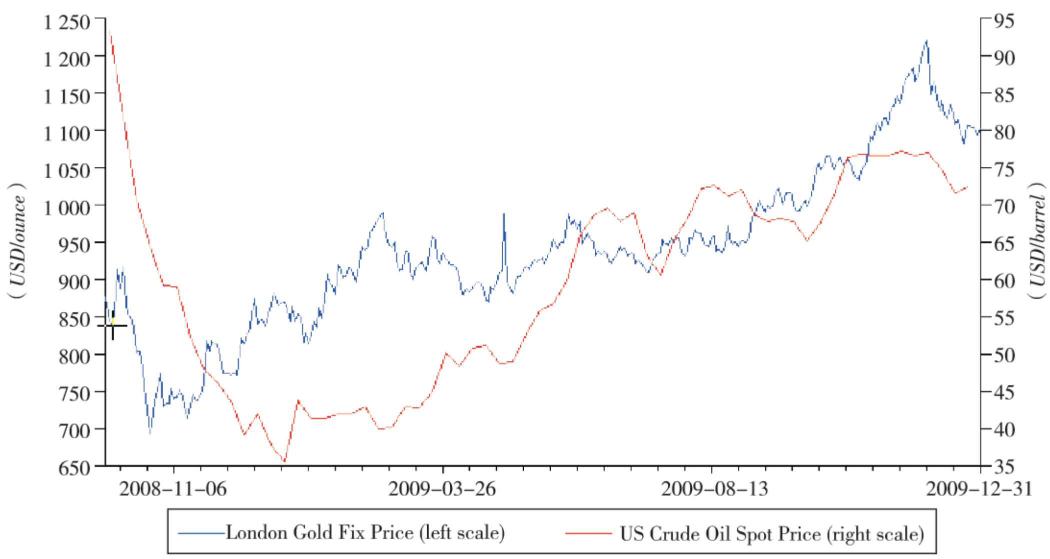
Source: CEIC.

International Commodities Markets

International crude oil prices continued to rise, rebounding substantially back to a high level at end-2009. Crude oil prices reached record high in mid 2008, then fell sharply after the outbreak of the financial crisis, with the OPEC crude oil spot price reaching USD 35 per barrel in early January 2009. Since February crude oil prices entered the trajectory of rise with fluctuations, increasing to USD 77 per barrel at the end of November. The bouncing of crude oil prices was explained by following factors: on the one hand, investors believed the worst of the financial crisis was over and oil demands were to rise ultimately with increasing signals of recovery. On the other hand, the weakening of the dollar in mid and late 2009 resulted in soaring investment demands for futures of commodities including crude oil.

In terms of gold price, the rising period outweighed the falling period during the year, bringing the price to a series of record highs. On September 8, 2009, London gold fix price exceeded USD 1 000 per ounce, and hit a one-year peak of USD 1 218 per ounce on December 3 (Figure 1.4). The gold price soared mainly because of gold's natural function as store of value and capability in withstanding inflation and its increasing attribute of financial asset. In addition, there is strong negative correlation between gold price and the exchange rate of the US dollar since gold price is denominated in the dollar.

Figure 1.4 Gold and Crude Oil Price Changes



Source: CEIC.

Box 1 Economic Stimulus in Major Economies

In September 2008, the US sub-prime crisis rapidly evolved into a global financial crisis marked by the bankruptcy of Lehman Brothers. In response to the shock of the financial crisis, major economies generally launched large economic stimulus measures. The stimulus measures were basically to adopt expansionary fiscal and monetary policies following emergency financial bailouts to maintain financial stability, with a view to boosting market confidence and catalyzing aggregate demand. The aim was also to coordinate short-term demand management and medium and long-term industrial development policies so as to foster sustainable driving forces for economic growth.

Expansionary fiscal policy is an important part of economic stimulus plans. In February 2009, the Obama Administration launched a stimulus plan worth of USD 787 billion based on stimulus measures of the Bush administration featuring tax cuts, with 35 percent of the funds used for tax cuts, and 65 percent used for government investment, including for individual and corporate tax cuts, investment in health care, alternative energies and infrastructure, and fiscal support for state and local governments. The European stimulus plan comprised of stimulus measures both at the European level and member country level. The European Commission approved the economic stimulus plan of EUR 200 billion, including government investment, tax cuts, and subsidies to the disadvantaged. The GBP 20 billion of stimulus plan in UK centered on tax cuts, particularly in VAT of goods sales. Germany launched two stimulus plans one after another, mainly in increasing government subsidies, tax cut, expanding investment in public construction and encouraging businesses not to fire employees. The EUR 26 billion of stimulus plan in France was mainly about fostering car and construction industries, boosting construction of public infrastructure, supporting SMEs and granting subsidies to the poorest families. After August 2008, Japan launched many stimulus plans successively, with the total spending reaching around USD 300 billion. The main elements were helping SME financing, tax (fee) cut, increasing subsidies and protecting employment and public livelihood. Furthermore, stimulus measures were taken in Australia, Canada and Korea, etc. In sum, expansionary fiscal policy measures were concentrated in tax cut (rebate), boosting investment, supporting SMEs and protecting public livelihood, with support for the car industry emphasized both in US and in Europe. In terms of policy intensity, stimulus plans in US and Japan as a percentage of GDP were obviously higher than those in other countries.

