China Monetary Policy Report
Quarter Four, 2011

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Monetary Policy Analysis Group of

the People's Bank of China

Executive Summary

In 2011, in the face of complex situations both at home and abroad, policies aimed at macro-economic management were adopted, properly handling their pace and dynamism and producing good results. The growth rate of the Chinese economy and the growth of overall price levels gradually stabilized, the balance of payments continued to improve, employment figures were fairly good, and the performance of the macro economy was consistent with the anticipated direction of the macro-economic management. In 2011 the Gross Domestic Product (GDP) registered 47.1 trillion yuan, up 9.2 percent year on year, and the Consumer Price Index (CPI) rose by 5.4 percent year on year.

The PBC implemented a prudent monetary policy and when necessary carried out proper fine-tuning. In the first three quarters, facing growing inflation pressures, in accordance with the overall arrangements of the State Council, the PBC, regarding inflation control as the top priority of macro-economic management, employed a mix of various monetary policy instruments and enhanced macro-prudential regulation. The deposit reserve requirement ratio was raised six times by a total of three percentage points, and the benchmark lending and deposit rates were raised three times by a total of 0.75 percentage points. Open market operations were conducted in a flexible manner, and a mechanism for dynamic adjustments of differentiated deposits required by the reserve ratio mechanism was adopted to guide the growth of money and credit to gradually readjust and to keep the all-system financing aggregate at an appropriate volume. In the last three months, in view of the spreading sovereign debt crisis in Europe, deceleration of the domestic growth rate, and moderation of the price hike, the PBC improved the targeting, flexibility, and effectiveness of policy measures, and took precautionary measures for adjustments and fine-tuning; meanwhile, the issuance of three-year central bank bills was suspended, the deposit reserve requirement ratio was reduced by 0.5 percentage points, and the parameters for the dynamic adjustment of the differentiated reserve requirement were adjusted and optimized to guide financial institutions to step up credit support to small and micro enterprises, rural borrowers, the agricultural sector, and follow-up projects of key national projects. In general, the prudent monetary policy gradually produced results.

Growth of broad money supply gradually moderated and the RMB exchange rate became more flexible. At end-2011, M2 recorded 85.2 trillion yuan, up 13.6 percent year on year, representing a deceleration of 6.1 percentage points from the previous year. Outstanding RMB loans were up 15.8 percent year on year, representing growth of 7.47 trillion yuan from the beginning of the year and a deceleration of 4.1 percentage points. In 2011, all-system financing aggregates posted 12.83 trillion yuan and bond financing recorded a large increase. In general, loan interest rates moved up. The weighted average lending rate offered to non-financial enterprises and other sectors posted 8.01 percent. At end-2011, the central parity of the RMB against the US dollar was 6.3009 yuan, up 5.11 percent over end-2010.

At present, China is still at a stage of important strategic opportunities in terms of social and economic development and there are various favorable conditions for the economy to continue its stable and fairly rapid growth. Yet the economic situations at home and abroad are very complex and serious. The sovereign debt crisis in Europe is unlikely to be resolved effectively in the short term, and uncertain and unstable factors are on the rise in the global economy. The unbalanced, uneven, and unsustainable problems and issues are obvious in China's economic performance and it faces both downward growth pressures and inflationary pressures.

In line with the overall arrangements of the Central Economic Work Conference and the National Financial Work Conference, the PBC will follow the theme of sustainable development and transformation of the growth pattern, properly handle the relationships to support stable and fairly rapid economic growth, economic restructuring, and to manage inflation expectations, continue to implement a prudent monetary policy, maintain policy continuity and stability, closely monitor economic and financial developments at home and abroad, enhance the targeting, flexibility, and forward-looking nature of the macro-economic management measures, and initiate fine-tuning and preemptive adjustments as appropriate in order to keep the overall price levels generally stable and to contribute to stable and fairly rapid economic growth. A mix of various monetary policy instruments will be used and the macro-prudential policy framework will be improved to make counter-cyclical adjustments, to further optimize the credit structure on the basis of a proper aggregate volume, to make proper adjustments in money and credit supply, to keep all-system financing aggregates at proper a volume, and to provide good services to the real sector. The market-based interest rate reform and the RMB exchange-rate regime reform will be advanced. The PBC will continue to promote the sound development of financial markets and will deepen the reform of financial institutions. Effective measures will be taken to mitigate and prevent systemic financial risks and to preserve the stability of the financial system.

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Part 1 Monetary and Credit Performance

In 2011 China's economy maintained stable and relatively rapid development, and the growth of money and credit moved in the direction of a normal level. The financial system performed soundly.

I. The growth of money supply generally declined

At end-2011 outstanding M2 registered 85.2 trillion yuan, up 13.6 percent year on year and a deceleration of 6.1 percentage points year on year. Outstanding M1 stood at 29 trillion yuan, an increase of 7.9 percent year on year and a deceleration of 13.3 percentage points over 2010. Currency in circulation M0 totaled 5.1 trillion yuan, up 13.8 percent year on year and a deceleration of 2.9 percentage points compared with 2010. In 2011 net cash injections posted 616.1 billion yuan, 21.4 billion yuan less year on year. In general, the growth of M2 and M1 slowed down from January through November and rebounded in December. In the final month of 2011, M1 growth was 0.1 percentage point higher over November due to the heightened demand for cash with the approach of the Spring Festival. The growth of M2 was 0.9 percentage points over the previous month due to the conversion of some off-balance sheet wealth management products to deposits to meet regulatory requirements, enhanced fiscal expenditures, and the rise in loan extensions. Moreover, because financial innovation accelerated the diversion of traditional deposits, the M2 data may be an underestimation of real monetary conditions.

