China Monetary Policy Report
Quarter One, 2009

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Monetary Policy Analysis Group of

the People's Bank of China

Executive

Summary

In the first quarter of 2009, the package of policies released by China to expand domestic demand and promote stable and relatively rapid economic growth to address the international financial crisis began to take effect. Economic performance showed positive changes, market confidence was restored to some extent, and the situation was better than previously expected. Consumption grew rapidly, investment growth accelerated, and domestic demand rose steadily. The situation in the agricultural sector remained generally stable, and industrial production growth was stabilizing. Liquidity in the banking system was ample, money and credit supply increased rapidly, and the financial system performed in a stable manner. In the first quarter, the Gross Domestic Product (GDP) registered 6.6 trillion yuan, representing a year-on-year rise of 6.1 percent, and the Consumer Price Index (CPI) declined 0.6 percent year on year.

In line with the overall arrangements of the CPC Central Committee and the State Council, and in order to serve the overall objective of supporting economic growth, expanding domestic demand, and restructuring the economy, the PBC implemented a moderately loose monetary policy, adopted flexible and effective measures to step up financial support for economic growth, and ensured that aggregate money and credit supply satisfy the needs of economic development. The PBC timely and appropriately conducted open market operations to ensure ample liquidity in the banking system in general and to stabilize market expectations. At the same time, the PBC guided financial institutions to increase the credit supply, optimize the credit structure, and, following the principle of *differentiated treatment and encouraging growth in some sectors while discouraging growth in others*, to strengthen credit services to agriculture, rural areas, farmers, small- and medium-sized enterprises, employment programs, post-disaster reconstruction, consumption expansion, and independent innovation, while ensuring that loans to eligible central government investment projects are granted in a timely manner.

Money and credit supply increased rapidly, and lending rates continued to decline. At end-March 2009, broad money supply M2 posted 53.1 trillion yuan, up 25.5 percent year on year and an acceleration of 9.3 percentage points over the same period of the last year. RMB loan growth accelerated further. At end-March, outstanding RMB loans stood at 35 trillion yuan, a year-on-year increase of 29.8 percent and an acceleration of 15 percentage points over the same period of the last year, or 11.1 percentage points over the end of the last year. In the first quarter, RMB loans increased 4.6 trillion yuan, 3.2 trillion yuan more than the growth in the same period of the last year. RMB lending rates continued to decline. In March, the weighted average interest rate of loans to non-financial corporations and other sectors was 4.76 percent, down 0.8 percentage points from the beginning of the year. The RMB exchange rate remained basically stable at an adaptive and equilibrium level, with the central parity of the RMB against the U.S. dollar posting 6.8359 yuan per dollar at end-March.

The international financial crisis is still spreading, and its impact on the Chinese economy is deepening. Continuously weakening external demand, excess capacities in some industries, falling corporate profits, and intensifying employment difficulties have imposed relatively huge downward pressures on the Chinese economy. However, as China is now in the process of rapid industrialization and urbanization, there is enormous demand and growth potential, and the long-term trend of China's economic development remains unchanged. This, along with the gradual implementation of a package of policies released in response to the crisis, is expected to help the economy continue to grow in a stable and relatively rapid manner.

In accordance with the overall arrangements of the CPC Central Committee and the State Council, the PBC will continue to thoroughly carry out the scientific outlook on development, resolutely implement a moderately loose monetary policy, and maintain policy consistency and stability so as to promote stable and relatively rapid economic development. The PBC will continue to ensure ample liquidity in the banking system, guide financial institutions to reasonably increase credit supplies, optimize the credit structure, and prevent potential risks in order to provide better credit support for economic development. The PBC will continue to advance the market-based interest rate reform and to improve the RMB exchange rate mechanism. It will press ahead with the reform of the financial system to improve the competitiveness of financial institutions and the efficiency of financial markets in resource allocation and to maintain financial stability.

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Part 1 Monetary and Credit Performance

In the first quarter of 2009, money supply and RMB lending grew rapidly, the credit structure was further optimized, the banking system had sufficient liquidity, and the lending rate continued to decline, all indicating that the financial sector was providing stronger support to economic development.

I. Money supply grew rapidly

At end-March, the outstanding balance of broad money M2 grew 25.5 percent year on year to 53.1 trillion yuan, an acceleration of 9.3 and 7.7 percentage points from the same period of 2008 and end-2008 respectively. The outstanding balance of narrow money M1 reached 17.7 trillion yuan, an increase of 17.0 percent year on year, representing a deceleration 1.2 percentage points from the first quarter of 2008 and an acceleration of 8.0 percentage points from end-2008. Cash in circulation M0 grew 10.9 percent year on year to 3.4 trillion yuan, down 0.3 percentage points from the growth in the first quarter of 2008. Net cash withdrawals in Q1 of 2009 totaled 47.3 billion yuan, 78.5 billion yuan more than that recorded in the first quarter of 2008.

Growth of M2 maintained an accelerated momentum in the first quarter due to the rapid increase in credit. In particular, growth of M0 accelerated remarkably month by month, returning at end-March to the growth level registered before June 2008 and representing an acceleration of 6.4 percentage points from that in February. This reflected the preliminary boosting effects of the recently adopted macroeconomic policies and the subsequent increased economic activities.

II. Growth of deposits of financial institutions accelerated

At end-March, the outstanding balance of deposits of all financial institutions (throughout this Report, “all financial institutions” includes foreign-funded financial institutions) denominated in both RMB and foreign currencies increased 25.7 percent year on year to 53.6 trillion yuan, 9.5 percentage points higher than the growth in the same period of 2008, representing an increase of 5.7 trillion yuan from the beginning of the year and an acceleration of 3.1 trillion yuan year on year. In particular, the outstanding balance of RMB deposits rose 25.7 percent year on year to 52.3 trillion yuan, 8.4 percentage points higher than the growth in the same period of 2008, representing an increase of 5.6 trillion yuan from the beginning of the year and an acceleration of 3.0 trillion yuan year on year. The outstanding foreign currency deposits rose 28.9 percent to US$200.3 billion, 34.7 percentage points higher than the growth in the first quarter of 2008, representing an increase of US$7.5 billion from the beginning of the year and an acceleration of US$13 billion year on year.

Broken down by sectors and maturities, the growth of household and non-financial companies' deposits remained relatively rapid, and the growth of corporate demand deposits accelerated. At end-March, the outstanding balance of household RMB deposits had grown 29.8 percent to 24.7 trillion yuan, 21.1 percentage points higher than the growth in the first quarter of 2008, representing growth of 2.6 trillion yuan from the beginning of 2008 and an acceleration of 1.1 trillion yuan year on year. The outstanding balance of non-financial corporate RMB deposits stood at 24.6 trillion yuan, an increase of 27.0 percent year on year, 4.2 percentage points higher than the growth in the same period of 2008, representing an increase of 2.9 trillion yuan from the beginning of the year and an acceleration of 2.4 trillion yuan year on year. In the first quarter, growth of corporate demand deposits accelerated by 1 trillion yuan year on year, among which in March alone an acceleration of 799.4 billion yuan was recorded, indicating a stronger funding situation and payment capability in the corporate sector, which should have come from the restored production in the first quarter and should signal growth potential for the near future. At end-March， because of the shrinking fiscal revenue and expanding expenditures, the outstanding balance of fiscal deposits decreased 24.7 percent year on year to 1.7 trillion yuan, representing a reduction of 88.2 billion yuan from the beginning of the year and a reduction of 589 billion yuan more than that registered at end-March 2008.

III. RMB loans issued by financial institutions grew rapidly

At end-March, the outstanding balance of loans issued by all financial institutions in both RMB and foreign currencies stood at 36.6 trillion yuan, representing a growth of 27.0 percent year on year, 10.7 and 9 percentage points higher than the growth in the same period of 2008 and end-2008 respectively, and representing an increase of 4.5 trillion yuan from the beginning of the year or an acceleration of 2.9 trillion yuan year on year. At end-March, the outstanding balance of RMB loans had grown by 29.8 percent year on year to 35.0 trillion yuan, 15.0 percentage points higher than the growth at end-March 2008, representing an increase of 4.6 trillion yuan from the beginning of the year or an acceleration of 3.2 trillion yuan year on year. The rapid growth of credits resulted from several elements. With the implementation of a proactive fiscal policy and moderately loose monetary policy, plenty of liquidity in the banking system and lower interest-rate levels stimulate both credit demand and credit supply. Moreover, the relatively high capital adequacy ratios, low NPL ratios, and good profitability enable commercial banks to expand their credit. In addition, commercial banks have actively implemented a macro-adjustment policy aimed at boosting domestic demand to sustain economic growth, enhanced their credit-approval efficiency, and intensified support to domestic demand-boosting projects. Broken down by institutions, the share of state-owned commercial banks in aggregate credit increased. In the first quarter, new loans of state-owned commercial banks accounted for 50.5 percent of the total new loans of all financial institutions, up 12.7 percentage points from that in the fourth quarter of 2008. At end-March, the outstanding balance of foreign currency loans stood at US$235.2 billion, representing a decline of 11.7 percent year on year, down 68.6 percentage points from the growth during the same period of the previous year or a decease of US$8.5 billion from the beginning of the year and a deceleration of US$57.3 billion from the same period of the last year. The decrease was comparatively high due to the high volume in the base period, and it was also associated with sliding exports, trade financing difficulties, and the strong dollar.

Table 1: RMB loans of financial institutions

Unit: 100 million yuan

	Q1 of 2009		Q1 of 2008	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Policy banks①	3 688	2 085	1 602	744
State-owned commercial banks②	23 120	17 893	5 227	−721
Joint-stock commercial banks	11 778	9 079	2 699	−817
City commercial banks	2 706	2 019	687	−207
Rural financial institutions③	4 225	1 902	2 323	−252
Foreign-funded financial institutions	−264	−654	389	165

Note:① Policy banks include the China Development Bank, the Export-Import Bank of China, and the Agricultural Development Bank of China. Due to the reform the China Development Bank has become a share-holding company and at present is in t transitional period, so in statistical terms it is included with the policy banks.

② The state-owned commercial banks include the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and China Construction Bank.

③ Rural financial institutions include rural cooperative banks, rural commercial banks, and rural credit cooperatives.

Source: The People's Bank of China.

In terms of loan destinations, the growth of household loans recovered steadily, whereas the lending to non-financial institutions and other sectors accelerated markedly. The outstanding balance of household loans at end-March had grown 16.9 percent year on year, 8.7 percentage points lower than the growth in the same period of 2008 but 3.2 percentage points higher than that at end-2008, representing an increase of 422.3 billion yuan from the beginning of the year and an acceleration of 181.7 billion yuan year on year. In particular, the outstanding balance of household consumption-based loans grew 202.7 billion yuan from the beginning of the year, representing an acceleration of 78.7 billion yuan year on year, the first quarterly acceleration since 2008 and reflecting the recent housing and auto sales recovery. The outstanding balance of household business-oriented loans grew by 219.6 billion yuan, representing an acceleration of 103 billion yuan year on year. The outstanding balance of loans issued to non-financial institutions and other sectors grew 32.9 percent year on year, an acceleration of 20.4 percentage points from the same period of 2008, an increase of 4.2 trillion yuan from the beginning of the year or an acceleration of 3.1 trillion yuan year on year. In particular, paper financing and medium- and long-term loans grew rapidly, with paper financing accelerating by 1.6 trillion yuan year on year and medium- and long-term loans accelerating by 1.0 trillion yuan year on year.

The bulk of RMB medium- and long-term loans went to the infrastructure sector, the leasing and the business services sector, the real estate sector, and the manufacturing sector.[1] In the first quarter, new RMB medium- and long-term loans of major financial institutions (including state-owned commercial banks, policy banks, joint-stock commercial banks, and city commercial banks) to the infrastructure sectors (transportation, warehousing and postal services, electricity, gas, and water production and supply, water conservation, environmental protection, and public facility management), and to the leasing and business services sector stood at 894.8 billion yuan and 220.7 billion yuan respectively, accounting for 50.1 percent and 12.4 percent of all new medium- and long-term RMB loans, 9.9 percentage points and 7.9 percentage points higher than the growth in the first quarter of 2008. New medium- and long-term loans that went to the real estate sector and the manufacturing sector amounted to 200.6 billion yuan and 141.4 billion yuan respectively, accounting for 11.2 and 7.9 percent of all new medium- and long-term loans, down 8.7 and 4.3 percentage points respectively from the same period of 2008.