Monetary policy played an important role in fostering recovery. Major economies all cut interest rates by a large margin after the outbreak of the crisis. The US Federal Reserve cut interest rate on ten occasions with the federal funds target interest rate falling from 5.25 percent to 0 – 0.25 percent. The ECB cut interest rates on seven consecutive occasions by 325 basis points to 1 percent. The Bank of Japan cut interest rates twice by 40 basis points to 0.1 percent, and the Bank of England cut interest rates on nine consecutive occasions to 0.5 percent. As a result, policy rates in all major economies were cut to zero or close to zero. Meanwhile, the Federal Reserve provided liquidity support to financial institutions and markets with a series of innovative instruments such as TAF, TSLF, and PDCF which are targeting financial institutions and CPFF, MMIFF and TALF which are targeting financial markets. Since the adoption of the " zero -

interest-rate" policy, major economies took a series of unconventional monetary policy measures focusing on quantitative adjustment. The US Federal Reserve's unconventional monetary policy comprised two parts: the first was purchase of private assets, mainly MBS and bonds of Fannie Mae and Freddie Mac. The second part was direct purchase of treasury bonds. Like the Federal Reserve, the Bank of England took the above two measures to directly buy private assets, and as the first to declare implementation of "quantitative easing" monetary policy, to launch APF to purchase government bonds. The ECB announced a plan to purchase 60 billion euros of covered bonds. Japan provided support for corporate financing through purchasing CPs from financial institutions, launching acquisition plan of bank sub-prime lending and subordinated bonds, and increasing quota of government bonds purchase.

Moreover, major economies also focused on guiding the development of newly emerging industries. The US stressed fostering development of new energies and environmental protection industries, and the Europe emphasized on lifting "green technology" level to promote development of low carbon industries. These efforts were aimed to look for new driving forces for growth and lay the foundation for next round of sustainable growth.

In sum, stimulus packages in major economies played an active role in fighting the shock of the international financial crisis, boosting market confidence and fostering economic recovery. However, prolonged and excessive reliance on expansionary fiscal and monetary policies may bring about inflation and systemic fiscal and financial risks. Therefore there is a need for timely adjustment and exit of stimulus plans in light of economic developments, posing challenges to macro management in all countries. Despite a slow recovery of the global economy, new driving forces of growth were not clear yet. In the long run, economic transformation and structural adjustment will be needed to increase economic growth potential and transform development patterns to shape a sustainable development mode.

Highlights of China's Economic and Financial Performance in 2009

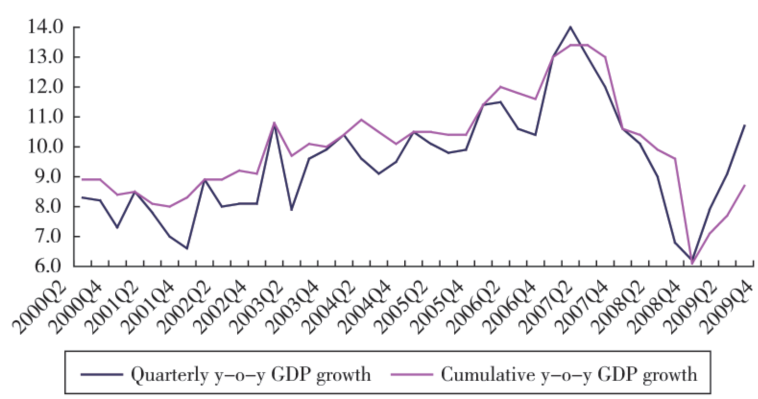
The year 2009 turned out to be the most difficult year for the Chinese economy since the beginning of the new century. In the face of serious challenges and complex situation brought about by the global financial crisis, China adopted a proactive fiscal policy and moderately loose monetary policy, and implemented and enhanced a package of policy measures to address the crisis, which helped reverse the sharp decline in growth quickly and secure an overall economic upturn.

Economic Growth Recovered Quickly

According to the preliminary data released by the NBS, China's GDP registered RMB 33.5 trillion yuan in 2009, representing a y-o-y growth of 8.7 percent in comparable terms, down 0.9 percentage point from the previous year (Figure 1.5). Quarterly GDP growth gained pace, growing by 6.2 percent, 7.9 percent, 9.1 percent and 10.7 percent in each quarter. Broken down by industries, added value of the primary industry stood at RMB 3.55 trillion yuan, a rise of 4.2 percent, down 1.3 percentage points from the growth in 2008; added value of the secondary industry reached RMB 15.70 trillion yuan, growing by 9.5 percent, up 0.2 percentage point y-o-y; and added value of the tertiary industry recorded RMB 14.29 trillion yuan, an increase of 8.9 percent, which is 0.6 percentage point lower than the growth in 2008. Regarding their respective share in the GDP, added value of the primary industry accounted for 10.6 percent of GDP, down 0.2 percentage point from the year earlier; added value of the secondary industry made up 46.8 percent of GDP, down 0.6 percentage point; and added value of the tertiary industry was 42.6 percent of GDP, up 0.8 percentage point.

Figure 1.5 Cumulative and Quarterly Y-o-Y GDP Growth

(*percent*)



Source: NBS.