At the end of 2011, outstanding base money registered 22.5 trillion yuan, up 23.2 percent year on year and 4.2 trillion yuan more than that at the beginning of the year. The money multiplier stood at 3.79, which was 0.13 lower than at end-2011. The excess reserve ratio of financial institutions stood at 2.3 percent and that for rural credit cooperatives (RCCs) stood at 7.3 percent.

II. The deposit growth of financial institutions slowed down

At end- 2011 outstanding deposits in domestic and foreign currencies of all financial institutions (including foreign-funded financial institutions, the same hereinafter) stood at 82.7 trillion yuan, up 13.5 percent year on year and a deceleration of 6.3 percentage points over 2011. The outstanding value was 9.9 trillion yuan more than that at the beginning of 2011, a deceleration of 2.1 trillion yuan year on year. Outstanding RMB deposits registered 80.9 trillion yuan, up 13.5 percent year on year and a deceleration of 6.7 percentage points over that at end-2011. This was 9.6 trillion yuan more than that at the beginning of 2011 and a deceleration of 2.3 trillion yuan year on year. Outstanding deposits in foreign currency posted US$275.1 billion at end-2011, an increase of 19 percent year on year or US$49.4 billion over that at the beginning of 2011, which was US$29.5 billion more than the growth in 2010.

Broken down by type, the growth of household deposits was stable while that of non-financial institutions generally slowed down. At end-2011 outstanding household deposits stood at 34.8 trillion yuan, up 15.7 percent year on year and a deceleration of 0.8 percentage points over end-2011. This was also 4.7 trillion yuan more than that at the beginning of 2011 and 429.7 billion yuan less than the growth during the same period of the last year. Outstanding RMB deposits of non-financial institutions totaled 30.4 trillion yuan, up 9.2 percent year on year and a deceleration of 12.3 percentage points over 2010. This was also 2.6 trillion yuan more than that at beginning of 2011 and a deceleration of 2.7 trillion yuan year on year. At end-2011, outstanding fiscal deposits reached 2.6 trillion yuan, up 2.6 percent year on year and 30 billion yuan less than that at the beginning of 2011.

III. Loan growth of financial institutions moved in the direction of a normal level

At end-2011, outstanding loans in domestic and foreign currencies of all financial institutions reached 58.2 trillion yuan, up 15.7 percent year on year and a deceleration of 4 percentage points over end-2010. This was also 7.9 trillion yuan more than that at the beginning of the 2011, a deceleration of 377.9 billion yuan. The growth of RMB loans continued to slow down. At end-2011, outstanding RMB loans stood at 54.8 trillion yuan, up 15.8 percent year on year and a deceleration of 4.1 percentage points over end-2010. This was also 7.47 trillion yuan more than that at the beginning of 2011 and a deceleration of 390.1 billion yuan year on year. Since the beginning of Q4 2011, loan extensions have been on a rise. A total of 1.8 trillion yuan of new loans was extended in Q4, 207.7 billion yuan more year on year. Credit-expansion pressures continued.

Broken down by type, the loan growth of the household sector slowed down, whereas that of non-financial institutions stabilized. At end-2011, loans to the household sector increased 20.9 percent year on year, a deceleration of 16.7 percentage points. This was 2.4 trillion yuan more than that at the beginning of 2011 and 454.6 billion yuan less year on year. The main contributing factor for this was the slowdown in the growth of home mortgages. This was 832.1 billion yuan more than that at the beginning of 2011, 461.8 billion yuan less year on year. Consumption loans of the non-housing sector grew rapidly, 648.5 billion yuan over the beginning of 2011, and 55.8 billion yuan more year on year. Loans to non-financial institutions and other sectors grew 13.9 percent year on year, a deceleration of 1.4 percentage points compared with end-2010 and an acceleration of 0.4 percentage points over end-September. This was 5 trillion yuan more than that at the beginning of 2011, which was 49.3 billion yuan more year on year. Among this total, the growth of medium- and long-term loans continued to slow down. At end-2011, it rose 2.1 trillion yuan compared with the beginning of the year, a deceleration of 2.1 trillion yuan year on year. Bill financing went up by 11.2 billion yuan over the beginning of the year, 916.4 billion yuan more year on year. Broken down by institutions, loan growth of Chinese-funded large-sized national banks decelerated significantly, whereas that of national small and medium banks accelerated by a large margin. The loan structure of both the large banks and the small and medium banks has improved.

Table 1 RMB loans of financial institutions in 2011

Unit: 100 million yuan

	2011		2010	
	New loans	Acceleration year on year	New loans	Acceleration year on year
Chinese-funded Large Banks Operating Nationwide①	37461	-3361	40822	-12899
Chinese-funded Small and Medium Banks Operating Nationwide②	22583	-873	23456	-1704
Chinese-funded Small and Medium Local Banks③	7329	2039	5290	-2017
Rural Cooperative Financial Institutions④	10014	359	9655	-72
Foreign-funded Financial Institutions	779	-849	1628	1610

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

② Chinese-funded small and medium banks operating nationwide refer to banks that operate across different provinces with assets of less than 2 trillion yuan denominated in domestic and foreign currencies.