Box 1: Analysis of credit growth

Since 2009, RMB loans issued by financial institutions have increased rapidly, with new loans issued in the first quarter reaching 4.6 trillion yuan. In terms of their maturity structure, the large bulk of credits was medium- and long-term loans and paper financing. In the first quarter, the medium- and long-term loans grew 1.9 trillion yuan, representing an acceleration of 1.1 trillion yuan year on year, accounting for 40.7 percent of the total credits and continuing the trend of a large share of medium- and long-term loans going to investment in projects that began in the fourth quarter of 2008. Paper financing increased 1.5 trillion yuan, accelerating by 1.6 trillion yuan year on year and accounting for 32.3 percent of the total credit. In particular, paper financing accounted for 19.5 percent of the total credits, down 19.0 and 26.0 percentage points from January and February respectively. Short-term lending increased by 1.2 trillion yuan, 582.8 billion yuan more than the increase in the same period of 2008 and accounting for 26.3 percent of the total credit, up 4.4 percentage points from the fourth quarter of 2008. Among the medium- and long-term credit of major financial institutions, lending to a majority of sectors accelerated on a year-on-year basis. In the first quarter, new loans directed to the water conservation, environmental protection and public facility management industries, transportation,

[1] According to the standard sectoral definitions of the National Bureau of Statistics, individual commercial housing loans are not included in real estate loans.

warehousing, and postal services, and leasing and business services industries accelerated by 377.9 billion yuan, 230.4 billon yuan, and 189.5 billion yuan respectively year on year.

The rapid loan growth will facilitate stable and relatively rapid economic development. The increase in medium- and long-term loans will help implement the policy aimed at boosting domestic demand and maintaining economic growth and meeting credit requirements for project construction. With the gradual launch of investment projects, the matching medium- and long-term loans increased accordingly, reflecting the financial support for economic development. Financial institutions maintained a risk awareness and actively conducted investigations on the repayment sources,returns and guarantees of loan-receiving projects to strike a good balance between maintaining economic growth and warding off risks. Growth of paper financing helps to strengthen financial support to enterprises. In terms of the payment procedure, the signing and endorsement of commercial drafts postpones the payment date of the draft issuer (the payer) and reduces its financial cost; furthermore, it helps link up the producer side with the seller side and reduces enterprise fund usage in final products and receivables on the one hand, and provides a low-cost and convenient financing tool for the supplier (the payee) on the other. In terms of loan destinations, paper financing mainly supports active economic agents, including down-stream enterprises in the manufacturing sector and wholesale and retail industries in the real sector, and plays a positive role in solving capital turnover difficulties and stabilizing employment. To some extent, paper financing and short-term lending can substitute for one another, and the acceptance, negotiation, and discount of commercial papers can also meet enterprises' short-term working capital requirements. Taking into account both short-term lending and paper financing, the enterprises' working capital maintained a momentum of relatively rapid growth in the first quarter.

Credit support to small- and medium-sized enterprises (SMEs) should be strengthened further. The financial crisis has hurt their effective borrowing demand and financing capabilities. In addition, because of differences in lending costs, risks, and responsibilities, commercial banks tend to provide credit to large projects or large enterprises, and are cautious about lending to SMEs. To a certain extent, this has suppressed the credit growth of SMEs. However, as SMEs play a crucial role in promoting economic development, employment creation, and industrial restructuring, an increase in credit extensions to SMEs will be a new profit-earning source for commercial banks. Some commercial banks have already expanded credit services to SMEs, establishing "specialized branches" to provide financial services for SMEs in areas with abundant client sources, setting assessment indicators for SME loans, and introducing credit products in line with the risk profiles and credit demands of the SMEs. Gradually, these measures will produce results. Of course, efforts should be made to further improve the financial institution system, the multi-layered financing channels, fiscal and tax support, the credit system, and the guarantee mechanism to solve the lending problems of the SMEs.

The quality of credit growth should be enhanced further. The contrast between the rapid expansion in the money and credit supply and the relatively slow growth of the real economy is somewhat reasonable, but attention should be given to preventing the risks of intensified economic fluctuations and rebounding NPLs. Given the excess capacities in China, economic restructuring may slow down if the principle of “differentiated treatments” in credit extension is not followed. Banks should adhere to this principle in order to better combine boosting domestic demand and restructuring. Moreover, recent bank lending has concentrated on government projects. Though this helps stimulate investment, efforts should be made to assess local governments’ liability-bearing capacities and to monitor its effect in encouraging social investment.

Generally, against the backdrop of the global financial crisis, the moderately rapid growth in money and credit, as a result of the effective transmission of a moderately loose monetary policy, has more advantages than disadvantages, as it helps to stabilize the financial market, boost confidence, and promote sound and rapid economic development. Yet, it should be noted that the credit surge in March was to some extent due to factors such as the end-quarter performance evaluations of commercial banks, when they rushed to extend credits so as to have respectable figures. From April on, financial institutions and enterprises need a period of time to “digest” those credits. In the near future, it is necessary to have strong credit growth if the global financial crisis continues to worsen. In the process of further implementing a moderately loose monetary policy, efforts should be made to strengthen guidance of financial institutions to adjust and optimize the credit structure and to prevent the potential risks of credit structural problems. Furthermore, efforts should be made to increase credit to those innovative SMEs and private enterprises in promising industries that have orders and have the ability to create job opportunities, and to continue strengthening rural financial services and to intensify credit inputs in line with the characteristics of agricultural production.

IV. Liquidity in the banking system was sufficient

At end-March the outstanding balance of base money increased by 19.2 percent to 12.4 trillion yuan, representing a decline of 494.5 billion yuan from the beginning of the year and a deceleration of 16.1 percentage points year on year. The money multiplier at end-March was 4.27, up 0.21 percentage points from the same period of 2008 and 0.59 percentage points from the end of 2008, indicating stronger money creation capacity. At end-March, the excess reserve ratio of financial institutions rose by 0.27 percentage points to 2.28 percent from the first quarter of 2008. In particular, the excess reserve ratio of the four state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives was 2.53 percent, 0.49 percent, and

4.58 percent respectively.

V. The lending rate of financial institutions declined further

Entering into 2009, due to the interest rate cut and peer competition in lending, the lending rate of financial institutions declined further. In March, the weighted average rate of RMB loans to non-financial companies and other sectors stood at 4.76 percent, down 0.80 percentage points from the beginning of the year and 2.63 percentage points from before the cut in the rate level in August 2008. Companies' financing costs were reduced by a large margin. The weighted average rate of loans and the weighted average paper financing rate stood at 5.70 percent and 1.88 percent, down 0.53 and 1.01 percentage points from the beginning of the year respectively and down 2.16 and 4.02 percentage points from the cut in the rate level in August respectively. Due to the policy of lowering the floor mortgage interest rate for commercial mortgage loans, the decline in the mortgage interest rate was larger than the decline in the interest rate on loans to non-financial companies and other sectors. In March, the weighted average interest rate on individual housing loans stood at 4.45 percent.

The proportion of loans with an upward adjusted interest rate declined markedly. In March, the share of loans to non-financial companies and other sectors with an upward adjusted interest rate was 36.43 percent, down 7.88 percentage points from the beginning of the year; the share of loans with a downward adjusted interest rate and a benchmark interest rate accounted for 28.39 percent and 35.18 percent, up 2.82 and 5.06 percentage points from the beginning of the year respectively.

Domestic foreign currency deposits and lending rates declined substantially. The domestic U.S. dollar deposit rate for demand deposits and 3-month maturity deposits stood at 0.15 percent and 0.55 percent respectively, down 0.70 and 0.66 percentage points from the beginning of the year respectively. The domestic foreign currency lending rate for within three-month maturity and three-month to six-month maturity stood at 2.23 and 2.44 percent respectively due to the low interest rate volatility in international financial markets in March, down 1.42 and 1.57 percentage points from the beginning of the year respectively.

Table 2: Shares of loans with rates adjusted at various ranges, January through March 2009

Unit: Percent

	Adjusted downward	At benchmark	Adjusted upward					
	[0.9，1.0)	1	Sum	(1.0，1.1]	(1.1，1.3]	(1.3，1.5]	(1.5，2.0]	Above 2.0
January	23.52	34.27	42.21	14.62	12.79	4.97	6.98	2.86

February	28. 82	33. 56	37. 62	12. 29	10. 36	4. 82	6. 98	3. 18
March	28. 39	35. 18	36. 43	12. 21	10. 46	4. 37	6. 64	2. 75

Source: The People's Bank of China.

Table 3: The average interest rate for large value deposits and loans denominated in U.S. Dollars, January through March 2009

unit: %

	Large value deposits						Loans				
	Demand Deposit	Within 3-month	3-6 month	6-12 month	1-year	Above 1-year	Within 3-month	3-6 month	6-12 month	1-year	Above 1-year
January	0. 34	0. 55	1. 36	1. 26	1. 91	1. 46	2. 89	3. 33	3. 48	3. 04	3. 62
February	0. 16	0. 48	1. 46	1. 79	1. 95	5. 01	2. 18	2. 87	3. 13	2. 61	2. 74
March	0. 15	0. 55	1. 32	1. 77	2. 20	1. 30	2. 23	2. 44	3. 05	2. 51	3. 39

Source: The People's Bank of China.

VI. The RMB exchange rate remained basically stable at an adaptive and equilibrium level

Since 2009 the RMB exchange rate has remained basically stable at an adaptive and equilibrium level. At end-March the central parity of the RMB against the U.S. dollar was 6.8359 yuan per U.S. dollar, a depreciation of 13 basis points or 0.02 percent from the end of 2008; the central parity of the RMB against the euro was 9.0323 yuan per euro, an appreciation of 6.94 percent from the end of 2008; and the central parity of the RMB against the Japanese yen was 6.9630 yuan per 100 yen, an appreciation of 8.65 percent from the end of 2008. From the initiation of the exchange rate regime reform to end-March 2009, the RMB cumulatively appreciated 21.07 percent against the U.S. dollar, 10.87 percent against the euro, and 4.92 percent against the Japanese yen.

The RMB exchange rate fluctuated in both directions. In the first quarter, the peak and trough central parities of the RMB against the U.S. dollar were 6.8293 yuan per U.S. dollar and 6.8399 yuan per U.S. dollar respectively. The largest appreciation of the RMB central parity against the U.S. dollar in a single business day was 0.07 percent (50 basis points) and the largest depreciation in a single business day was 0.04 percent (27 basis points). Among the 57 trading days in the first quarter, the inter-bank foreign exchange market saw RMB appreciations on 24 days and depreciations on 33 days.

Part 2 Monetary Policy Conduct

In the first quarter of 2009, according to the State Council's overall arrangements and in an effort to implement the scientific outlook on development in a deep manner, the PBC, in order to serve the overall objective of supporting growth, expanding domestic demand, and restructuring the economy, applied a moderately loose monetary policy, worked to keep sufficient liquidity in the banking system, and guided financial institutions to increase lending and optimize the credit structure, in order for the financial sector to play an active role in achieving economic growth.

I. Open market operations were conducted in a timely manner and with appropriate strength

In Q1, the PBC implemented a moderately loose monetary policy and conducted open market operations in a timely manner and with appropriate strength to keep fairly sufficient liquidity in the banking system and to stabilize market expectations. First, the PBC managed the pace and strength of open market operations appropriately to provide sufficient liquidity to the banking system. Based on a close monitoring of the dynamics in demand and supply of banking system liquidity, the PBC maintained consistency and stability in open market operations, continued the strategy of short-term operations, and managed the strength and pace of operations in a proper manner. In Q1, 1.1 trillion yuan of repo operations were conducted, and 480 billion yuan of central bank bills were issued. At end-March, the volume of outstanding central bank bills was 4.2 trillion yuan, a decrease of 500 billion yuan from end-2008. Second, instruments of open market operations were further optimized to effectively smooth fluctuations in liquidity supply and demand in the banking system. Operation instruments were further refined to address the hefty supply and withdrawal of cash around Spring Festival and the maturing of a large amount of open market operations in Q1. Specifically, while maintaining the strength of repo operations, the issuance of 3-month central bank bills was restarted in a timely fashion after the Spring Festival holiday, not only effectively smoothing fluctuations in demand for and supply of liquidity in the banking system, but also playing a positive role in guiding commercial banks to manage the pace of their fund use and in promoting the stable growth of money and credit. Third, the interest rates of open market operations were kept basically stable to stabilize market expectations. At end-March, the interest rate of 3-month central bank bills, 28-day repo, and 91-day repo was 0.965 percent, 0.90 percent, and 0.96 percent respectively, roughly the same levels as their equivalents at the beginning of the year. Fourth, coordination and cooperation with the proactive fiscal policy were strengthened and state treasury cash management conducted time deposit business promptly with the commercial banks. Time deposit business was conducted on both January 21 and March 25, a higher frequency than in previous years and offering more maturities.