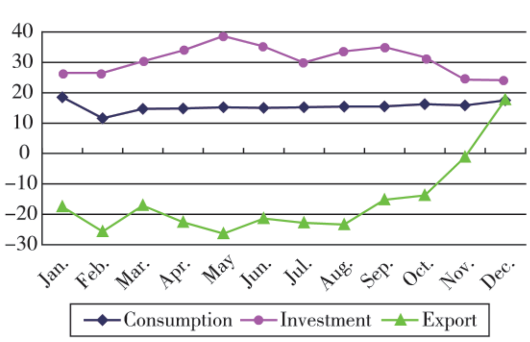
Domestic Demand Expanded Rapidly and External Demand Improved

Domestic demand expanded rapidly in 2009. Total fixed asset investment reached RMB 22.48 trillion yuan, y-o-y growing by 30.1 percent in nominal terms, an acceleration of 4.6 percentage points, or by 35.2 percent in real terms, which was 17.1 percentage points higher than the real growth in 2008. In particular, urban fixed asset investment increased by 30.5 percent to RMB 19.41 trillion yuan, which was 4.4 percentage points higher than in 2008. It grew by 35.6 percent in real terms, an acceleration of 17 percentage points. Total retail sales recorded RMB 12.53 trillion yuan, representing a nominal growth of 15.5 percent y-o-y, down 6.1 percentage points, or a y-o-y real growth of 16.9 percent, up 2.1 percentage points.

External demand improved. In 2009, export dropped by 16 percent to USD 1 201.7 billion, while import declined by 11.2 percent to USD 1 005.6 billion, narrowing the trade surplus to USD 196.1 billion, down USD 102 billion y-o-y. In terms of monthly growth, supported by global recovery, export began to improve since August 2009, culminating in the first positive y-o-y growth in December, while import also resumed expansion in November, ending the contraction that lasted for 11 and 12 consecutive months since November 2008 respectively (Figure 1.6).

Figure 1.6 Monthly Y-o-Y Growth of Consumption, Investment and Export 2009

(*percent*)



Source: NBS.

Fiscal Revenue Recovered Month on Month while Fiscal Spending Kept Increasing Rapidly

China implemented a proactive fiscal policy in 2009. Major measures in this regard included efforts to increase public investment to support key projects, reform tax and fees to deliver structural tax reduction, raise income for low-income groups, optimize the fiscal spending structure to improve people's livelihood, and step up support for technological innovation, energy conservation and emission reduction to promote economic restructuring and the transformation of development pattern. Fiscal revenue increased gradually as the fundamentals improved, and fiscal pressures, which had been high at the beginning of the year, began to ease in the second half of the year. As the y-o-y revenue growth climbed to 55.8 percent in December from −17.1 percent in January, fiscal revenue for 2009 as a whole registered RMB 6.8 trillion yuan, a y-o-y rise of 11.7 percent. Fiscal spending had been growing quickly, particularly in the first three months, when spending was expanded by 32.5 percent, 42.0 percent and 31.4 percent respectively y-o-y in an effort to boost economic improvement amid sluggish performance. Although it slowed down later as the overall economic performance gradually strengthened and due to a large base in the last year, overall fiscal spending remained high. For 2009 as a whole, fiscal spending stood at RMB 7.6 trillion yuan, a y-o-y increase of 21.2 percent, down 4.5 percentage points.

Box 2 China's Stimulus Package

To address the heavy shocks of the global financial crisis and the extremely complex situation both at home and abroad, based on a review of the developments and a scientific decision-making process, the CPC Central Committee and the State Council designed and enhanced a package of policy measures to deal with the financial crisis, marking the beginning of a new round of macroeconomic management in China.

On November 5, 2008, the State Council Regular Meeting discussed measures to expand domestic demand and support sound and relative rapid growth. The meeting decided to adopt a proactive fiscal policy and moderately loose monetary policy, and to take 10 measures to support domestic demand expansion and economic growth. These measures included strengthening efforts to enhance affordable housing projects, rural infrastructure, railway, highway, airports and other key infrastructure projects, healthcare, cultural and education programs, ecological development, independent innovation and structural adjustment, and post-disaster reconstruction. In addition, measures will be taken to increase income of urban residents, press ahead with the nation-wide VAT reform in all industries to encourage technological upgrading, and step up financial support to economic growth. According to the plan laid down in November 2008, the central government will invest another RMB 1.18 trillion yuan in the next two years until 2010, which is expected to leverage private investment, bringing the total investment in this round of economic stimulus to RMB 4 trillion yuan.

To ensure the implementation of these policy measures, the State Council released a series of policies. On November 12, 2008, the State Council set out 4 measures in an effort to boost domestic demand, i.e., to introduce examination-based approval process for fixed asset investment projects, raise tax rebate and adjust tariff for a number of export products, finalize the detailed arrangement of the post-disaster reconstruction fund backed by the central government budget, and strengthen efforts to restore forest ecology. On December 13, the State Council issued the *Several Opinions of the General Administration Office of the State Council on Extending Financial Support to Economic Development*, which includes 30 opinions on 9 areas that require efforts in implementing moderately loose monetary policy, maintaining steady money and credit growth, providing better credit services and meeting reasonable demand for funds. On December 21, the *Several Opinions of the General Administration Office of the State Council on Promoting Healthy Development of the Real Estate Market* was issued. In 2009, the Chinese government announced plans to revitalize 10 major industries, i.e., automobile, steel, textiles, equipment manufacturing, shipping, electronic and information, light industry, petroleum and petrochemicals, non-ferrous metal and logistics. In parallel, the government made plans to enhance the supportive role of technology and speed up the progress of key technological projects. It released policies to encourage rural residents to purchase cars and household appliances and to trade in used home appliances, and designed 6 policy measures to stabilize external demand. It also approved in principle the *Plan to Reinvigorate the Cultural Industry and the Opinions on Accelerating the Development of Tourism.*