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

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

Source: People's Bank of China

The growth of foreign currency-denominated loans declined. At end-2011, outstanding foreign-currency loans of financial institutions reached US$538.7 billion, up 19.6 percent year on year and an acceleration of 0.1 percentage points over end-2010. This was also US$88.2 billion more than that at the beginning of 2011, an acceleration of US$16.3 billion year on year. Trade financing increased by US$27.4 billion, an acceleration of US$9.6 billion year on year, and maintained the support to import and export financing. Overseas loans and medium- and long-term loans climbed by US$40.6 billion.

IV. All-system financing aggregate stood at an appropriate level, and bond financing rose significantly

It is estimated that the all-system financing aggregate registered 12.83 trillion yuan in 2011, down 1.11 trillion yuan compared with 2010. Among this total, new RMB loans posted 7.47 trillion yuan, a reduction of 390.1 billion yuan. Foreign-currency-denominated loans increased the equivalent of 571.2 billion yuan, an acceleration of 85.7 billion yuan year on year. New entrusted loans rose by 1.3 trillion yuan, an acceleration of 420.5 billion yuan year on year. Trust loans increased by 201.3 billion yuan, a deceleration of 185.2 billion yuan. Undiscounted banker's acceptances grew 1.03 trillion yuan year on year, a deceleration of 1.31 trillion yuan. Net financing through corporate bonds registered 1.37 trillion yuan, an acceleration of 259.5 billion yuan. A total of 437.7 billion yuan was raised by domestic non-financial institutions via the stock market, down 140.9 billion yuan year on year.

Bond financing played a significantly more important role in fund allocations. First, bond financing accounted for a much larger share of total financing to the real economy. Net financing through corporate bonds accounted for a record 10.6 percent of the all-system financing aggregates, up 2.7 percentage points year on year. Second, non-banking financial institutions extended much greater support to the real economy. Compensation payments by insurance companies and new loans extended by micro credit companies and loan companies totaled 439.2 billion yuan, much more than that in 2010.Third, off-balance sheet financing from financial institutions to the real economy was notably lower than that in the previous year. In 2011, a total of 2.52 trillion yuan was financed through entrusted loans, trust loans, and undiscounted bankers' acceptances, a deceleration of 1.07 trillion yuan over 2010. This accounted for a 19.7 percent share of the all-system financing aggregates, which was 6.0 percentage points lower than that in 2010. Among this total, financing through entrusted loans, undiscounted bankers' acceptances, and trust loans accounted for 10.1 percent, 8 percent, and 1.6 percent respectively of the all-system financing aggregates, marking an increase of 3.9 percentage points, a reduction of 8.7 percentage points, and a decline of 1.2 percentage points respectively year on year.

V. The lending rates of financial institutions climbed steadily

In the first three quarters, lending rates offered to non-financial institutions and other sectors climbed due to consecutive upward adjustments of benchmark lending and borrowing rates, but in Q4 they declined as a result of stabilized economic growth and the reduction in the reserve requirement ratio. In December, the weighted average lending rate stood at 8.01 percent, up 1.82 percentage points over the beginning of the year. The weighted average loan interest rate registered 7.80 percent, up 1.47 percentage points over the beginning of 2011, and the weighted average bill financing rate posted 9.06 percent, up 3.57 percentage points over the beginning of the year. The weighted average residential mortgage rate rose steadily, reaching 7.62 percent in December, up 2.27 percentage points over the beginning of 2011.

The share of loans with interest rates higher than the benchmark constituted a much larger share, while the share of loans with interest rates lower than or flat with the benchmark accounted for a smaller share. In December, the share of loans with interest rates higher than, flat, or lower than the benchmark stood at 7.02 percent, 26.96 percent, and 66.02 percent respectively, marking a decrease of 20.78 percentage points, a decrease of 2.2 percentage points, and an increase of 22.98 percentage points respectively compared with the beginning of 2011. Macro-economic management policies were transmitted effectively so as to affect the price levels.

Foreign currency deposits and lending rates moved up among fluctuations due to changes in the supply and demand for funds in China and the evolution of interest rates on the international financial market. In December, the weighted average demand interest rates and of less than 3-month large-value US dollar deposits registered 0.31 percent and 3.29 percent respectively, marking a decline of 0.02 percentage points and an increase of 1.45 percentage points respectively compared with the beginning of the year. The weighted average of less than 3 month and 3(including 3-month)-6 month US dollar lending rates posted 3.85 percent and 4.31 percent respectively, up 1.28 percentage points and 1.46 percentage points over the beginning of 2011.