II. Credit policy guidance was enhanced

Since the beginning of 2009, the PBC has worked earnestly to implement the *State Council's Ten Measures and Thirty Opinions to Further Expand Domestic Demand and Support Economic Growth* and enhanced credit policy guidance. The financial institutions were encouraged and guided to continue to follow the principle of differentiated treatment to borrowers to support the development of some industries on the basis of balanced growth of credit aggregates, to further improve the credit structure, to allocate credit resources with a clear view of the bigger picture, to guarantee the disbursement of matched lending to support eligible central government-invested projects, to provide credit to support the agricultural sector, the countryside, and the farmers, SMEs, employment creation, students in need, post-disaster reconstruction, domestic consumption, and independent innovation, and to implement a housing credit policy to support the healthy development of the housing market. The financial institutions were also urged to strengthen monitoring, analysis, and assessment of the credit structure, to manage the structure, pace, and progress of loan disbursements, to pay special attention to avoiding an over-concentration of loans in large enterprises and an overly large share of long-term loans and maturity mismatches, and to take effective measures to manage and dissolve credit risks.

III. Financial enterprise reform was advanced

The reform of the large state-owned banks was deepened. Facing the pressures of the ongoing international financial crisis and the downturn in domestic economic performance, the four listed companies, i.e., the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications continued to advance internal reform, improve governance, strengthen risk control, improve business operation management and services, and to made good profits. At the end of Q1, the capital adequacy ratio of the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications registered 12.1 percent, 12.3 percent, 12.4 percent, and 12.8 percent, the NPL ratio was 2.0 percent, 2.2 percent, 1.9 percent, and 1.6 percent, and pre-tax profits were 45.62 billion yuan, 25.29 billion yuan, 33.98 billion yuan, and 10.13 billion yuan respectively.

The joint stock reform of the Agricultural Bank of China and the China Development

Bank made good progress. On January 16, 2009, the Agricultural Bank of China Co. Ltd. was established. To achieve the overall objectives of serving the agricultural sector, rural areas, and farmers, operating on a commercial basis, restructuring the entire bank and getting listed on the stock market at an opportune time, the Agricultural Bank of China has established an Agricultural Financial Operations Department to provide services to farmers and the agricultural sector, has introduced the pilot reform of county-level operations to a wider area, and has enhanced credit support to the agricultural sector, farmers, and the countryside. The China Development Bank is strengthening internal institutions including risk and internal control, expanding business areas, and improving operational mechanisms.

The reform of policy financial institutions is also making progress. In February 2009, the State Council decided to speed up the policy of financial institution reform. The PBC is working together with the relevant agencies to study possible reform options for the Export-Import Bank of China, the China Export and Credit Insurance Corporation, and the Agricultural Development Bank of China. At the same time, the three institutions are furthering internal reform and strengthening risk management and internal control to prepare for the upcoming overall reform.

The reform of rural credit cooperatives was furthered and the bulk of financial support was disbursed. At end-March, a total of 156.9 billion yuan of special bills was redeemed for rural credit cooperatives in 2,259 counties and cities, accounting for 93 percent of all the bills issued for this purpose; 1.5 billion yuan of ear-marked loans were disbursed. The smooth implementation of the financial support policy acted as a positive incentive to promote the rural credit cooperative reform. The asset quality of the rural credit cooperatives was significantly improved. At end-March, based on the four-category loan classification, the total volume and ratio of NPLs in the rural credit cooperatives was 313.4 billion yuan and 7.6 percent respectively, representing a reduction of 201.4 billion yuan and 29.3 percentage points from end-2002. Their lending ability increased by a fairly large margin, consequently their lending grew. At end-March, total deposits and outstanding loans of rural credit cooperatives posted 6.3 trillion and 4.1 trillion yuan respectively, the latter accounting for 11.9 percent of the outstanding loans of all financial institutions, 1.3 percentage points higher than that at end-2002. In the recent five years, total deposits with the rural credit cooperatives surged by an average of 20.1 percent every year and the total outstanding loans by 19.1 percent, both higher than the nationwide average for financial institutions. The reform of the property rights system continued. At end-March, 25 rural commercial banks, 172 rural cooperative banks, and 2,001 institutions with legal person status at the county level were established.

Box 2: Improve management of central bank lending for agriculture-supporting purposes and support greater credit extensions to the agricultural sector, the countryside, and farmers

Approved by the State Council, the PBC started lending to support agricultural development. At end-2008, a total of 1.2 trillion yuan of central bank lending was issued to support lending by rural credit cooperatives to farming households.

In order to carry out the decisions made by the Central Economic Work Conference and the Central Rural Work Conference, to implement a moderately loose monetary policy, and to allow the agriculture-supporting central bank lending to play a larger role in guiding financial institutions, the PBC further improved policy for such lending. First, arrangements were made to increase the quota of such lending. In this spring farming season, an extra quota of 10 billion yuan was arranged to support agriculture in China’s west and major grain-producing areas. As a result, the total quota of agriculture-supporting central bank loans reached 149.2 billion yuan, and the share for the west and major grain-producing areas in the total went up to 93 percent, further optimizing the geographical distribution of such loans. Second, the criteria for recipients and use of agriculture-supporting central bank lending were adjusted. The coverage was expanded from rural credit cooperatives only to include rural cooperative banks, rural commercial banks, village and township banks, and other deposit-taking banking institutions whose legal persons are at the county, village, and township levels. Also, agriculture-supporting central bank lending is provided for agriculture-related purposes instead of only for farmers. Third, the maturity and ledger management of agriculture-supporting central bank lending has been improved. Now the maturity of such lending can be as long as three years, basically covering the cycle of planting, animal husbandry and aquaculture. The various branches of the PBC decide, in light of the local agriculture production cycle and the asset and liability structure of the local financial institutions, on the time of the disbursement of central bank loans, as well as the size and maturity of such loans. Ledger management has been improved, and lending procedures have been simplified. Financial institutions are no longer required to prepare detailed and separate ledgers for credit extensions based on agriculture-supporting central bank loans. Fourth, the application criteria for agriculture-supporting loans have been clarified to make sure the funds are used entirely for agricultural development, for the countryside, and for farmers. Financial institutions that apply for such central bank loans should have at least 70 percent of all loans supporting agriculture, rural areas, and farmers, have sound internal management and good or improving CAR, asset quality, and other financial indicators.

The adjustments in the agriculture-supporting central bank lending policy are expected to enhance the efficiency of lending and enable the policy to play a guiding role and to dissolve risks. For financial institutions, there will be a positive incentive for them to expand lending to support agriculture, rural areas, and farmers and to provide better financial services to the rural areas.

IV. Active participation in international financial institutions to address the international financial crisis

To respond to the needs of neighboring countries and regions, the PBC signed bilateral domestic currency swap agreements with the monetary authorities of six economies, i.e., the Republic of Korea, Hong Kong, Malaysia, Belarus, Indonesia, and Argentina, to support bilateral trade and investment and to join forces in countering the ongoing international financial crisis. On April 8, the State Council approved the experiment for Renminbi settlement of cross-border trade in Shanghai and four cities in Guangdong province, i.e., Guangzhou, Shenzhen, Zhuhai, and Dongguan, which is expected to help manage exchange rate risks and thus bolster the stable growth of foreign trade.

Box 3: The PBC actively participated in international cooperation to address the financial crisis

From 2007 on, the sub-prime mortgage crisis that started in the United States gradually evolved into a global financial crisis. To cope with such a once-in-a-century challenge to the international economy, the international community took active measures and carried out multi-layered cooperation. First, financial support for international financial institutions was enhanced, including tripling the lending resources of the International Monetary Fund to US$750 billion, supporting a new SDR allocation of US$250 billion, supporting at least $100 billion of additional lending by the multilateral development banks, devoting $250 billion of support for trade financing, and providing concessional financing for the poorest countries through the IMF. Second, international cooperation was strengthened in terms of financial supervision and regulation. An action plan was formulated on regulation and supervision, and a declaration titled “Strengthening the Financial System” was issued. The agreed-upon measures include establishing a Financial Stability Board that will collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them, improving standards on valuation and provisioning and global accounting standards, extending regulatory oversight, etc. Third, the mandates, scope, and governance of the IMF, the World Bank, and other international financial institutions will be reformed and modernized to reflect changes in the world economy and the new challenges of globalization, and to give the emerging and developing economies and poor countries greater voice and representation.

As a responsible member of the international community, China has called for trade and investment cooperation at the level of the real economy, more trade financing cooperation, and efforts to promote the relevant reform to reshape the international financial order and to the best of its ability has also joined international efforts for crisis assistance. The PBC implemented these policies, provided fund assistance in various forms, and made commitments for assistance, contributing to regional economic and financial stability and international cooperation in crisis response. First, domestic currency swap arrangements were made with other monetary authorities to provide liquidity support to neighboring economies. Since the outbreak of the crisis, the PBC has signed six domestic currency swap agreements totaling 650 billion yuan, i.e., with the Bank of Korea, Hong Kong Monetary Authority, Bank Negara Malaysia, National Bank of Belarus, Bank Indonesia, and Central Bank of Argentina. In the future, the PBC is ready to sign more bilateral currency swap agreements based on actual needs. Second, the PBC actively promoted multilateralization of the Chiang Mai Initiative to support regional economic and financial stability. After the finance ministers of the ASEAN countries, China, Japan, and Korea signed the Chiang Mai Initiative to establish a regional network of bilateral swap arrangements in May 2005, China signed six currency swap agreements totaling US$23.5 billion and has endeavored to promote the creation of a foreign exchange reserve pool under the multilateralization of the Chiang Mai Initiative. In May 2008, China, ASEAN, Japan, and Korea (namely ASEAN + 3) announced the establishment of an US$80 billion reserve pool. In February 2009, they announced the expansion of the pool to US$120 billion. In early May, China, Japan, and Korea reached agreements on the size of each country’s contribution, with China contributing US$38.4 billion. Furthermore, in order to maintain economic and financial stability and to enhance financial cooperation and trade development in the region, China has decided to set up a US$10 billion China-ASEAN Investment Cooperation Fund and to provide US$15 billion credit to ASEAN countries in the coming three to five years. Third, China has actively participated in crisis-handling activities of the IMF and multilateral development institutions. Since 2008, based on the quota China has paid to the IMF, China contributed US$1.47 billion in an indirect manner to the IMF's assistance to several countries. In addition, China negotiated for participation in the IFC's trade finance program and decided to provide US$1.5 billion as the first batch of financing support. China has purchased bonds issued by multilateral development banks including the World Bank. On the basis of fund safety and returns, China will continue to take an active part in these institutions' crisis-assistance activities.

Participation in international cooperation is conducive to global economic and financial stability and restoration of confidence in emerging markets and developing countries and to greater resilience to crisis in the region; it helps to promote bilateral trade and investment for the recovery of growth in the region; it enhances multilateral cooperation and the voice and representation of emerging market and developing countries in crisis assistance and international financial system reform, enabling international crisis assistance to play a positive role.

V. Foreign exchange administration reform was deepened

The reform of the foreign exchange administration system continued to be deepened to support the sound development of foreign trade. First, the short-term external debt quota of financial institutions was adjusted upward. In 2009, the quota was increased 12 percent year on year and the increase was earmarked for supporting external trade financing of domestic enterprises to resolve their financing difficulties. Second, the policy of raising the share of advance receipts of foreign exchange payments by exporting enterprises and postponed payment of foreign exchange by importing enterprises was implemented and enterprises were allowed to receive foreign exchange in advance and to sell it to banks; the banks were allowed to transfer foreign exchange payments to recipients before the network verification procedure was completed so as to help enterprises speed up fund turnovers. Third, measures were taken to promote the development of the foreign exchange market. The Finance Company of Wuhan Steel Company was approved to trade on the inter-bank foreign exchange market, and two money brokerage companies were approved to conduct foreign exchange brokerage business. These measures have increased trade on the foreign exchange market and have boosted liquidity.

VI. The Renminbi exchange rate regime was improved

The managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies was further improved in a self-initiated, controllable, and gradual manner to enable market supply and demand to play a fundamental role in the yuan exchange rate formation and to keep the exchange rate basically stable at an adaptive and equilibrium level. Monitoring of liquidity in financial institutions was enhanced to guide the management of domestic and external investment in a balanced manner based on the principle of safety, liquidity, and reasonable returns and to adjust the structure of their domestic and external assets.