China's stimulus package consisted of policies in four major areas, i. e., massive government investment, wide industrial adjustment and revitalization, strong technological support and substantial improvement of social security. These four mutually reinforcing and integral areas testified to the stimulus package's ambition to deal with both immediate and long-term issues and address both symptoms and root causes. As a result of the stimulus package, supportive factors increased, and the sharp decline in growth was quickly reversed, contributing to an overall economic upturn.

Household Income Grew Steadily and Employment Outperformed Expectations

In 2009, per capita disposable income of urban residents was RMB 17 175 yuan, a y-o-y growth of 8. 8 percent in nominal terms, or 9. 8 percent in real terms, which was 1. 4 percentage points higher than the real growth in 2008. Net per capita income of rural residents was RMB 5 153 yuan, a y-o-y growth of 8. 2 percent in nominal terms or 8. 5 percent in real terms, up 0. 6 percentage point. Supported by quick domestic recovery and a rebound in the global economy, business orders rose to the pre-crisis level, and companies began to see an employment shortage. The PMI employment index had remained above 50 percent since June and stood at 52. 2 percent in December, indicating an improving employment in the manufacturing sector. According to statistics, urban employment increased 9. 1 million in net terms y-o-y in 2009, while migrant workers from rural areas totaled 149 million at end-2009, an increase of 1. 7 million from the end of the first quarter in 2009.

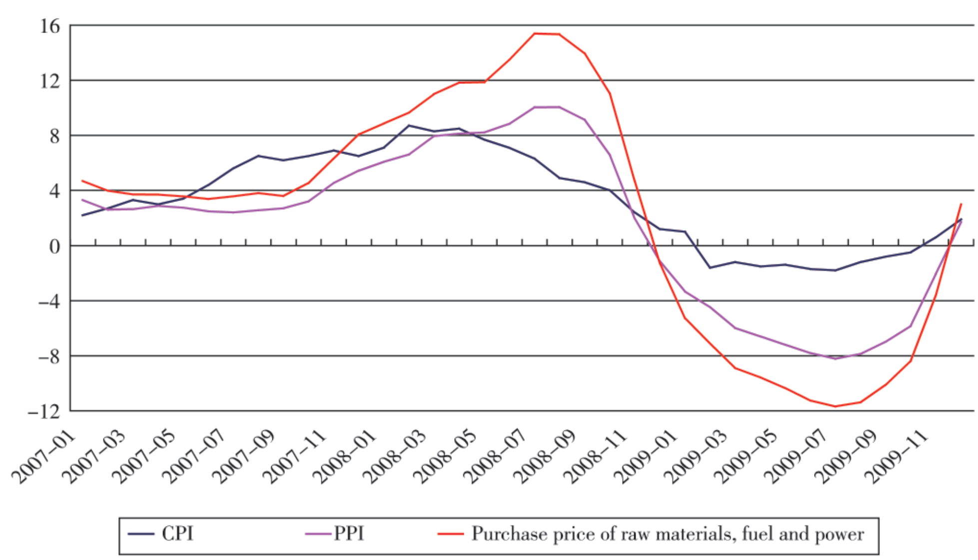
Price Picked up after Remaining Low, and Faced Intensifying Upward Pressure

The CPI stayed at a low level and then picked up later in the year. Due to weak demand as a result of the global financial crisis and the high base level in 2008, CPI registered in February 2009 its first negative y-o-y growth of 1. 6 percent since 2003. It further dropped by 1. 8 percent y-o-y in July to a record low since July 1999. Later, supported by a strong recovery momentum and weaker effect of the negative tail-raising factor, CPI rose by 0. 6 percent y-o-y in November, ending the negative y-o-y growth seen in the past 9 months in a row. For 2009 as a whole, CPI declined by 0. 7 percent, a deceleration of 6. 6 percentage points. It dropped by 0. 6 percent, 1. 5 percent and 1. 3 percent and went up by 0. 7 percent y-o-y in each quarter respectively.

The price of industrial products rebounded quickly after noticeable decline earlier in the year. The PPI continued its downward trend since September 2008 in the first 6 months of 2009, and dropped y-o-y by 9.2 percent in July, the sharpest monthly drop in record. It then began to rise along with production materials price as commodity prices increased and the domestic economy began to recover. In December 2009, the PPI rose by 1.7 percent from the same period of last year, ending the 12-month negative growth. The PPI dropped by 5.4 percent from the previous year in 2009, a deceleration of 12.3 percentage points, and decreased by 4.6 percent, 7.2 percent, 7.7 percent and 2.1 percent y-o-y in each quarter respectively. The purchase price of raw materials, fuel and power went down by 7.9 percent annually, a deceleration of 18.4 percentage points, and declined y-o-y by 7.1 percent, 10.4 percent, 11.1 percent and 3.0 percent in each quarter (Figure 1.7).

Figure 1.7 Movements of Major Price Indicators

(*percent*)



Source: NBS.