Table 2 Shares of loans with rates floating at various ranges of the benchmark rate in 2011

unit: %

	Lower than the benchmark	At the benchmark	Higher than the benchmark					
	[0.9, 1)	1	sum	(1, 1.1]	(1.1, 1.3]	(1.3, 1.5]	(1.5, 2]	Above 2
January	21.35	29.45	49.20	15.97	15.01	6.08	8.67	3.48
February	19.94	31.80	48.26	17.91	14.55	5.61	7.29	2.90
March	13.96	30.22	55.82	18.25	17.76	6.96	9.24	3.60
April	12.54	28.43	59.04	18.72	20.56	7.39	9.14	3.22
May	11.18	27.96	60.87	20.81	21.34	7.29	8.69	2.74
June	9.94	28.91	61.15	20.56	22.70	7.22	8.08	2.60
July	8.53	26.72	64.74	20.75	23.98	8.14	8.99	2.89
August	6.05	25.27	68.67	22.40	25.80	8.42	9.06	3.00
September	6.96	25.86	67.19	21.62	25.47	8.29	8.89	2.91
October	5.06	29.96	64.99	21.54	25.02	7.81	7.87	2.75
November	7.00	26.90	66.10	21.16	25.25	8.20	8.34	3.14
December	7.02	26.96	66.02	21.51	24.20	8.26	8.98	3.08

Source: People's Bank of China

Table 3 The average interest rate for large-value deposits and loans denominated in US dollars in 2011

Unit: %

	Large-value deposits						Loans				
	Demand deposits	Within 3 months	3-6 months	6-12 months	1 year	Above 1 year	Within 3 months	3-6 months	6-12 months	1 year	Above 1 year
January	0.24	1.99	2.01	1.87	3.47	4.45	2.76	2.92	3.04	2.91	3.35
February	0.27	2.14	2.68	2.55	3.34	3.91	2.94	3.16	3.12	3.16	3.16
March	0.32	2.31	2.67	3.01	2.91	4.47	3.04	3.26	3.76	3.25	3.15
April	0.28	2.61	2.58	2.96	4.19	5.20	3.02	3.25	3.57	3.41	3.16
May	0.29	2.63	3.14	3.38	3.60	5.58	3.12	3.44	3.68	3.54	3.60
June	0.26	2.79	2.80	2.66	1.48	3.22	3.16	3.46	3.73	3.78	3.46
July	0.33	2.68	2.98	3.39	2.78	5.47	3.30	3.58	4.23	3.90	3.78
August	0.31	2.95	3.47	3.44	3.58	5.36	3.34	3.69	4.03	3.97	3.58
September	0.35	2.99	3.81	3.15	3.86	5.61	3.37	3.75	4.37	3.70	3.76
October	0.34	2.98	3.48	3.48	1.74	5.03	3.72	4.17	4.76	3.72	4.92
November	0.30	3.36	3.85	4.48	3.84	2.52	3.76	4.29	4.78	4.37	3.74
December	0.31	3.29	3.97	4.08	2.82	3.37	3.85	4.31	4.57	3.89	4.26

Source: People's Bank of China

VI. RMB exchange-rate flexibility rose significantly

In 2011 the RMB exchange rate moved in both directions and appreciated slightly, with greater flexibility and stable expectations. At end-2011, the central parity of the RMB against the US dollar was 6.3009 yuan per US dollar, up 3218 basis points or 5.11 percent over end-2010. From the reform of the RMB exchange-rate regime in 2005 to end-2011, the RMB appreciated 31.35 percent against the US dollar. The BIS estimates that in 2011 the nominal effective RMB exchange rate appreciated 4.95 percent, the real effective exchange rate appreciated 6.12 percent, and from the exchange-rate reform in 2005 to December 2011 the nominal effective RMB exchange rate appreciated 21.16 percent and the real effective exchange rate appreciated 30.34 percent.

Part 2 Monetary Policy Operations

In 2011, following the overall arrangements of the State Council, the PBC implemented a prudent monetary policy while making policies more targeted, flexible, and effective and making preemptive adjustments and fine-tunings as appropriate to maintain overall price stability -- the priority of China's macro-economic management. To this end, the PBC strengthened macro-prudential management, employed a rich mix of monetary policy tools, improved management of liquidity in the banking system, guided a steady normalization of money and credit supply, maintain the all-system financing aggregates at a reasonable level, and encouraged financial institutions to improve the credit structures, thereby contributing to stable and sound economic and financial development.

Box 1 Monetary policy in the fourth quarter of 2011: Forward-looking and flexible fine-tunings

Monetary policy has become more forward-looking during the recent years as China has addressed the challenges brought about by the rapid and profound economic and financial developments both at home and abroad. For instance, in response to the weakening external demand as the sub-prime mortgage crisis in the U.S. grew in mid-2008, despite the inflationary pressures, timely adjustments were made to monetary policy, including cutting the benchmark lending rates, lowering the reserve requirement ratio, and encouraging proper credit expansions, culminating, after the international financial crisis, in a shift to a moderately easy policy stance in the fourth quarter. In mid-2009, policy intensity was refined to moderate credit growth in the third and fourth quarters as the economy began to stabilize and recover. In early 2010, in anticipation of rising inflationary pressures, the mix of quantitative and price-based tools was used to guide normalization of monetary conditions that had been eased to fight the financial crisis. This shift was enhanced in 2011, when monetary policy was moved from its relatively easy stance to a prudent stance, supported by the use of quantitative and price-based monetary policy tools as well as macro-prudential policy instruments to control liquidity supply and monetary conditions, successfully containing sharp price increases and promoting stable and sound economic development.