Part 3 Financial Market Analysis

In Q1 2009 the financial market continued to perform in a sound and stable manner and market liquidity was adequate. The money market witnessed active trading with stable interest rates. Activities on the bond market remained brisk, and the volume of issuance steadily increased. The stock market rose sharply amid fluctuations. The total financing by the domestic non-financial institution sector (including households, non-financial enterprises, and the government sector) increased by 163.8 percent over the same period of the last year. In terms of the financing structure, the weight of loans was enhanced significantly. Due to the accelerated issuance of medium-term notes, enterprise bond financing continued to grow rapidly; the share of equity financing declined noticeably.

Table 4: Financing by domestic non-financial sectors in Q1 2009

	Volume of financing (100 million yuan)		As a percentage of total financing (%)	
	Q1 2009	Q1 2008	Q1 2009	Q1 2008
Financing by domestic non-financial sectors	47 757	18 104	100.0	100.0
Bank loans	45 235	16 123	94.7	89.1
Equities [1]	266	1 489	0.6	8.2
Government securities	63	−247	0.1	−1.4
Enterprise bonds[2]	2 193	739	4.6	4.1

Notes: 1. Equity financing in this table does not include financing by financial institutions on the stock market.

2. Enterprise bonds include enterprise bonds, corporate bonds, short-term financing bills, and medium-term notes.

Source: The People's Bank of China.

I. Financial market analysis

1. Transactions on the money market were brisk with stable interest rates

Bond repos on the money market continued to grow rapidly and inter-bank borrowing declined. In Q1, the turnover of bond repos on the inter-bank market totaled 16.9 trillion yuan, with the daily turnover averaging 281.5 billion yuan, representing year-on-year growth of 41.7 percent. The turnover of inter-bank borrowing reached 3.2 trillion yuan, with the daily turnover averaging 53.8 billion yuan, decreasing by 6.6 percent year on year. In terms of the maturity structure, overnight products were traded most frequently, accounting for 77.7 percent and 83.6 percent respectively on the repo and inter-bank borrowing markets. The turnover of government bond repos on the stock exchanges increased by 27.9 percent year on year to 602.9 billion yuan.

With respect to the lenders on the repo and inter-bank borrowing markets, state-owned commercial banks significantly increased their lending. As for the borrowers, the sustained recovery of the capital market greatly boosted the financing demand of securities and fund management companies and insurance companies. In Q1, funds borrowed by securities and fund management companies and insurance companies increased by twelvefold and 82.3 percent year on year respectively. Demand for funds by foreign-funded financial institutions on the money market was still quite strong, borrowing 57.7 percent of the total net fund inflow.

Table 5: Fund flows among financial institutions in Q1 2009

Unit: 100 million yuan

	Repo		Inter-bank borrowing	
	Q1 2009	Q1 2008	Q1 2009	Q1 2008
State-owned commercial banks	−77 238	−22 396	−4 130	7 155
Other commercial banks	−3 740	−401	−103	−8 577
Other financial institutions[1]	72 118	13 686	1 790	−389
Of which: Securities and fund management companies	28 767	2 221	317	1 329
Insurance companies	12 595	6 909	—	—
Foreign financial institutions	8 860	9 111	2 443	1 811

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, and fund management companies. 2. A negative sign indicates net lending; a positive sign indicates net borrowing.

Source: The People's Bank of China.

The interest rate derivatives market resumed growth after a decline. In Q1, the bond forward and interest rate swap transactions decreased by 39.0 percent and 13.0 percent respectively year on year, and increased by 25.6 percent and 47.3 percent respectively quarter on quarter, while the trading volume of forward rate agreements was small. The Shibor played an increasingly greater role in the pricing of interest rate derivative products. Shibor-based interest rate swaps in Q1 accounted for 20 percent of the total RMB interest rate swaps; forward rate agreements were all traded based on the Shibor.

Table 6: Transactions of interest rate derivatives

	Bond forward		Interest rate swaps		Forward rate forward	
	Transactions	Amount (100 million yuan)	Transactions	Nominal principal amount (100 million yuan)	Transactions	Nominal principal amount （100 million yuan）
2005	108	178	—	—	—	—
2006	398	665	103	356	—	—
2007	1 238	2 518	1 978	2 187	14	11
2008	1 327	5 006	4 040	4 122	137	114
Q1 2009	251	913	721	801	11	38

Source: China Foreign Exchange Trade System.

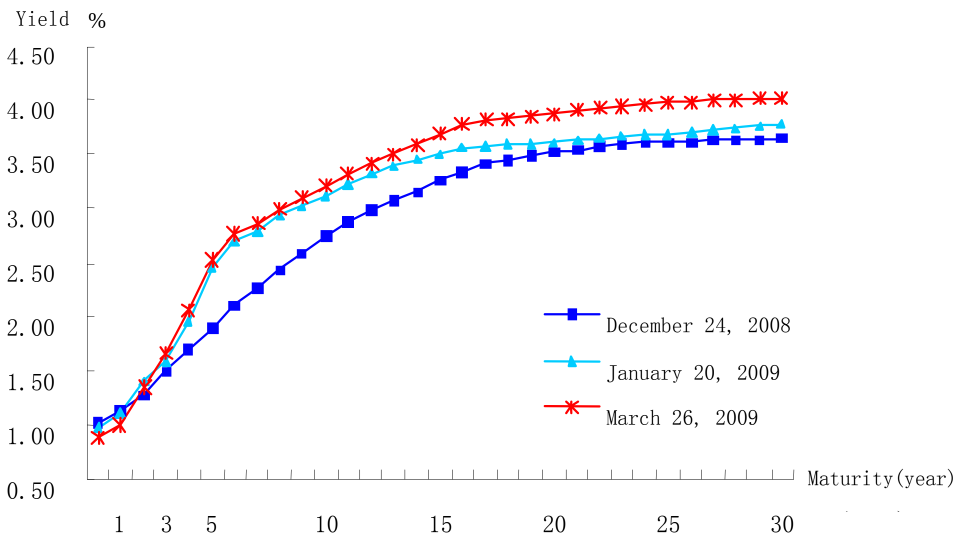
Money market interest rates remained basically stable. In Q1, the monthly weighted average interest rates of pledged bond repo and inter-bank borrowing basically were within the range of 0.84 percent to 0.90 percent. In March, the monthly weighted average interest rates of both pledged bond repo and inter-bank borrowing were both 0.84 percent, hitting a record low. At end-Q1, the overnight and 1-week Shibor were 0.8025 percent and 0.9354 percent respectively, down 0.14 percentage points and 0.07 percentage points respectively from the beginning of 2009; the 3-month and 1-year Shibor registered 1.2241 percent and 1.8754 percent respectively, down 0.55 percentage points and 0.48 percentage points from the beginning of the year and representing a larger decrease than Shibor with shorter maturities.

2. Transactions on the bond market were active and the volume of bond issuances grew steadily

Spot bond trading was active on the inter-bank bond market. Affected by factors including adequate liquidity and a rebound of the stock market, the fund demand of securities and fund management companies and insurance companies increased noticeably. In Q1, the turnover of bond spot trading totaled 10.2 trillion yuan, with the average daily turnover reaching 169.2 billion yuan, representing year-on-year growth of 35.1 percent. Government bond spot trading on the stock exchanges registered 58.2 billion yuan, 26.6 billion yuan more than that during the same period of the previous year. On the inter-bank spot bond market, the state-owned commercial banks conducted net purchases of 322.6 billion yuan, up 120 percent over the same period of 2008. Securities and fund management companies, insurance companies, and foreign-funded financial institutions, the net bond buyers in Q1 of 2008 became net bond sellers, with net sales of 241.8 billion yuan, 77 billion yuan, and 27.4 billion yuan respectively.

The bond index edged down. The China Bond Composite Total Return Index fell 1.15 points from 132.22 points at the beginning of this year to 131.07 points at the end of March, representing a decrease of 0.87 percent.

The yield curve of government securities on the inter-bank market steepened. In Q1, the yields of medium- and long-term government bonds were enhanced, while the yields of short-term government bonds continued to decline. Since March, the share of government bonds with maturities ranging from 3 to 5 years increased, pushing up the yields of medium-term government bonds; meanwhile, the generally adequate liquidity on the market and the decrease in the yields of short-term government bonds steepened the short- and medium-term section of the yield curve.



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

Figure 1: Yield curves of government securities on the inter-bank bond market in 2009

Bond issuances continued to grow steadily. In Q1, a total of 597.1 billion yuan of bonds (excluding central bank bills) was issued, up 9.9 percent over the same period of the previous year. Among this total, the issuance of policy financial bonds decreased significantly and the issuance of subordinated bonds, hybrid capital bonds, and enterprise bonds rose rapidly. In order to provide supporting funds for investment projects financed by the central government, the Ministry of Finance issued 7 billion yuan in municipal bonds in Q1 on behalf of local governments. In terms of their maturity structure, the proportion of bonds issued with a maturity of less than 5 years was 64.9 percent, and the issuance of medium-term bonds increased noticeably. The share of bonds issued with a maturity of less than 1 year fell by 2.8 percentage points over the same period of the previous year, and the proportion of bonds issued with maturities of 1 to 3 years and 3 to 5 years rose by 9.1 percentage points and 2.4

percentage points respectively from Q1 2008. As of end-March 2009, outstanding bonds deposited with the China Government Securities Depository Trust & Clearing Co. Ltd. totaled 15 trillion yuan, 14.9 percent more than in Q1 2008 (excluding special treasury bonds). The issue rate of medium- and long-term bonds went up. The interest rate of book-entry government bonds with a maturity of 10 years issued in March 2009 was 3.05 percent, up 0.15 percentage points over government bonds of the same maturity issued in December 2008.

Table 7: Issuances of major bonds in Q1 2009

Types of bonds	Issuances (100 million yuan)	Year-on-year growth (%)
Government securities [1]	1 119	−2.6
Policy financial bonds	1 103	−58.8
Bank subordinated bonds and hybrid capital bonds	490	536.4
Bank ordinary bonds	0	—
Enterprise bonds [2]	3 258	143.9
Of which: Short-term financing bills	925	−17.1
Medium-term notes	1 671	—

Note: 1. Including 7 billion yuan of municipal bonds issued by the Ministry of Finance.

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

Source: The People's Bank of China.

The Shibor continued to play a role in the pricing of bonds. In Q1, 47 fixed-rate bonds were issued, totaling 66.7 billion yuan, which were all priced based on the Shibor; 20 short-term financing bills were issued based on the Shibor rates, totaling 27.9 billion yuan, accounting for 30 percent of the total issuance, which is less than the share in the same period of the previous year; five medium-term notes were issued based on the Shibor rates, amounting to 9.6 billion yuan, accounting for 6 percent of the total issuance.

3. Paper financing grew rapidly

The acceptance and discount of commercial bills maintained rapid growth and the interest rate of discounted bills declined by a large margin. In Q1, a total of 3.0 trillion yuan of commercial bills was issued by the corporate sector, up 80.9 percent year on year. Discounted bills totaled 6.2 trillion yuan, up 107.7 percent over Q1 2008. Rediscounted bills totaled 540 million yuan, down 69.4 percent over the same period of the previous year. At end-Q1 2009, outstanding commercial bills totaled 4.5 trillion yuan, up 80.1 percent over the same period of the previous year. Outstanding discounted bills totaled 3.1 trillion yuan, up 130.3 percent year on year. Outstanding rediscounted bills amounted to 670 million yuan, down 81.5 percent over Q1 2008. At the beginning of this year, the interest rates of discounted bills declined sharply as the interest rates on the money market fell, but the decline eased in March, with the weighted average interest rate of discounted bills standing at 1.88 percent in March.

Paper financing grew rapidly since the beginning of 2009, at a pace that was much faster than that of loans. New paper financing in Q1 totaled 1.5 trillion yuan, accounting for 32.3 percent of new loans. Generally, the rapid growth of paper financing was a result of the market-based choice of financial institutions to balance the expansion of credit extensions and risk controls in the context of the moderately loose monetary policy, which would help reduce the financing costs of enterprises and satisfy their financing needs, especially for small- and medium-sized enterprises.

4. The stock indices surged amid fluctuations

In Q1, affected by several factors such as adequate liquidity in the banking system and positive signs of an economic recovery, the turnover on the stock market increased significantly, and the stock indices surged amid fluctuations. The total turnover on the Shanghai and Shenzhen Stock Exchanges amounted to 9.3 trillion yuan, up 4.2 trillion yuan over the previous quarter, and the daily turnover averaged 162.9 billion yuan, an increase of 100 percent over Q4 2008 and flat with that during the same period of the previous year. As of end-March, the market capitalization of tradable shares totaled 6.8 trillion yuan, up 50.7 percent from end-2008.