Price of Major Assets Went up Quickly

Driven by a stabilizing and improving economy, abundant liquidity and rising profits of listed companies, the stock market and the real estate market warmed up and surged to new highs. The Shanghai Stock Exchange and the Shenzhen Stock Exchange recorded a combined cumulative annual turnover of RMB 53.60 trillion yuan in 2009, up 100.66 percent y-o-y, and the daily average turnover stood at RMB 219.7 billion yuan, up 102.31

percent y-o-y. At end-2009, the Shanghai Composite Index and the Shenzhen Component Index closed at 3 277.14 points and 13 699.97 points respectively, up 79.98 percent and 111.24 percent from the same period of last year. Total market capitalization of tradable shares soared by 234.54 percent y-o-y to RMB 15.13 trillion yuan as of end-2009. The average P/E ratio[1] for A-shares in the Shanghai Stock Exchange and the Shenzhen Stock Exchange rose to 29 times and 46 times at end-2009 from 15 times and 17 times at end-2008 respectively.

In 2009, the Chinese government introduced a raft of policies to promote the healthy development of the real estate market. These policies played an important role in boosting confidence, supporting market activities, addressing housing problem of low-income families and encouraging consumption and investment in the real estate market. As a result, house price index had been on the rise since March 2009, and picked up by 8.2 percent cumulatively in 70 large and medium-sized cities between March and December.

Money and Credit Grew Rapidly and the RMB Exchange Rate Remained Basically Stable on an Adaptive and Equilibrium Level

In 2009, in line with the overall arrangement of the CPC Central Committee and the State Council, PBC and other government agencies implemented a moderately loose monetary policy, ensured that liquidity in the banking system remained abundant, and guided financial institutions to increase credit extension, optimize credit structure, and step up financial support to economic growth. In general, the moderately loose monetary policy was transmitted effectively, playing a critical role in expanding aggregate demand, supporting economic upturn and checking the deflationary expectation, which was high at the beginning of the year. PBC also attached great importance to maintaining stable and sustainable credit growth and preventing financial risks, and managed the focus, intensity and pace of policies in a forward-looking and flexible manner. As a result, credit growth in the third and fourth quarter moderated with a steadier pace, which helped prevent and resolve possible risks that may affect the long-term stability of economic development.

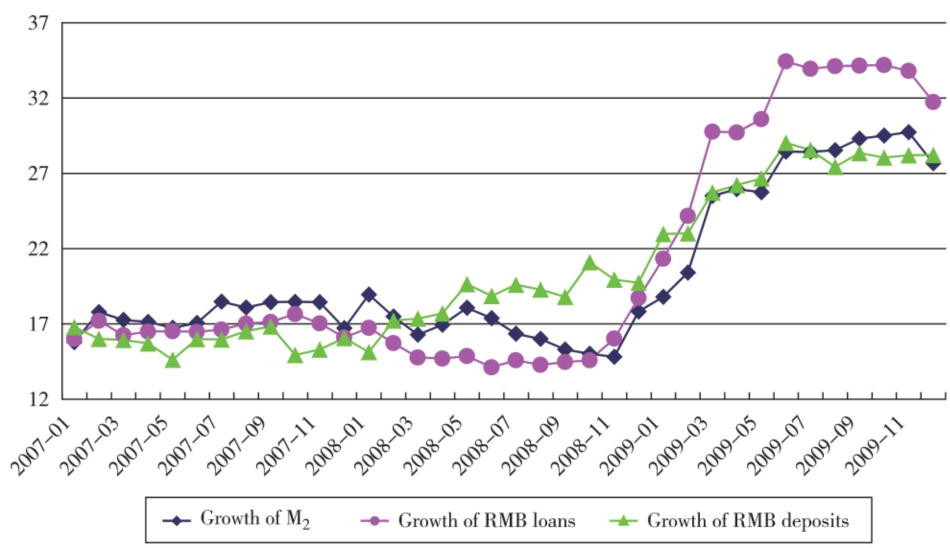
At end-2009, broad money supply M_2 stood at RMB 60.62 trillion yuan, representing a y-o-y increase of 27.68 percent, an acceleration of 9.86 percentage points (Figure 1.8). RMB loans grew 31.74 percent y-o-y to 39.97 trillion yuan, a growth that is 13.01 percentage points higher than the growth in the same period of last year. In particular, newly extended RMB loans reached 9.59 trillion yuan, up 4.69 trillion yuan from a year earlier. RMB deposits registered 59.77 trillion yuan, expanding by 28.21 percent in y-o-y terms, an acceleration of 8.48 percentage points. Foreign exchange reserve grew by 23.28 percent y-o-y to USD 2 399.2 billion, up USD 453.1 billion, an acceleration of USD 35.3 billion. The RMB exchange rate remained basically

1 The P/E ratio for 2009 is based on financial data of 2008.

stable at an adaptive and equilibrium level, with the central parity of the RMB against the US dollar posting 6.8282 yuan per dollar at end-2009.

Figure 1.8 Y-o-Y Growth of M_2, RMB Loans and Deposits

(*percent*)



Source: PBC.

Box 3 The Pilot Program of RMB Settlement of Cross-border Trade Transaction Proceeded Steadily

There have been increasingly stronger calls for a reform of the existing international monetary system since the financial crisis broke out. The RMB is more widely accepted in emerging market economies, neighboring economies in particular, and is in greater demand for cross-border uses. In response to this development, and to meet market demand, the cross-border use of the RMB was promoted in a steady manner.