Uncertainties over the global recovery increased again after September 2011 as the sovereign debt crisis in Europe escalated, with recession-stricken Greece being pushed to the edge of default, and Spain and Italy facing higher debt risks. Financial markets were thrown into fresh turmoil, fueled by concerns that the debt crisis might spread to the core Euro area economies and spill over into the banking sector and cause a banking crisis. As risk aversion heightened and fiscal and credit tightening in the Euro area intensified, China and other emerging market economies felt the shock as there was sharp volatility in short-term capital flows. Though a net capital inflow was recorded for China in 2011, a temporary decline in RMB issued for sterilization purposes in the fourth quarter had an impact on the supply of liquidity. At the same time, as the Chinese economy slowed down, price levels dropped and many enterprises reported intensified operational difficulties. In this context, the PBC decided to make policies better targeted, more flexible, and forward-looking, while also maintaining policy consistency and stability in following the prudent monetary policy. As a result, a number of preemptive adjustments and fine-tunings were made since September to increase liquidity and ensure proper money and credit supply.

First, a combination of measures was taken to accommodate liquidity needs in the market. The PBC suspended the 3-year central bank bills, adjusted the issuance of central bank bills of other maturities, provided liquidity through reverse repos and mature central bank bills, and lowered the interest rate for 1-year central bank bills. Building on the effects of open market operations as a preemptive adjustment and fine-tuning, the PBC announced on November 30 that the reserve requirement ratio would be cut by 0.5 percentage points on December 5. In addition, the PBC proactively signaled its short-term liquidity support by announcing it would address the surging need for cash expected during the short period of both the New Year festival and the Chinese lunar New Year celebrations. These measures were quite effective in ensuring a stable liquidity supply in the banking system and in stabilizing market expectations.

Second, the mechanism to adjust the differentiated reserve requirement on a continuous and case-by-case basis was used as a counter-cyclical tool to increase credit supply. Based on economic and financial developments in the fourth quarter, the PBC calibrated the coefficients used in the mechanism, encouraging financial institutions with a strong capital adequacy ratio, quality capital assets, sound governance, and a good record of implementing credit policies to increase credit support for small- and micro-sized enterprises in industries encouraged by industrial policies, agriculture, rural areas, and farmers, as well as key national projects in progress. As a result, lending in RMB expanded by 1.8 trillion yuan, an increase of 207.7 billion yuan year on year. The use of this mechanism by adjusting the coefficients is continuing in 2012 to maintain proper credit growth.

Since early 2012, capital flows to China have resumed as global economic and financial developments have showed signs of stabilization, and the RMB is expected to return to stability, or even to appreciate modestly, as indicated by the Non-deliverable Forward (NDF) market. The PBC will keep a close watch on the developments and sustainability of the rebound in the issuance of RMB for sterilization purposes and the increase in liquidity provisions. Following the prudent monetary policy, the PBC will strengthen the monitoring and assessments of domestic and international economic and financial developments to make its policies better targeted, more flexible, and forward-looking.

I. Flexible open market operations

In 2011, building on more intensive analysis and monitoring of liquidity supply and demand in the banking system, the PBC properly managed the intensity and pace of open market operations in response to liquidity changes in the banking system, which, together with the use of the reserve requirement policy, helped maintain proper liquidity in the banking system. Issuance of central bank bills in 2011 totaled about 1.4 trillion yuan, and repurchase operations totaled about 2.5 trillion yuan on a cumulative basis. Outstanding central bank bills stood at about 1.9 trillion yuan as of end-2011. The role of open market operations in pre-adjusting and fine-tuning liquidity was given full play through an improved mix of open market operations tools. In line with domestic and international economic developments, the PBC improved the maturity of structure of open market operations by combining central bank bills with a maturity less than one year and short-term repurchase operations, which were supplemented by refined timing and frequency of the issuance of 3-year central bank bills. This allowed the banking system to better address short-term liquidity volatility in the complex situation.

Interest rates of open market operations played a successful role in shaping market expectations. Open market operations interest rates moved up gradually in the first three quarters, supporting adjustments in the benchmark deposit and lending rates and responding to upward movements in market interest rates. In the last quarter, the interest rate for 1-year central bank bills edged down and stabilized, which was important for stabilizing market expectations. As of end-2011, interest rates for 3-month and 1-year central bank bills stood at 3.1618 percent and 3.4875 percent respectively, up 114.6 basis points and 97.6 basis points from end-2010.

State treasury cash management operations were continued. In 2011, a total of 450 billion yuan of state treasury funds was deposited in commercial banks on eleven separate operations, with an outstanding amount of 290 billion yuan at year's end.

II. Increases in the reserve requirement ratio and the adoption of a mechanism to adjust the differentiated reserve requirement on a continuous and case-by-case basis

As a potent tool to mop up excessive liquidity, the reserve requirement ratio was used in a flexible manner to manage liquidity, complementing open market operations that were used to manage daily liquidity. Against the background of a continued, large BOP surplus, the reserve requirement ratio for RMB deposits in depository financial institutions was raised by 3 percentage points on a cumulative basis in the first half of the year, including six increases of an increment of 0.5 percentage points on January 20, February 24, March 25, April 21, May 18, and June 20. The scope of deposits against which reserves are required was broadened to cover margin deposits, effective from September 2011 and enforceable within 3 to 6 months depending on the liquidity level at each financial institution, helping to ensure that the coverage of the required reserves remains complete and that they play a better role in macro-economic management. In the fourth quarter, in response to fluctuations in RMB issued for sterilization purposes, as the sovereign debt crisis worsened and risk aversion intensified the PBC lowered the reserve requirement ratio by 0.5 percentage points on December 5 while continuing open market operations for preemptive and fine-tunings, so as to keep banking system liquidity at a reasonable level.