At end-March, the Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed at 2373 points and 784 points respectively, 552 points and 231 points higher than that at end-2008, representing an increase of 30.3 percent and 41.7 percent respectively. The average P/E ratios of A-shares on the Shanghai and Shenzhen Stock Exchanges rallied to 19 times and 26 times at end-March 2009 from 15 times and 17 times at end-2008.

Stock market financing declined. According to preliminary statistics, in Q1 a total of 26.6 billion yuan was raised by non-financial enterprises and financial institutions through IPOs, secondary offerings, rights issues, and the issuance of convertible bonds on equity markets both at home and abroad, 150.8 billion yuan or 85.0 percent less than that raised during the same period of the last year. Among this total, 24.6 billion yuan was raised through IPOs and rights issues on the A-share market, down 132.6 billion yuan over the same period of the previous year and representing a decrease of 84.4 percent.

5. The growth of premium income and the total assets of the insurance industry moderated

The growth of premium income slowed down noticeably. Affected by several factors such as the high base figures in 2008 and the decrease in investment-linked products, the premium income of the insurance industry totaled 327.7 billion yuan in Q1 2009, up 10.0 percent over the same period of the previous year, a deceleration of 41.6 percentage points. Among this total, life insurance premium income increased by 10.7 percent year on year, a deceleration of 51.4 percentage points from the same period of the last year; and property insurance premium income rose by 12.0 percent, a deceleration of 12.6 percentage points over the same period of the previous year. Claims and benefit payments in the insurance industry amounted to 82.4 billion yuan, 2 billion yuan less than that during Q1 2008.

The growth of total assets in the insurance industry continued to slow down. At end-March total assets amounted to 3.5 trillion yuan, an increase of 20.5 percent year on year and a deceleration of 10.7 percentage points. In particular, investment-type assets grew by 12.6 percent year on year, a deceleration of 27.1 percentage points; bank deposits increased by 44.9 percent from the previous year, an acceleration of 36 percentage points.

Table 8: Use of insurance funds in March 2009

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-March 2009	End-March 2008	End-March 2009	End-March 2008
Total assets	35 434.7	29 437.6	100.0	100.0
Of which: Bank deposits	10 004.7	6 906.0	28.2	23.5
Investment	22 178.5	19 694.6	62.6	66.9

Source: The China Insurance Regulatory Commission.

6. The foreign exchange market developed in a stable manner

The spot foreign exchange market operated smoothly and the trading volume of swap transactions continued to rise. The trading volume of forward transactions increased and the trading volume of foreign currency pairs rallied. In Q1, the daily trading volume of the RMB foreign exchange spot market edged down over the previous quarter and rose by a small margin year on year; the turnover on the RMB foreign exchange swap market totaled US$105.3 billion, and the daily turnover increased by

4.4 percent over the previous quarter. The overnight RMB/USD swap was the dominant product type, accounting for 56.4 percent of the total trading volume of swap transactions, which showed an obvious trend of shortening maturities; the turnover on the RMB foreign exchange forward market amounted to US$1.7 billion, and the daily turnover increased by 25 percent over the previous quarter; The turnover in eight foreign currency pairs reached US$9.5 billion, and the daily turnover declined by 12.5 percent quarter on quarter. Starting from February, the monthly turnover in foreign currency pairs on the spot inter-bank market rallied, putting an end to the decline for 5 consecutive months since September 2008, and the bulk of the transactions were USD/HKD and EUR/USD currency pairs, accounting for 71.2 percent of the total turnover in Q1.

7. The trading volume of the gold market declined slightly and gold prices continued to fluctuate

The Shanghai Gold Exchange operated in a generally sound manner, and its trading volume declined slightly year on year. In Q1, the volume of gold transactions totaled 105.73 tons, down 2.7 percent over the same period of the previous year; the turnover in gold transactions amounted to 212.3 billion yuan, a decrease of 8.8 percent year on year; the daily trading volume stood at 18.6 tons, up 0.7 percent over Q1 2008.

Affected by the uncertainties in the global economy and the turbulence in international financial markets, prices on the gold market continued to fluctuate. The price on the Shanghai Gold Exchange was closely linked with that on the international market. The price of Au9995 closed at 192.6 yuan/gram at the beginning of 2009, reaching a peak and trough of 218.0 yuan/gram and 178.0 yuan/gram respectively during Q1 and closing at 202.3 yuan/gram at end-Q1, 6.4 percent more than that at the end of 2008.

II. Financial market institutional building

1. Reinforced basic institutional building of the inter-bank bond market

The policies on bond trading were adjusted to facilitate the financing of small- and medium-sized enterprises (SMEs). In January, the PBC released Announcement No.1 of 2009, removing the restriction that a bond had to be at least 500 million yuan to be traded on the market, thus providing an accommodative policy environment for SMEs to access financing through bond issuances.

The management of issuance of financial bonds was standardized. In March, the PBC released the *Administrative Procedures for the Issuance of Financial Bonds on the Inter-bank Bond Market*, which served to further standardize and improve the management of issuance of financial bonds, to enhance the transparency of approvals of financial bond issuances, and to strengthen market discipline and the risk-sharing mechanism.

Bond registration, trust management,, and settlement were standardized. In March, the PBC promulgated the *Administrative Measures on the Registration, Trust Management, and Settlement of Bonds on the Inter-bank Bond Market* (PBC Decree No.1 [2009]) to further regulate bond registration, trust management,, and settlement, which is conducive to bond trading, protecting the legitimate rights and interests of investors, preventing risks, and putting the role of the bond market into better play.

Institutional investors were fostered to diversify investors. In March, the PBC issued Announcement No.5 of 2009, allowing fund management companies to open bond accounts on the inter-bank bond market in the name of a specific asset management portfolio and to regulate the operations of such transactions, which helped increase investor types on the national inter-bank bond market, protect the interests of investors, promote the diversity of market demands, and enhance market liquidity.

The role of the existing regional financing platforms was put into better play to expand the scope of medium-term note issuers. At beginning-March, the local financing platforms in Shanghai, Beijing, and Guangdong successfully accomplished the pilot projects for the first issuance of medium-term notes, raising a total of 31 billion yuan. The issue rate was much lower than the lending rate during the same period, which effectively promoted the development of key enterprises and the construction of large infrastructure projects.

2. Standardized the master agreement for over-the-counter (OTC) transactions of financial derivatives

The PBC released Announcement No.4 of 2009 in March, approving the *Master Agreement for Trading Financial Derivatives on the Inter-bank Market* issued by the National Association of Financial Market Institutional Investors, bringing trading of all OTC financial derivatives under a uniform master agreement, enhancing trading efficiency, and lowering legal risks.

3. Improved basic institutional building of the securities market

The China Securities Regulatory Commission released the *Interim Measures on Administration of Initial Public Offerings and Listings on the Growth Enterprise Board*, which defined the standards and procedures for initial public offerings and listings on the growth enterprise board, and provided an important policy basis for the launch of the growth enterprise board.

Part 4 Macroeconomic Analysis

I. Global economic and financial developments

Since 2009 the risks for a prolonged and coordinated world recession have increased. The major developed economies have fallen into a full-blown recession while the emerging market economies have, because of weak confidence and a sharp decline in exports, become more fragile in the face of financial market pressures. The international financial markets have undergone exacerbating turmoil and have witnessed a generally strong U.S. dollar and rising yields of treasury bonds in the major economies. Global stock markets picked up after dropping. Worldwide price levels fell steadily. In order to cope with the financial crisis and moderate recession, the monetary authorities of the major economies reduced interest rates by a large margin, and the major developed economies began to take unconventional methods such as "quantitative easing," which has become a new trend in monetary policy.

1. Economic developments in the major economies

The U.S. economy slid into recession. In Q1 2009, the seasonally adjusted annualized GDP growth was -6.1 percent, 7 percentage points lower than that during the same period of the last year and the third negative figure in three consecutive quarters. The employment situation continued to deteriorate, with the monthly unemployment rate reaching 7.6 percent, 8.1 percent, and 8.5 percent for the first three months respectively, averaging 8.1 percent, 3.2 percentage points higher year on year and posting a 25-year high. Foreign trade contracted notably and the trade deficit decreased continuously. In the first two months, the accumulated trade deficit registered US$62.2 billion, down by US$58.9 billion year on year. Fiscal conditions rapidly deteriorated. In the first five months of the 2009 fiscal year starting on October 1, 2008, the accumulated fiscal deficit soared to US$765 billion, even higher than that during the entire 2008 fiscal year, which was US$455 billion. Prices continued to fall back. The year-on-year CPI grew by -0.2 percent, 0.1 percent, and -0.4 percent respectively for the first three months, averaging -0.2 percent, which was much lower than last year's 4.2 percent.

The euro area sank further into recession. Year-on-year GDP growth in 2008 was 0.8 percent, down 1.8 percentage points from the previous year and the growth rate for Q4 was -1.5 percent. The job market was gloomy, with the unemployment rate standing at 8.3 percent, 8.7 percent, and 8.9 percent respectively for the three months of Q1, averaging 8.6 percent, a 3.7 percentage point increase compared with the last year. Nor were trade conditions were encouraging. The accumulated trade deficit for the first two months was 12.8 billion euros, an increase of 3.4 billion euros year on year. Price levels further declined. The year-on-year HICP growth rates for the three months of Q1 were 1.1 percent, 1.2 percent, and 0.6 percent, averaging 1.0 percent, down 2.4 percentage points compared with the same period of the last year and lower than the 2 percent target set by the ECB for the fourth consecutive month.

The Japanese economy was in recession. The year-on-year GDP growth in 2008 slid by 0.6 percent, a deceleration of 3 percentage points from the previous year and the GDP in Q4 plummeted by 12.1 percent month on month, the biggest drop in 35 years. The employment situation was not optimistic, with the unemployment rate registering 4.1 percent, 4.4 percent, and 4.8 percent respectively for the three months of Q1 2009, averaging 4.4 percent, up by 0.6 percentage points year on year. The trade situation was also worsening. The accumulated trade deficit for the first three months registered 863 billion yen, contrasting with the 1925.7 billion yen surplus during the same period of the last year. Price levels fell back, with the CPI growth rate standing at 0.0 percent, -0.1 percent, and -0.3 percent for the three months of Q1, averaging -0.1 percent, a significant decrease from the 1.0 percent increase last year.

The impact on the emerging markets and developing economies deepened. Since both the financial system and the real economy felt the chill of the financial crisis almost simultaneously, the latter being hit by a sharp decline in exports, the emerging markets and developing economies have witnessed substantially slower economic growth, a large currency depreciation, and an outflow of capital. Those economies that relied heavily on exports and capital inflows were severely affected，and the outstanding structural problems became more prominent. With both external borrowing conditions and regional economic prospects worsening, some Central and Eastern European countries even fell into serious debt difficulties.

2. Global financial market developments

The exchange rates of the major currencies saw large fluctuations and the U.S. dollar grew strong. Despite worries about the long-term value of the U.S. dollar in the market coming from the successive large-scale economic stimulus packages and extremely loose monetary policy in the United States, the U.S. dollar went upward amidst small fluctuations since the beginning of the year due to its advantages of fairly strong fundamentals and liquidity, especially against the backdrop that the pace and the extent of the recession in the euro area, Japan, and other economies were greater than expected. At the end of March, the exchange rates of the dollar against the euro, the dollar against the pound, and the yen against the dollar closed at 1.325 dollar per euro, 1.433 dollar per pound, and 98.81 yen per dollar, an appreciation of the dollar by 5.5 percent, 2.1 percent, and 9.1 percent respectively from the start of the year.

The U.S. dollar Libor was low and fluctuating. On January 13, 2009, the 1-year U.S. dollar Libor slumped to 1.74 percent, its bottom level since May 2004, but it rebounded to 1.97 percent on March 31, still 0.03 percentage points lower than the start of the year. The 1-year Euribor posted 1.812 percent on March 31, down 1.24 percentage points compared with that at the beginning of the year.

The yields of government securities of the major countries generally went upward. The weak confidence caused by the deepening crisis and the financial market turbulence raised the risk premium. Moreover, the market expected that the issuance of government bonds would increase in the following several years due to large-scale stimulus packages launched by the major economies. As a result, worldwide yields of major treasury bonds climbed up. At the end of March, the yields of 10-year treasury bonds of the United States, euro area, and Japan closed at 2.668 percent, 2.991 percent, and 1.347 percent respectively, growth of 0.4442, 0.0472, and 0.1790 percentage points respectively from the level at the beginning of the year.