An overview of cross-border use of the RMB. China has taken a series of measures to facilitate trade and investment in recent years to promote the healthy development of foreign trade and cross-border investment. First, the pilot program of settling border trade in domestic currencies was started. To support border trade development, PBC has entered into domestic currency settlement agreements with the central banks of 8 neighboring countries, i.e., Vietnam, Mongolia, Russia, Kyrgyzstan, Laos, the DPRK, Nepal and Kazakhstan. The agreements provided arrangements on transferring RMB notes and opening RMB accounts in border area, which facilitated the use of RMB in settling border trade transactions. Second, RMB clearing arrangements were established for banks in Hong Kong and Macao. To meet the demand of growing economic and trade ties between the mainland and Hong Kong SAR and Macao SAR, and to facilitate tourism, consumption and travel, at the request of the government of the Hong Kong SAR and the Macao SAR, PBC provided clearing arrangements for RMB businesses conducted by banks in Hong Kong SAR and Macao SAR in November 2003 and August 2004 respectively. As of end-2009, the balance in the RMB clearing accounts in Hong Kong SAR stood at RMB 47.7 billion yuan, and totaled RMB 1 836 million yuan in the RMB clearing accounts in Macao SAR. Third, the pilot program of RMB settlement of cross-border trade transactions was launched. In July 2009, the first RMB settlement of cross-border trade deal was completed in Shanghai, and the program was then started in four cities in Guangdong province, i.e., Guangzhou, Shenzhen, Zhuhai and Dongguan. Fourth, cross-border RMB financing was initiated on a trial basis. Since November 2009, a number of banks, including CDB, EXIM, ICBC, BOC and CMB, have been allowed to finance overseas projects in RMB on a trial basis in an effort to encourage financial institutions to extend greater support to foreign trade and the "Going Global" initiative and to facilitate trade and investment.

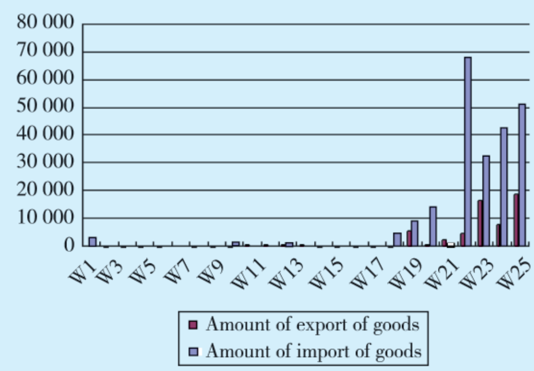
The pilot program of settling cross-border trade transactions in RMB was advanced smoothly. First, relevant institutions have been established. In July 2009, *the Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions* and *the Regulations for Implementing the Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions* were published. Following this, the State Administration of Taxation and the General Administration of Customs issued notices, which specified that a pilot enterprise did not need to provide foreign exchange verification forms for claiming export tax rebate (exemption) and customs declaration, and could make customs declaration in the RMB outside the local region. The notices also defined rules on export tax rebate (exemption), customs declaration and other issues. PBC also signed separate memoranda on data exchange with the General Administration of Customs and the State Administration of Taxation to realize information sharing, which marked the completion of the development of basic settlement and clearing institutions and the policies on customs declaration and export tax rebate (exemption). Second, the RMB RCPMIS, which was designed by PBC to collect statistics of cross-border RMB receipt and payment and support analysis and monitoring, performed stably. Third, various businesses under the pilot program progressed in an orderly manner. In general, the pilot program advanced smoothly with efficient settlement and clearing channels, clear policies and easily actionable procedures on export tax rebate and customs declaration, and continued progress in RMB settlement, financing and RMB purchase and selling. As of end-2009, a total number of 409 cross-border trade transactions were settled in the RMB, involving RMB 3 583 million yuan. Agent banks in the mainland sold RMB 359 million yuan in 59 cross-border deals, and purchased RMB 218 million yuan in 16 cross-border deals. They also reported 4 cross-border RMB financing deals worthy of RMB 7.11 million yuan. Clearing banks in Hong Kong processed 6 cross-border RMB borrowing deals, totaling RMB 1.61 billion yuan. Interbank RMB accounts opened for overseas participating banks by agent banks in the mainland reached 160, with a balance of RMB 688 million yuan. The weekly number and turnover of RMB settlement deals, and settlement broken down by countries (regions) are shown in Figure 1.9, Figure 1.10, and Figure 1.11.

Figure 1.9 Weekly Number of RMB-settled Cross-border Deals

Source: PBC.

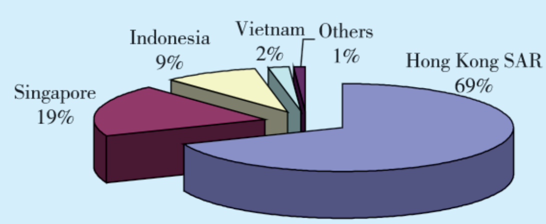
Figure 1.10 Weekly Amount of RMB-settled Cross-border Deals

(10 thousand of RMB yuan)



Source: PBC.

Figure 1.11 RMB-settled Cross-border Deals Broken down by Countries (Regions)



Source: PBC.