Based on the lessons of the international financial crisis, in early 2011 the PBC introduced a mechanism to adjust the differentiated reserve requirement on a continuous and case-by-case basis, encouraging financial institutions to operate prudently and to pace credit supply from a counter-cyclical perspective by subjecting credit growth to the capital level in a macro-prudential sense and by taking into consideration the systemic significance and soundness of the financial institutions as well as the business cycles. Based on economic and financial developments in the fourth quarter, the PBC calibrated the coefficients used in the mechanism, encouraging financial institutions with a strong capital adequacy ratio, quality capital assets, sound governance, and a good record of implementing credit policies to increase credit support for small- and micro-sized enterprises in industries encouraged by industrial policies, agriculture, rural areas, and farmers, as well as key national projects in progress, playing a strong role in the making of preemptive adjustments and fine- tunings.

Box 2 Latest progress in the macro-prudential policy framework

The essence of macro-prudential management is to maintain monetary and financial stability by taking measures from a macro and counter-cyclical perspective to prevent systemic risks that may arise from pro-cyclical volatility and cross-sector contagion in the financial system. As one of the key areas for international financial regulatory reform after the financial crisis, international efforts to enhance macro-prudential policy have been fruitful, establishing a preliminary operational framework.

For policy tools, the Group of Twenty countries (G20) endorsed the basic framework of Basel Ⅲ in late 2010, which includes progress on many issues to strengthen macro-prudential management and counter-cyclical adjustments. First, banks are asked, on top of the existing minimum capital requirement, to put a capital requirement set for macro-prudential purposes. A 2.5 percent capital buffer will be in place to help banks better cope with future economic and financial shocks. Banks also are required to increase their counter-cyclical capital buffer by a range of 0-2.5 percent, depending on how much the credit to GDP ratio deviates from the trend level, to protect them from shocks brought about by credit surges. In addition to the minimum capital requirement, systemically important banks are asked to develop a stronger ability to absorb losses. Second, requirements for liquidity and the leverage ratio were strengthened. Two new standards, the liquidity coverage ratio (LCR) and the net stable financing ratio, were introduced in an effort to encourage financial institutions to better manage liquidity risks. As a complement to the minimum capital requirement, off-balance sheet risks are included in assessing the leverage ratio, which is now calculated by looking at the tier 1 capital as a percentage of on-balance sheet capital, the off-balance sheet risk exposure, and the total exposure of derivatives.

Central banks are playing a dominant role in implementing financial regulatory reforms. In the U.S., a financial stability supervision committee was established to identify and prevent systemic risks in line with the Financial Reform Act, giving the Federal Reserve a greater role in overseeing systemically important financial institutions and authorizing the Federal Reserve to supervise large and complex financial institutions, as well as the clearing, payment, and settlement systems, with the aim of identifying, measuring, and resolving systemic financial risks. In the U.K., the Bank of England is authorized to promote macro-prudential management, supported by the establishment of a financial policy committee within the central bank to make macro-prudential policies and by the transfer of financial supervisory power from the FSA to the central bank, reflecting a major change in the philosophy on financial regulation and supervision. The role of the Bank of Korea in macro-prudential management was also enhanced after the recent revision of the Law on the Bank of Korea in September 2011, providing necessary tools and means to the central bank to maintain financial stability. The Bank of Japan fulfills its macro-prudential management mandates in various ways, including conducting regular financial stability assessments, combining macro-prudential management with micro-level on-the-spot and off-site monitoring, providing necessary liquidity support as the lender of the last resort, following a macro-prudential approach in the making of monetary policies, and monitoring the payment and settlement system. Moreover, in its report on central bank governance and financial stability, the Bank for International Settlements (BIS) suggests that macro-prudential responsibility should be better performed by central banks as they are in a stronger position to carry out macro and systemic analysis. This view was echoed by Mr. Blanchard, chief economist of the International Monetary Fund (IMF), who, in his report on rethinking the macro-prudential policy framework, argued that it is important to give central banks a macro-prudential management mandate because they are ideally capable of monitoring macro-economic developments and because monetary policies may weigh on leverage and risk behavior.

As a member of the G20, China is working to enhance and improve its macro-prudential policy framework, announcing in the 12th Five-year Program to build a "counter-cyclical financial macro-prudential management framework." Currently, China uses both quantitative and price-based approaches in financial macro management. The central bank follows the movements of interest rates and other price-based indicators and closely watches money and credit growth, supported by measures aimed at improving macro-prudential management, including the use of credit policy, differentiated reserve requirements and adjustments in the down payment share for mortgage loans, as well as risk warnings through window guidance, which have been quite effective. After the outbreak of the international financial crisis, in 2009 the PBC began studies on further enhancing macro-prudential management in accordance with the central government's arrangement to improve the macro-prudential policy framework. In 2011 the PBC introduced the mechanism to adjust the differentiated reserve requirement on a continuous and case-by-case basis to effectively ensure steady money and credit growth and the soundness of financial institutions by linking aggregate control of money, credit, and liquidity with macro-prudential policy. Going forward, drawing on the lessons from the recent international financial crisis as well as successful international practices, and taking into consideration China's circumstances, the PBC will further improve the macro-prudential policy framework by building a system whereby macro-prudential management and micro-prudential supervision are mutually reinforcing. It will improve measures for macro-prudential management, and the central bank will play a dominant role in enhancing counter-cyclical macro-prudential management.