The major stock indices dropped after rebounding. Business profits fell due to deteriorating fundamentals and market expectations for economic growth were gloomy. Therefore, at the beginning of the year worldwide stock markets continued the downward trend that started with the outbreak of the crisis. However, boosted by an arsenal of forceful unconventional measures deployed by the U.S. government to restore stability to the financial markets, the stock markets experienced an overall rebound after mid-March when the international financial stresses eased somewhat and market confidence recovered a bit. At end-March, the Dow Jones Industrial Average, the NASDAQ, the STOXX50, and the Nikkei 225 closed at 7608.9 points, 1528.6 points, 2071.1 points, and 8109.5 points respectively, down 13.3 percent, 3.1 percent, 15.5 percent, and 8.5 percent from the beginning of the year.

3. Housing market development in the major economies

The U.S. housing market showed scattered signs of improvement. The national housing price index for January and February 2009 grew by 1.7 percent and 0.7 percent respectively month on month. In March, the start of new homes, new home sales, and new homes yet to be sold reached 510,000, 356,000, and 31,100 respectively, down 48.4 percent, 30.6 percent, and 33.7 percent year on year, a slower decline compared with the last year.

The European housing market remained sluggish, with the Halifax housing index growing by 2.0 percent, -2.3 percent, and -1.9 percent in the first three months of 2009. Affected by the weak income growth, the higher cost of housing loans, and the reduced availability of mortgage loans, housing prices spiraled downward in Spain, Ireland, France, Germany, Portugal, and Belgium.

The Japanese housing market cooled down noticeably. Influenced by the financial crisis, overseas capital withdrew from the Japanese housing market and domestic demand for housing contracted, driving housing prices lower. The average listed land price in Japan published on January 1, 2009 decreased for the first time in over the past three years, among which the price of land for residential housing dropped by 3.2 percent and the price of land for commercial use declined by 4.7 percent. Among the 280,000 spots being surveyed nationwide, only 23 witnessed an increase in land prices, the lowest level since first surveyed in 1970. In the first three months of 2009, the start of new home construction slid by 10.9 percent, 13.1 percent, and 24.6 percent respectively year on year.

4. The monetary policies of the major economies

Against the backdrop of the gloomy economic outlook and plummeting commodity prices, global prices have fallen persistently of late and signals of deflation have appeared in some economies. In order to combat the crisis and the recession, the central banks of the major economies have cut their benchmark interest rates by a large margin, some even close to zero. In the period under review, the Open Market Committee of the U.S. Federal Reserve maintained the target range for the federal funds rate at 0 to 1/4 percent, while the Bank of Japan announced that it would keep its uncollateralized overnight call rate at around 0.1 percent. On January 15, the ECB reduced the major refinancing rate by 50 basis points to 2.0 percent, expanded the spread between deposit and marginal lending facilities from 100 to 200 basis points, and lowered the major refinancing rate by 50 basis points and 25 basis points on March 5 and April 2 respectively to 1.25 percent. The Bank of England cut its bank rate by 50 basis points three times, on January 8, February 5, and March 5, reducing the rate to 0.5 percent, a record low in the 300 years since its establishment. The major central banks worldwide, except for the ECB, have all taken unconventional monetary policies featuring “quantitative easing.”

Box 4 Unconventional monetary policies adopted by the major central banks since 2009

Since the beginning of 2009, the impact of the international financial crisis on the major economies has deepened. After providing liquidity to financial institutions through various newly-created lending facilities and cutting benchmark interest rates to almost zero, the central banks of the UK, Switzerland, the United States, and Japan turned to unconventional monetary policies featuring “quantitative easing,” such as purchasing medium- and long-term bonds, including treasury notes in the secondary market, to pump in more liquidity. On March 5, the Bank of England announced it would reduce the official bank rate by 50 basis points to 0.5 percent and undertake a program of purchasing up to £75 billion of 5- to 25-year maturity conventional government debt in the following three months. On March 12, the Swiss National Bank decided to lower the upper end of the range of its target rate by 25 basis points to 0.75 percent and it planned to inject enormous liquidity into the market through the purchasing of private sector debt and foreign exchange. On March 18, the Federal Reserve declared it would maintain the target range for the federal funds rate at 0 to1/4 percent; furthermore, it also decided to purchase up to US$300 billion of treasury securities with 2- to 10-years of maturity over the next six months and to expand the existing mortgage-backed securities purchasing facility. On the same day, the Bank of Japan announced that its policy rate would remain unchanged at around 0.1 percent, and the amount of outright purchases of Japanese Government Bonds would be increased to 1.8 trillion yen per month.

The term *quantitative easing* describes central bank intervention through the purchasing of medium- and long term-bonds, such as treasury notes, to boost the supply of base money and market liquidity, where interest rates are either at or close to zero. Different from traditional tools like interest rates, quantitative easing is categorized as an unconventional tool. A typical case where this tool was attempted was Japan from 2001 and 2006. Troubled by the persistent recession, the Bank of Japan cut the policy rate to zero and regularly bought long-term treasury bonds. By expanding the balance sheet of the central bank, the goal of this tool is to increase money supply, retain medium- and long-term market rates, and subdue deflation expectations, thus contributing to the recovery of the credit market and the prevention of a persistent economic worsening

Since the outbreak of the financial crisis, demand in the major economies has shrunk continuously. Though policy rates have been cut to near zero, the risk premium in financial markets still remains high and credit markets have contracted dramatically, showing the failure of the traditional monetary policy transmission mechanism which relies mainly on short-term interest rates. In this special circumstance, an unconventional monetary policy featuring quantitative easing becomes a necessary method for the central banks to fight deflation and stabilize the economy. At the current stage, the aggressive monetary policies taken by the major economies have caused a worldwide easing, which is conducive to preventing worsening expectations of deflation. However, since international financial markets are not back on track, the effectiveness of this unconventional tool in lowering market interest rates and promoting recovery of the credit market is yet clear.

Also, an unconventional monetary policy featuring quantitative easing is potentially risky and could have far-reaching implications for international financial markets and the global economy. First, it might increase the risks of future global inflation. If the central banks fail to drain the massive liquidity once the economy recovers, seeds for future asset bubbles and inflation would be sowed. In addition, given the global nature of the inflation in recent years, a policy mistake by a major central bank would give rise to risks of global inflation. Second, it increases the possibility of major exchange rate fluctuations. Although the U.S. dollar appreciated against the major currencies at the beginning of the year, the announcement by the Federal Reserve on

March 18 to purchase a vast amount of bonds triggered a round of depreciation in the dollar. With more central banks turning to quantitative easing, the risks of depreciation of the major exchange rates are also growing. The third influence is on the bond markets of the major economies. In the short run, large-scale purchases of medium- and long-term treasury notes and agency debts might keep yields at a low level. However, from a long-term perspective, when financial markets normalize and the economy gradually recovers, factors such as intensified inflation expectations, rising interest rates, and the draining of liquidity by the central banks might lead to substantial fluctuations in bond prices.

In general, central banks that have taken or are planning to adopt an unconventional monetary policy face the major challenge of properly managing the strength of follow-up policies and formulating credible exit strategies. On the one hand, heightened short-turn expectations of deflation should be restrained to facilitate an early recovery; on the other hand, the value of their currencies should also be preserved to avoid medium- and long-term risks. In particular, a hasty exit from these unconventional policies once the economy recovers might bring new shocks to the economy, while a delayed exit and indecisive withdrawal of liquidity run the risk of setting off hyperinflation.

5. World economic outlook

In April 2009 the International Monetary Fund (IMF) projected that world economic growth would drop from 3.2 percent in 2008 to -1.3 percent in 2009, the lowest level since World War II, with the United States, the euro area, and Japan slowing from 1.1 percent in 2008 to -2.8 percent in 2009, 0.9 percent in 2008 to -4.2 percent in 2009， and -0.6 percent in 2008 to -6.2 percent in 2009 respectively and that of the emerging market economies and developing economies sliding from 6.1 percent in 2008 to 1.6 percent. At the same time, inflation in the developed economies and emerging market economies and developing economies will fall from 3.4 percent and 9.3 percent in 2008 to -0.2 percent and 5.7 percent respectively in 2009.

Looking to the future, factors weighing on the global outlook include the risks of the ongoing financial crisis spreading and deepening, whether the current weak signs of recovery in some major economies will become stronger, the effectiveness and implications of the crisis-handling measures to contain the recession and boost confidence, developments in the reform of the international financial system, and inflation uncertainties. As the crisis deepens and the economic and employment situations worsen in various countries, lessons should be drawn from the Great Depression of the 1930s and vigilance is needed against all kinds of protectionism, including trade protectionism, so that all countries can work together to promote a global recovery.

II. Analysis of China's macroeconomic performance

In the first quarter of 2009, China's economic performance experienced positive changes and was generally better than expected, which shows that the economic stimulus package aiming to expand domestic demand and promote stable and relatively fast economic development has produced effects. Consumption grew rapidly, investment growth accelerated, and domestic demand steadily increased; the agricultural sector remained generally stable and industrial production gradually stabilized; public confidence was restored and market expectations improved. However, the economic recovery was not solidly based, as large downward pressures remained on the economy due to the persistent contraction of external demand as a result of the spread of the international financial crisis. In the first quarter, the Gross Domestic Product (GDP) registered 6.6 trillion yuan, representing year-on-year growth of 6.1 percent and a deceleration of 4.5 percentage points from the same period of the last year. In this total, the contribution of final consumption, capital formation, and net exports of goods and services to GDP posted 4.3 percent, 2.0 percent, and –0.2 percent respectively. The Consumer Price Index (CPI) dropped 0.6 percent year on year, in contrast to a hike of 8.0 percent in the same period of the previous year. The trade surplus reached US$62.3 billion, up 53.6 percent year on year.

1. Domestic demand steadily increased, while external demand continued to shrink

Urban and rural household income rose, and sales on the domestic market grew at a relatively rapid pace. In the first quarter, the per capita disposable income of urban residents registered 4,834 yuan, up 10.2 percent year on year in nominal terms or 11.2 percent in real terms, an acceleration of 7.8 percentage points from the same period of the last year. The per capita cash income of farmers grew by 8.6 percent in inflation-adjusted terms to 1,622 yuan, a deceleration of 0.5 percentage points. Sales on the domestic market grew in a stable and relatively rapid manner. In the first quarter, retail sales grew 15.0 percent in nominal terms year on year, or 15.9 percent in real terms, which was an acceleration of 3.6 percentage points from the same period of 2008 and represented a high level in the recent decade.

Fixed-asset investments grew more rapidly. In the first quarter, fixed-asset investments rose by 28.8 percent, an acceleration of 4.2 percentage points from the same period of the last year; the inflation-adjusted real growth posted 30.4 percent, representing an acceleration of 15.6 percentage points. Broken down by the types of projects, in the first quarter planned total investments in projects under construction grew 26.7 percent year on year, an acceleration of 7.2 percentage points from the same period of 2008; planned total investments in new projects increased 87.7 percent, about 92.1 percentage points faster than the growth during the same period of the previous year.

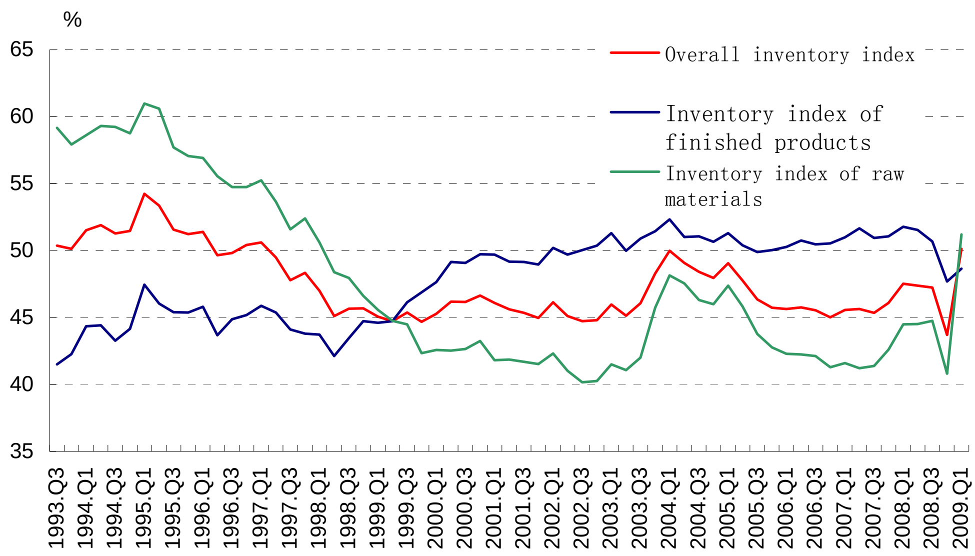
Foreign trade fell sharply. In the first quarter, imports and exports totaled US$428.7 billion, down 24.9 percent year on year. Among this total, exports dropped 19.7 percent to US$245.5 billion, whereas imports declined by 30.9 percent to US$183.2 billion. The trade surplus stood at US$62.3 billion, a year-on-year increase of 53.6 percent. In the first quarter, actual utilized foreign direct investment posted US$21.8 billion, down 20.6 percent year on year.