Greater cross-border use of RMB. Going forward, efforts will be needed to promote the development of cross-border use of RMB and other related businesses. This would be guided by the principle of making it a steady and gradual process and making sure risks are under control, so that its progress will be in line with that of financial institutional reform and liberalization of capital accounts. First, the pilot program of RMB settlement of cross-border trade will be expanded to cover other regions and a greater number of companies, and the pilot program of settling cross-border services trade in RMB will be launched. Second, efforts will be made to make interest rates market-oriented, further open up the domestic financial market, and provide more channels for overseas institutions to access and use the RMB. Third, commercial banks shall receive support in providing RMB trade financing and project financing overseas by market principle. Fourth, it is important to explore the development of a bilateral exchange rate mechanism between the RMB and small currencies, and introduce products of RMB against small currencies in the interbank foreign exchange market. Fifth, the Hong Kong market's role as a window will be enhanced to encourage the cross-border use of the RMB.

Global Economic Outlook in 2010

As a result of the exit of extraordinary stimulus policies across countries, reduced intensity of policies that have been the main growth driver, delayed restoration of normal function of the financial sector and slow consumption and investment growth, global growth in 2010 is expected to remain below the pre-crisis level. According to the forecast of IMF, the global GDP will grow by 4.2 percent, which is 1 percentage point lower than the growth in 2007 before the crisis started.

Recovery in advanced economies will be slow in 2010, accompanied by high unemployment rate, while recovery in emerging market economies will proceed at a faster pace. Projections made by IMF indicate that the economy of the US, Euro Zone, Japan, UK, and emerging market and developing economies will expand by 3.1 percent, 1.0 percent, 1.9 percent, 1.3 percent and 6.3 percent respectively in 2010, up 5.5 percentage points, 5.1 percentage points, 7.1 percentage points, 6.2 percentage points, and 3.9 percentage points y-o-y. Inflation pressure will build up in emerging market and developing economies, which is projected to stand at 6.2 percent, up 1 percentage point from 2009. Inflation in advanced economies will be moderate, and is projected to be 1.5 percent, up 1.4 percentage points from 2009.

Though the worst is already over, as shown by major economic indicators, global recovery faces great uncertainty. Going forward, the global economy will face a number of major potential risks.

Uncertainty over recovery is compounded by the difficult decision on the withdrawal of stimulus policies. Despite major economies' position that a premature exit of extraordinary policies should be avoided, the US and Europe had already begun phasing out financial rescue instruments since the third quarter of 2009. The US ceased rescue plans for the money market funds, the UK and Switzerland ended the 3-month dollar repurchase operations, while Israel, Australia and Norway raised interest rates. A lack of global coordination on the timing and modality of exit is likely to lead to massive carry trade and exacerbate the disorderly flows of speculative capital across countries, cause dramatic fluctuations in the financial market, and ultimately drag down recovery. Despite of signals of policy adjustment in a number of countries, more countries, promoted by a cautious reading of recovery, are likely to hold interest rate at a low level for a considerably long period of time, a move that will inflate asset prices and intensify inflation pressure.

Unemployment rate remains high in major advanced economies. Though countries had adopted a wide range of measures to lift the economy out of recession when the crisis hit, unemployment rate in major advanced economies remains elevated, which will have a direct impact on private consumption and push up savings rate, thus hindering economic recovery.

The financial system remains fragile. According to IMF estimation, of the massive USD 3.6 trillion worth of potential losses of financial institutions worldwide incurred by the financial crisis, a half has yet to be exposed. Though major banks have stabilized, the lingering excessive leveraging and the time-consuming repairing of financial institutions' balance sheets mean that the global financial system is still fragile.

Sovereign debt risks have heightened. The debt crises in Iceland, Dubai and Greece and the downgrading of a number of European countries' sovereign credit rating have triggered concerns over fiscal sustainability. If no effective measures are taken to cut fiscal deficits, major economies could also face default risks and sovereign debt crisis, which will threaten global growth.

Short-term international capital flows add to the difficulty for emerging market economies to manage their economy. Massive liquidity was injected into the market when the crisis struck. As the economy improves, international capital, particularly short-term capital, is beginning to find its way back to emerging market economies, particularly emerging market countries in Asia, where the recovery is strong. This will result in asset price hikes, rapid currency appreciation, and reactive expansion of foreign reserve, making macroeconomic management in these regions and countries considerably more difficult and exposing their economy to greater vulnerability. The expected reversal of international capital flows, which is supported by global economic and financial improvements and the gradual exit of stimulus policies, will deal a heavy blow to emerging market economies. It may even trigger a regional crisis in emerging market economies, and threaten the sustained global growth and stability.

Volatility in the US dollar will weigh on economic recovery. Dramatic fluctuations in the US dollar exchange rate may drag down global recovery. While sharp dollar appreciation will translate into pressures on global capital markets and commodity prices, thus having a direct impact on the development of countries dependent on resources, rapid dollar depreciation could undermine financial stability through higher commodity prices and asset price bubbles.

Trade protectionism is surging again. Despite of the much-repeated position on opposing trade protectionism by Leaders at the G20 Summits, many G20 countries, considering short-term interests, are taking protectionist measures in an explicit or implicit manner, including higher import tariff, "Green Barriers", and higher export subsidies. According to the statistics of the World Bank, 17 members of the G20 adopted as many as 47 protectionist measures in a short time span between November 2008 and March 2009. Trade protectionism hampers bilateral trade development, harms the robustness of the international market, and even puts economic recovery in danger.