III. Interest rates as policy leverage

The PBC raised the benchmark deposit and lending rates on three occasions in the first three quarters, i.e., on February 9, April 6, and July 7, increasing the 1-year benchmark deposit rate from 2.75 percent to 3.50 percent and the 1-year benchmark lending rate from 5.81 percent to 6.56 percent, both up by a cumulative 0.75 percentage points. These timely increases in the benchmark deposit and lending rates supported efforts to stabilize inflationary expectations and to guide reasonable money and credit growth. They were also important to reinforce the effect of property market policies, improve the allocation of funds, and protect household wealth. Benchmark deposit and lending rates remained stable in the fourth quarter, which was in line with domestic and international developments, especially the gradual slowdown of price hikes in the domestic market.

IV. Strengthened window guidance and credit policy guidance

Continuing to strengthen and improve window guidance and to implement a differentiated credit policy, the PBC encouraged financial institutions to properly manage the pace of credit supply, to improve the credit structure, and to prevent credit risks so as to enhance financial services to the real economy and in areas that are key to the people's livelihood. The PBC advanced assessments of the effects of credit policies, particularly lending policies for agriculture and SMEs, to promote their effective transmission. The PBC increased financial support to facilitate irrigation reforms, including farmland irrigation and water conservancy programs, and promoted innovation in financial products and services to rural areas. It encouraged financial institutions to take multiple measures to improve financial services to small- and micro-sized enterprises in accordance with the latest SME classification criteria. The PBC also actively supported industrial structural upgrading and economic restructuring, as well as the development of enterprises in the emerging strategic industries and other high- and new-tech enterprises. It urged financial institutions to implement policies to provide financial support for the cultural industry, services outsourcing, and logistics and tourism, and to provide greater credit support to the environmental protection industry, to circular economy, to energy conservation and emission reductions, and to technology upgrading. In the meantime, the PBC improved policies for micro-guaranteed loans aimed to promote employment by helping migrant workers, women, university graduates working as village officials, people with disabilities, ethnic minorities, and other groups to start their own businesses.

On the whole, lending to agriculture, rural areas, and farmers as well as SMEs remained robust. As of end-2011, outstanding agro-linked loans in both RMB and foreign currencies totaled 14.6 trillion yuan, or 25.1 percent of the total lending, including 2.7 trillion yuan of new lending in 2011, or 34.1 percent of the total new lending in the year. Outstanding loans (including bill discounts) to small enterprises increased 25.8 percent year on year to 10.8 trillion yuan, surpassing lending to large and medium-sized enterprises by 14.2 percentage points and 12.5 percentage points respectively.

V. Progress in cross-border use of RMB

Cross-border use of RMB was further expanded. In August 2011, after the PBC, together with five other government agencies, issued the *Notice on Extending the*

Geographical Coverage of the Use of RMB in Cross-border Trade Settlement, the program for RMB settlement of cross-border trade was expanded to cover enterprises in all provinces. In the meantime, cross-border use of RMB was allowed for some activities under the capital account as RMB settlement of outward direct investments and foreign direct investments made progress. In January 2011, the PBC released the *Administrative Measures for the Pilot RMB Settlement of Outward Direct Investments*, which allowed enterprises to make outward investments in RMB and banks to lend RMB to Chinese-invested overseas enterprises or projects. In October, with the issuance of the *Administrative Measures on Settlement of Foreign Direct Investments in RMB* by the PBC, and the detailed requirements on lending RMB to overseas projects provided in the same month in the *Guidance on RMB Lending to Overseas Projects by Banking Financial Institutions in the Mainland*, foreign direct investments in RMB were allowed.

In December, the China Securities Regulatory Commission (CSRC), the PBC, and the State Administration for Foreign Exchange (SAFE) jointly issued the *Pilot Measures on Investments in Securities in the Mainland by Fund Management Companies and Securities Companies as RMB Qualified Institutional Investors*, opening the door on a pilot basis for qualified Hong Kong-based subsidiaries of mainland fund management companies and securities companies to use RMB raised in Hong Kong for investments in securities in the mainland within an approved quota.

Cross-border trade and investments settled in RMB increased notably. In 2011, RMB settlement in cross-border trade registered 2.08 trillion yuan on a cumulative basis, expanding 3.1 times year on year. RMB receipts and payments became more balanced, with the receipt-to-payment ratio reaching 1:1.7, compared with 1:5.5 in 2010. Outward direct investments settled in RMB totaled 20.15 billion yuan, and foreign direct investments settled in RMB totaled 90.72 billion yuan.