2. The agricultural sector remained stable and industrial production stabilized

In the first quarter, the added value of primary industry was up 3.5 percent year on year to 470 billion yuan, contributing 3.5 percent to economic growth; the added value of secondary industry was up 5.3 percent to 3,196.8 billion yuan, driving up economic growth by 43.8 percent year on year; the added value of tertiary industry grew 7.4 percent year on year to 2,907.7 billion yuan, representing a 52.7 percent contribution to economic growth.

Agricultural production had a good start and the grain-sowing area increased. It is expected that the grain-sowing area will reach 108.14 million hectares, an increase of 1.35 million hectares from the previous year. In the first quarter, meat (pork, beef, and mutton) production posted 16.15 million tons, up 6.0 percent year on year. In the first quarter, the producer prices of agricultural products (the price at which farmers sell their products) decreased by 5.9 percent year on year. The prices of agricultural capital goods registered a year-on-year increase of 5.8 percent. Though 11.7 percentage points smaller than the figure recorded during the same period of the last year, the increase in prices of agricultural capital goods was still higher than the hike in the producer prices of agricultural products, placing greater pressures on the income gains of farmers.

Industrial production stabilized. In the first quarter, the added value of statistically large enterprises rose 5.1 percent year on year, representing a deceleration of 11.3 percentage points from the same period of the previous year; and the growth in March registered 8.3 percent, about 4.5 percentage points higher than that in the first two months. The sales ratio of industrial products declined slightly by 0.6 percentage points from the same period of the last year to 97.1 percent. According to the PBC’s survey of 5,000 industrial enterprises, the business activity index in the first quarter dropped by 5.2 percentage points from the previous quarter to 7.5 percent, but the decline was significantly smaller; in terms of the enterprises’ inventory, after a quarter-by-quarter decline in 2008, the inventory index gained 6.3 percentage points this quarter, which indicates that enterprises are likely to increase their use of capacity.



Source: PBC.

Figure 2: PBC inventory index of 5,000 enterprises

3. The CPI dropped year on year

Affected by the base period factor, the CPI dropped year on year. In the three months of the first quarter, the year-on-year CPI hike posted 1.0 percent, -1.6 percent, and –1.2 percent respectively, averaging –0.6 percent. Broken down by categories, food prices were up 0.5 percent, driving up the CPI by 0.1 percentage point; prices of non-food items fell 1.0 percent, pushing down the CPI by 0.7 percentage points. Between the base period factor and the new price-rising factor, the influence of the former is greater. In the three months of the first quarter, the base period factor stood at 0.1 percent, -2.5 percent, and –1.8 percent respectively, averaging –1.4 percent, while the new price-rising factor was 0.9 percent, 0.9 percent, and 0.6 percent respectively, averaging 0.8 percent.

Box 5 Correctly understand price indices

Since the beginning of 2008, affected by multiple internal and external factors, the CPI has fluctuated greatly. In February 2008 the CPI rose to a high of 8.7 percent year on year and then declined until it dropped into the negative zone in February 2009. In March 2009, the CPI dropped 1.2 percent year on year, but grew –0.3 percent month on month, about 0.3 percentage points higher than the average month-on-month CPI hike of –0.6 percent in March between 2001 and 2008. This has sparked a discussion about price movements. Some people hold that since the CPI growth has stepped into the negative zone and the situation might last for several months, it can be assumed that China has entered into deflation. Some believe that there are downward pressures on prices, but it is not yet a typical deflation. It is also believed by some people that inflationary pressures will loom large given the quantitative easing monetary policies adopted by the central banks of the major economies and the persistently rapid growth of the credit supply in China since November 2008. In order to judge price movements, it is necessary to have a correct understanding of the definitions of the price indices, inflation, and deflation.

There are many indicators that are used to gauge a country's inflation or deflation, such as the Consumer Price Index (CPI), the Producer Price Index (PPI), and the GDP deflator. Among them, the CPI is the most frequently used. The CPI is a measure of the price changes of consumer goods and services purchased by households, and it is an important indicator for monetary policy making. The CPI can be divided into a year-on-year price index and a month-on-month index according to the chosen base period. The year-on-year CPI base period is the same month of the last year, while the month-on-month CPI uses the previous month as the base period.

The year-on-year index reflects changes in prices within one year and can rule out the impacts of seasonal factors; however, it cannot reflect short-term trends in price movements and it has a certain lag. The year-on-year price hike is influenced by the base period factor and the new price-rising factor. The base period factor, also known as the tail-raising factor, refers to the cumulative index hike in the previous year shooting up the price index in the current year, even though the month-on-month price index in this year remains flat. The new price-rising factor is the index with December of the previous year as the base period, reflecting the price movements between December of the previous year and the reporting period. Take March 2009 as an example. The year-on-year CPI decline of 1.2 percent was mainly due to the influence of the tail-raising factor. The tail-raising factor in March 2009 was –1.8 percent, while the new price-rising factor posted 0.6 percent. The tail-raising factor will remain –1.2 percent throughout 2009, which means that even if the month-on-month CPI is 0 for the whole year and there is no new price-falling factor, the CPI in 2009 will drop by 1.2 percent.

The month-on-month price index reflects the degree to which the prices in the current month rise or fall against the prices in the previous month, measures the price change between two sequential months, and indicates recent price change trends, hence it is an important indicator to observe short-term price changes. However, when this index is used, full consideration should be given to the influence of seasonal factors. For example, prices of goods and services normally rise before and during the Spring Festival, pushing up the CPI, and they drop after the Festival.

When judging the price levels, in addition to a correct reading of the price indices, it is necessary to distinguish between deflation and disinflation, and inflation and reflation. There are different definitions of deflation. The single-factor theory holds that a consistent decrease in the general price level can be deemed as deflation; the two-factor theory argues that deflation occurs when the general price level and the money supply decrease in tandem; the three-factor theory believes a third factor of a persistent decline in economic growth is needed to define deflation. Different from the consistent decrease in the general price level in times of deflation, disinflation refers to a slowdown in the inflation rate, which usually occurs after high inflation. In times of disinflation, the prices of goods that have experienced a rapid increase might drop steeply, but the general price level continues to rise though at a considerably slower pace. Different from the persistent hike in the general price level when inflation takes hold, reflation refers to the act of stimulating the economy by increasing the money supply or other measures. Within a time horizon, it refers to the time period when the economy starts to recover and the general price level begins to increase after an economic recession and a consistent decrease in the general price level. Generally, inflation is the opposite of deflation, and disinflation is the opposite of reflation.

In general, in analyzing the price situation, a comprehensive analysis of both the year-on-year and month-on-month price indices is needed to determine the major factors influencing price movements, which should be combined with an analysis of the macroeconomic indicators in order to come up with a prudent judgment.

The producer prices declined faster than the consumer prices. The producer price of industrial products dropped by 4.6 percent year on year in the first quarter, and by 3.3 percent, 4.5 percent, and 6.0 percent respectively in the three consecutive months. The purchasing prices of raw materials, fuel, and power registered an average year-on-year decrease of 7.1 percent in the first quarter, and decreased by 5.3 percent, 7.1 percent, and 8.9 percent respectively in the three consecutive months. The prices of agricultural capital goods grew 5.8 percent year on year in the first quarter, and grew by 9.7 percent, 6.8 percent, and 1.3 percent respectively in the three consecutive months.

Import prices declined faster than export prices. In the first quarter, the growth of import prices registered –10.6 percent, -17.6 percent, and –18.5 percent in the three months and averaged –15.6 percent; export prices posted growth of 2.3 percent, -2.5 percent, and –5.6 percent respectively in the three consecutive months, averaging –1.9 percent. The sharp year-on-year decline of import prices was mainly due to tumbling commodity prices in the international market. In the first quarter, the price of crude oil futures on the New York Mercantile Exchange and the average Brent crude oil spot price fell by 26.7 percent and 19.8 percent respectively from the previous quarter, and by 55.7 percent and 53.9 percent from the same period of the last year. The spot prices of copper and aluminum on the London Metal Exchange fell by 12.7 percent and 25.7 percent respectively from the fourth quarter of 2008, and by 55.7 percent and 50.2 percent from the same period of 2008.

The year-on-year increase in labor compensation pulled back noticeably. In the first quarter, the national average monthly salary of urban employees was 2,466 yuan, up 13.4 percent year on year and a deceleration of 4.9 percentage points from the same period of the last year. Broken down by entity, employees in state-owned entities, urban collectively owned entities, and other types of entities earned 2,655.7 yuan, 1,510.7 yuan, and 2,344.7 yuan per month respectively, up 14.5 percent, 16.1 percent, and 11.2 percent year on year.

The GDP deflator declined significantly in year-on-year terms. The GDP registered 6.6 trillion yuan in the first quarter of 2009, representing real growth of 6.1 percent. The GDP deflator (as a ratio of nominal GDP versus real GDP) was –2.4 percent, down 10.5 and 9.6 percentage points respectively compared with that in the same period of the last year and the average figure for 2008.

The pricing reform of resource goods advanced. The National Development and Reform Commission adjusted the prices of refined oil products on two occasions in accordance with the improved pricing mechanism for refined oil products and oil price movements in the international market. Starting from January 15, the prices of petrol and diesel per ton were reduced by 140 yuan and 160 yuan respectively; starting from March 25, the prices of petrol and diesel were adjusted upward by 290 yuan and 180 yuan respectively. In order to put into better play the fundamental role of the market in resources allocation, it is necessary to continue improving the pricing mechanism for resource goods, reform and enhance the resource taxation system, and launch the reform plan when appropriate.

4. Fiscal revenues declined year on year, and fiscal expenditures continued to grow rapidly

In the first quarter, fiscal revenues reached 1,464.2 billion yuan, down 8.3 percent year on year; fiscal expenditures totaled 1,281.1 billion yuan, up 34.8 percent year on year. As a result, expenditures exceeded revenues by 183.1 billion yuan, about 463.4 billion yuan less than that during the same period of the last year. Tax revenues registered 1,302.4 billion yuan, down 10.3 percent from the same period of the last year. Among this total, the VAT of imported goods and excise tax, corporate income tax, and customs duty dropped by 15.8 percent, 16.7 percent, and 23.9 percent year on year.

There are mainly two reasons for the decline of fiscal revenues in the first quarter.

First, the sources of fiscal revenues dwindled as corporate profits fell as a result of the slowing economy. Second, in implementing the proactive fiscal policy, structural tax reduction programs were launched, including unilaterally taxing the equity market with stamp duties for securities transactions and cutting the tax rate, reforming the value-added tax, reducing and exempting the personal income tax, and raising the export rebate rate for some categories of goods. These policies resulted in considerably less tax revenue. In connection with the economic stimulus package, fiscal expenditures in the first quarter increased by a large margin.

5. The balance of payments (BOP) remained in a surplus position

In the first quarter, the BOP was basically stable and ran a surplus. As of end-March, foreign exchange reserves reached US$1.95 trillion, an increase of US$7.7 billion from end-2008, which represented slower growth.

Gross foreign debt remained basically unchanged with an improved maturity structure. As of end-2008, outstanding foreign debt posted US$374.7 billion, up 0.3 percent over the end of the previous year and a deceleration of 15.4 percentage points. Among this total, the registered outstanding foreign debt was US$260.6 billion, up 8.4 percent from end-2007; the outstanding short-term foreign debt stood at US$210.8 billion, a decrease of 4.2 percent from end-2007, accounting for 56.3 percent of the total and a deceleration of 2.6 percentage points from end-2007.

6. Industrial analysis

Industrial production gradually stabilized, but corporate profits generally slid. In the first quarter, 33 out of 39 major industries saw an increase of industrial added value in year-on-year terms, while six industries experienced a year-on-year decline. Twelve industries registered year-on-year profit growth, the profits of 23 industries decreased, and four industries were in the red. The supply of coal, electricity, oil, and transportation was generally adequate. In the first quarter, crude coal production and freight posted 600 million tons and 5.78 billion tons respectively, up 6.3 percent and 4.4 percent year on year; crude oil output and power generation reached 40.652 million tons and 779.7 billion kilowatts respectively, down 1.6 percent and 2.0 percent from the same period of the last year.

(1) The real estate industry

In the first quarter, driven by various policies, the sold acreage and sales revenue of commercial real estate rose in year-on-year terms. Though investment in real estate development declined steeply in the first quarter, it was higher than that in January and February. Sales prices continued to drop in year-on-year terms but registered positive growth quarter on quarter.