Box 4 International Capital Flows Since the Onset of the Financial Crisis

The eruption of the global financial crisis in the second half of 2008 led to widespread economic slowdown in major economies and even triggered recession in some cases. As financing in global financial markets deteriorated and financial institutions and companies began to de-leverage, global capital flows contracted quickly, and returned to advanced economies from emerging market and developing economies. According to the IMF statistics, net private capital flow to emerging and developing economies plunged by 81.4 percent from the record high of USD 696.5 billion in 2007 to USD 129.5 billion in 2008. Global FDI and cross-border mergers and acquisitions also diminished. Data from the UNCTAD shows that global FDI and cross-border mergers and acquisitions dropped by 15 percent and 29 percent y-o-y respectively in 2008.

International capital flows fell and then expanded later in 2009. As the financial crisis deteriorated in width and depth at the beginning of the year, advanced economies fell into severe recession, while in most emerging market economies, which were hit by weak external demand, falling commodity prices and a lack of funds, foreign trade and investment contracted notably and growth slowed down, further reducing global capital flows. Data from the UNCTAD suggests that global cross-border mergers and acquisitions in the first quarter of 2009 fell by 77 percent y-o-y and by 62 percent from the first quarter and fourth quarter of 2008 respectively. In the second half of 2009, driven by the vigorous macroeconomic management measures and financial rescue policies adopted by countries, and led by emerging market economies in particular, global economy showed signs of stabilization and improvement, and global capital flows began to restore gradually. Carry traders began to target at the US dollar as dollar interest rate had fallen below Japanese Yen in the money market since August 2009 due to low interest rate policy in the US. They borrowed in dollar to invest in high yield assets in emerging market economies. As housing and stock prices surged in Korea, India, Brazil, Argentina and other emerging market economies, more countries were considering capital control or other restrictions to minimize the shocks on their financial markets of massive hot money inflow.

Global capital flow is still below the pre-crisis level. According to the UNCTAD, global FDI in 2009 declined by 39 percent y-o-y, and was only half of the peak in 2007. Going forward, international capital flow is expected to stabilize as the global economic and financial situation improves. However, regional financial turbulence is likely to re-emerge, since the de-leveraging process and removing of bad loans in the financial system in major economies will take time, carry trade and speculation are on the rise again, and new asset price bubbles and financial risks are building up. All these may result in dramatic change in the size of international capital and uncertainties on its direction, and pose great challenges for developing countries in particular in improving monetary policies and safeguarding financial stability.

Outlook for China's Economy in 2010

Supported by an increasing number of favorable factors, China's economy is expected to continue the sound and relatively rapid growth in 2010. However, the growth will face challenges from complex domestic and global environment. GDP growth had already improved considerably and, compared with the growth of 6.1 percent in the first quarter of 2009, posted 10.7 percent in the last quarter of 2009, indicating an accelerating recovery is on the way. The external environment will improve gradually as the global economy recovers, while domestic economic activities and confidence will strengthen as macroeconomic management policies are being implemented. Local governments are enthusiastic about speeding up development and expanding investment. Urbanization and consumption structure upgrading will also contribute more to growth. Nevertheless, difficulties that weigh on stable and relatively rapid economic development persist. On the one hand, uncertainty over new global growth sources, limited space for greater stimulus measures in major economies because of concerns on fiscal sustainability and asset price bubbles, increasing trade frictions, and the exit of stimulus policies will have an impact on the global economy and China's external development environment as well. On the other hand, the root problems that limit China's economic development have yet to be resolved, the domestic demand expansion is not solidly based, and private investment and endogenous growth drivers will need to be enhanced. Expanding consumption, promoting development pattern shift and optimizing the economic structure remains a challenging task. Moreover, potential risks in public finance must not be overlooked. Particularly, management of risks arising from investment and financing platforms of local governments needs to be strengthened. In addition, uncertainty over price movements will increase as a result of movements of the US dollar exchange rate and commodity prices as well as the adjustment of resources and energy prices at home. In general, economic performance in 2010 will be subject to more complex developments, and macroeconomic management will face an increasing number of new problems and challenges.

In this context, it will be important to make polices better targeted and more flexible in line with new developments while ensuring policy consistency and stability. Particularly, it will be necessary to strike a balance between supporting sound and relatively rapid growth, restructuring the economy and managing inflationary expectations. First, the proactive fiscal policy and moderately loose monetary policy will be continued, and the package of measures aimed to address the global financial crisis will be improved to maintain the strong momentum of recovery. Second, with the focus on shifting economic development pattern and accelerating economic restructuring, actions will be taken to implement the differentiated credit policies so as to ensure that loans are used to support the real economy, particularly the most important and critical links of the economy. In this regard, financial institutions will be guided to rein in lending to highly energy-consuming and highly pollutant industries as well as industries with overcapacity. They will be encouraged to step up support to weak areas in the society, emerging industries of strategic importance, and industrial relocation, and to focus on credit quality and efficiency. Third, efforts will be made to employ a wide range of fiscal and monetary tools, closely watch price movements, properly manage inflationary expectations, and strengthen financial risk prevention to sustain the sound and relatively rapid economic development.