The growth of real estate development investment decelerated significantly year on year in the first quarter, but was faster than that in the first two months. In the first quarter, completed real estate development investment registered 488 billion yuan, up 4.1 percent year on year, a deceleration of 28.2 percentage points from the same period of the last year but an acceleration of 3.1 percentage points from the first two months of this year. Among this, investment in residential housing posted 342.2 billion yuan, representing year-on-year growth of 3.2 percent and a deceleration of 31.5 percentage points from the same period of the last year. In the first quarter, the acreage of completed land purchases nationwide reached 47.42 million square meters, down 40.1 percent year on year; the acreage of the start of new construction recorded 200 million square meters, a year-on-year decrease of 16.2 percent

The sold acreage and sales revenues of commercial real estate rebounded in year-on-year terms. In the first quarter, the cumulative acreage of sold commercial real estate grew by 8.2 percent year on year to 110 million square meters, representing the first positive growth after three quarters of negative growth since the second quarter of 2008. The sales revenue of commercial housing posted 505.9 billion yuan, up 23.1 percent year on year and an acceleration of 21.6 percentage points from the same period of the last year.

Sales prices continued to fall in year-on-year terms, but rose month on month. In March 2009, home sales prices in 70 large- and medium-sized cities dropped by 1.3 percent year on year, 0.1 percentage point greater than the decline in February, representing the fourth consecutive month of decline. However, sales prices rose by 0.2 percent month on month, the first hike after seven consecutive months of negative growth since August 2008. Among this total, sales prices of newly built housing fell by 1.9 percent year on year, but up by 0.1 percent month on month; sales prices of pre-owned housing dropped by 0.4 percent year on year, but up by 0.3 percent month on month. In the first quarter, the number of cities out of the 70 large- and medium-sized cities that experienced a month-on-month home sales price decline diminished month by month, recording 46, 37, and 22 in the three months respectively.

Outstanding commercial real estate loans slowed down in year-on-year terms but rose appreciably month on month. As of end-March 2009, outstanding commercial real estate loans nationwide registered 5.67 trillion yuan, up 12.7 percent year on year and representing a deceleration of 13 percentage points from the same period of the last year, but an acceleration of 2.3 and 2.6 percentage points from the beginning of 2009 and from end-February respectively. Among this total, outstanding real estate development loans posted 2.17 trillion yuan, a year-on-year increase of 16.3 percent and a deceleration of 2.8 percentage points from the same period of the previous year; outstanding home purchase loans posted 3.49 trillion yuan, an increase of 10.6 percent year on year and a deceleration of 19.2 percentage points from the same period of the last year. In the first quarter, new real estate loans grew by 140.3 billion yuan from the same period of the last year to 336.4 billion yuan. Among this total, new loans for real estate development recorded 221.8 billion yuan, up 125.7 billion yuan year on year; new loans for home purchases grew 14.6 billion yuan from the same period of the last year to 114.9 billion yuan.

(2) The iron and steel industry

In the first quarter, demand for iron and steel continued to weaken, and there was surplus production. As a result, supply exceeded demand on the domestic market. Steel prices declined across the board and hovered at low levels. Iron and steel enterprises generally suffered losses.

Demand for iron and steel continued to wane. Affected by sluggish investment in real estate development and other factors in the first quarter, the demand of domestic steel-consuming industries was not fully activated. The demand of the international market for steel products was still contracting. In the first quarter, net exports of steel products and billets, if converted into crude steel, posted 11.2 billion tons, down by 85.5 percent year on year, and the drastic decline aggravated the supply and demand situation on the domestic market.

There was a surplus of total iron and steel output. According to the China Iron and Steel Association, iron and steel production capacity reached 660 million tons as of end-2008, out of which 160 million tons were excess capacity. This means that compared with the current market demand, there was about a 20 percent over-capacity in the domestic iron and steel market. Production of rolled steel grew 2.8 percent year on year to 140 million tons in the first quarter of 2009. In the context of weakening demand, iron and steel production in the first quarter was excessive. The continuous increase in supply led to an over-supply on the domestic market.

The prices of steel products plummeted across the board and hovered at low levels. Due to low inventories of steel products at the end of 2008, traders increased inventories at the beginning of 2009, temporarily shoring up domestic steel prices. However, after mid-February, supply exceeded demand and steel prices dropped noticeably. At end-March, the composite index for domestic steel prices stood at 97.6, down 5.7 points from the beginning of the year and 44.7 points lower than that in the same period of 2008, representing a decline of 5.5 percent and 31.4 percent respectively.

In general, iron and steel enterprises suffered losses. Though the efforts of iron and steel enterprises to cut down on production costs and expenditures yielded initial results, iron and steel enterprises were generally in the red as steel prices fluctuated at low levels across the board. In the first quarter, 25 out of 72 large- and medium-sized iron and steel enterprises suffered losses, accounting for 34.7 percent of the total, up 23.6 percentage points from the same period of the last year. The total losses reached 3.31 billion yuan, in stark contrast to the 44.16 billion yuan of profits in the first quarter of 2008.

In March 2009, the State Council promulgated the *Plan for Adjusting and Revitalizing the Iron and Steel Industry*, which provided that the industry should observe the overall requirements of the State Council for maintaining growth, expanding domestic demand, and adjusting the economic structure, looking at both the domestic and overseas markets, advancing restructuring and upgrading of the industry with an emphasis on control of aggregate supply, scrapping backward capacity, restructuring enterprises, technological upgrading, and layout optimization, so as to improve the quality and international competitiveness of iron and steel enterprises and to accelerate the development of the industry.

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

I. Outlook for the Chinese economy

As the package of policies released to expand domestic demand and promote stable and relatively rapid economic development begins to take effect, China's economic performance shows positive changes and the situation is better than expected. Nevertheless, the foundation for an economic recovery is not solid, the external economic environment remains grim, and China's economy still faces uncertainties. Given that the long-term trends for China's economic development remain unchanged, the advantages for economic development still exist, and the package of policies in response to the financial crisis is being further implemented, the Chinese economy is expected to stay on the track of stable and relatively rapid growth.

In the first quarter of 2009, although GDP grew slower in year-on-year terms than in the fourth quarter of 2008, month-on-month growth improved compared with the previous quarter, and more factors that are conducive to economic stabilization and an economic upturn have emerged. Due to the sustained effect of the central government's policies to boost investment, the rapidly increasing size of overall planned investment for new projects, and the strong financial support for economic development, investment is expected to keep increasing rapidly. A gradually declining influence from inventory adjustments will also play a positive role in promoting an economic upswing. According to the PBC's business survey in the first quarter of 2009, business managers are less concerned about the prospects of a macroeconomic downturn in the following quarter. The national bankers' survey suggests that bankers expect the macro-economy to stabilize in the second quarter and the drop in the macroeconomic expectation index moderated significantly. The survey also indicates a rise of 5.6 percentage points in the loan demand index in the first quarter from that in the previous quarter, with demand for various loans generally increasing. Moreover, the government improved social security levels, advanced reform in the medical and healthcare system, and raised agricultural subsidies, which will contribute to consumption growth. The urban depositors' survey shows that the future income confidence index of urban residents in the first quarter rose from the fourth quarter of 2008.

However, the risks and challenges that weigh on stable and relatively rapid economic development persist. As the international financial crisis continues to spread, external demand continues to weaken, leading to unpromising prospects for foreign trade. The business survey conducted by the PBC in the first quarter of 2009 suggests that the export order index, which reflects the level of overseas demand, was down 5 percentage points from the previous quarter, although the drop in the index had moderated somewhat. Heightened employment pressures and reduced growth in corporate profits and household income may weigh on future consumption demands. In general, the foundation for an economic upswing is yet to be reinforced, particularly because of a low willingness for private investment and weak endogenous growth-driving forces. While recognizing the favorable conditions and positive elements for economic and social development, we should also fully assess the complex and severe situation so as to give greater play to the potential advantages for long-term economic development and to seize the development opportunities emerging from the economic restructuring process.

Prices will be affected by a host of factors in the next period, including excess capacity and fluctuation of commodity prices. As the global economy is still in recession and economic growth stays below trend levels, excess capacity and weak demand will pose the main downward pressures on prices in the next period. The urban depositors' survey conducted by the PBC in the first quarter of 2009 shows that the percentage of those surveyed expecting price rises in the following quarter declined by 2.3 percentage points compared with that in the previous quarter and down 22.8 percentage points in year-on-year terms, the lowest level since 2004. In the meantime, an upturn in economic performance and rapid money and credit supply will help contain price declines, and the downward adjustment of the global economy also shows signs of moderation, leading to a reduced possibility of continuous sharp falls in prices. As a result of the continued massive liquidity injection and economic stimulus plans, the global money supply is loose and the prices of primary goods and assets may rebound quickly once confidence is restored.

II. Monetary policy in the next stage

In the next stage, with the focus on addressing the international financial crisis and promoting stable and relatively rapid economic development, efforts should be made to continue to carry out the package of policies designed to promote stable and relatively rapid economic development in a coordinated and well-prioritized manner. In accordance with the overall arrangements of the CPC Central Committee and the State Council, the PBC will implement a moderately loose monetary policy, maintain policy consistency and stability, and, on the basis of providing guidance to optimize the credit structure, take flexible and effective measures to step up financial support for economic development and ensure that the aggregate money and credit supply meet the needs of economic development.

First, the PBC will continue to ensure ample liquidity in the banking system and will guide financial institutions to properly increase the credit supply. The PBC will arrange the mix and maturity structure of open market operation tools as well as the intensity of open market operations in a scientific manner and flexibly and properly manage liquidity in the banking system so as to continue to ensure ample liquidity in the banking system and to keep the interest rates in the money market at a stable level. The PBC will follow economic and financial developments and review effects of its policies more closely and flexibly deploy various monetary policy tools to adjust the supply and demand in the market and to ensure that the aggregate money and credit supply meet the needs of economic development.

Second, the PBC will guide financial institutions to optimize the credit structure and to improve the quality of credit support to promote economic development. The PBC will strengthen credit destination guidance for financial institutions to ensure that loans to eligible central government investment projects are granted in a timely manner. It will enhance credit support aimed at improving social welfare, including credit to agriculture, rural areas, farmers, employment programs, students, and post-disaster reconstruction, develop consumer credit, carry out credit policies to the real estate industry, and provide greater financing support to small- and medium-sized enterprises, independent innovation, mergers and acquisitions, industrial relocation and programs for balanced regional economic development. The PBC will place strict control over the granting of loans to enterprises in high-energy consuming, high-polluting industries and industries with excess capacity. It will guide financial institutions to innovate and improve financial services and extend greater financial support to economic development while effectively preventing and controlling credit risks.

Third, the PBC will continue to advance the market-based interest rate reform and improve the RMB exchange rate regime. It will accelerate the building of a benchmark interest rate system in the money market and improve the risk pricing ability of financial institutions. Following the principle of making the RMB exchange rate reform a self-initiated, controllable, and gradual process, the PBC will continue to improve the RMB exchange rate formation mechanism, increase the flexibility of the RMB exchange rate, and keep the exchange rate basically stable at an adaptive and equilibrium level. It will continue to deepen foreign exchange administration reform, promote the development of the foreign exchange market, and provide enterprises with more tools to manage exchange rate risks.

Fourth, the PBC will continue to press ahead with the reform of the financial system to improve the competitiveness of financial institutions and the efficiency of the financial market in resource allocation. It will build up the competitiveness of financial institutions and improve the resources allocation efficiency of financial markets by deepening the reform of financial institutions and boosting financial innovation. It will develop a multi-layered direct financing system, boost the volume of bond financing, vigorously promote short-term financing bills, medium-term notes, and other debt financing instruments, and proceed with asset securitization and making innovations in a stable manner. The PBC will guide private financing activities to develop in a healthy way.

It is worth noting that while we give play to the role of demand management policies to iron out economic fluctuations, it is more important to speed up economic restructuring, innovation, and reform so as to increase the intrinsic dynamism of the economy. The fact that the Chinese economy was able to eliminate the impact of deflation and enter a sustained upturn cycle after 2002 is closely related to a series of major restructuring and reform measures adopted in the wake of the Asian financial crisis, including accelerating SOE restructuring and reform, developing the real estate, automobile, and other new consumer markets, and joining the World Trade Organization. As a developing country and an economy in transition, China has enormous development potential and huge room for further reform and restructuring. While maintaining stable and relatively rapid economic growth, China should work to closely integrate its efforts to expand domestic demand, restructure the economy, advance reform, and improve the people’s livelihood.