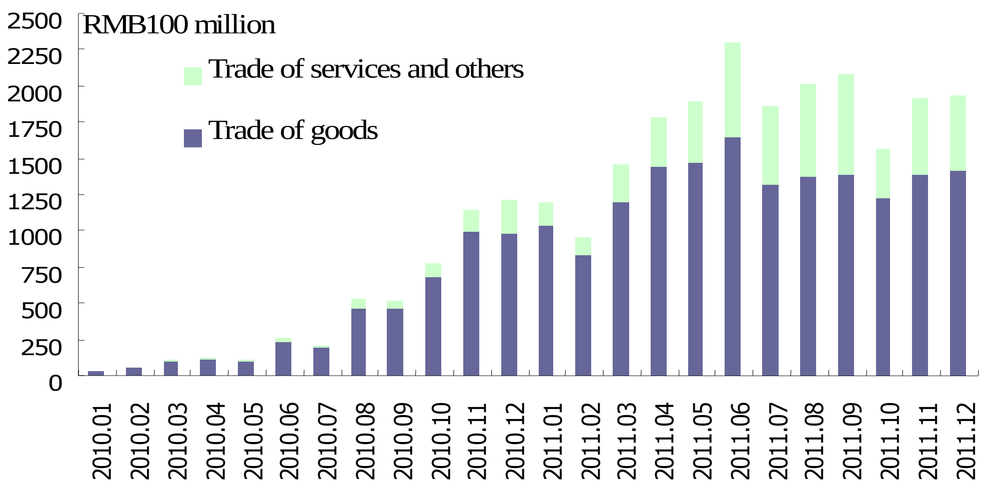

Figure 1 Monthly RMB Settlement of Cross-border Trade

Source: People's Bank of China

Box 3 Steady progress in advancing the RMB Qualified Foreign Institutional Investor (RQFII) scheme

RMB Qualified Institutional Investors (RQFII) are institutions that are allowed to use RMB raised in Hong Kong for investments in securities in the mainland. Hong Kong-based subsidiaries of mainland fund management companies and securities companies were chosen as the first group of RQFII under the pilot program.

The idea of RQFII was first announced by Vice Premier Li Keqiang in August 2011 when he attended a forum in Hong Kong on the 12th Five-year Program and on economic, trade, and financial cooperation between Hong Kong and the mainland. The RQFII program was officially launched on December 16, 2011, when the China Securities Regulatory Commission (CSRC), the PBC, and the State Administration for Foreign Exchange (SAFE) jointly issued the *Pilot Measures on Investments in Securities in the Mainland by Fund Management Companies and Securities Companies as RMB Qualified Institutional Investors* (Decree No. 76, hereinafter referred to as the *Pilot Measures*). For the first group of pilot participants, a quota of 20 billion yuan was approved by the State Council. The *Pilot Measures* include provisions on a number of key issues. First, a division of work among the CSRC, PBC, and SAFE is established, with the CSRC responsible for qualification examinations and securities investment activities, the PBC overseeing the opening of RMB accounts in the mainland by RQFIIs, and the SAFE managing the investment quota. The PBC will work together with the SAFE in monitoring capital inflows and outflows under the program. Second, as in the current QFII program, a trustee system is used in the pilot RQFII program. Third, detailed information is provided on criteria for applying to join the pilot program and for applying for a quota, as well as on the materials required. Fourth, regulatory requirements set by the CSRC and PBC on the products and shares of investments must be met. Fifth, the transfer of funds between Hong Kong and the mainland under the program should be made in accordance with the policies on the investment quotas, and after the exchange the capital and returns can be remitted out of the mainland either in RMB or foreign currency. Sixth, regulatory requirements must be met by the RQFIIs and their trustees and securities companies, and relevant obligations for statistical reporting must be met.

The RQFII program was created as a pilot measure to open capital markets by offering a new channel for RMB funds to flow back to China by encouraging Hong Kong-based Chinese securities institutions to expand their businesses as the RMB is more widely used in settling cross-border trade and direct RMB investments and off-shore RMB businesses continue to grow. While it draws on experiences from the QFII program, the RQFII program also has some new features. First, investments are made in RMB instead of foreign currencies. Second, participants are limited to Hong Kong-based subsidiaries of mainland fund management companies and securities companies. Third, investors under the RQFII program are allowed to invest not only in exchanges in RMB financial instruments, but also in the inter-bank bond market. Fourth, management of the quota and the cross-border receipts and payments under the program is streamlined as much as possible as long as the statistical and monitoring requirements are satisfied.

To ensure sound implementation of the pilot RQFII program, the CSRC, PBC, and SAFE released a more detailed document in line with the *Pilot Measures*. As of January 2, 2012, an approved 20 billion yuan quota was allocated to the 21 qualified institutions chosen as the first group of participants in the program, some of which are already raising funds and issuing products in Hong Kong.

The RQFII program will provide direct support for the development of the offshore RMB market in Hong Kong by promoting cross-border RMB businesses and offering new channels for overseas RMB holders to invest their RMB funds. It offers opportunities for Hong Kong-based investors and Chinese securities companies to leverage their advantage of having a better understanding of the mainland market in making securities investments in the mainland. It is also important for promoting a greater opening-up of the Chinese capital market in multi dimensions.

VI. Improvement in the RMB exchange-rate regime

The PBC further improved the RMB exchange-rate regime reform in line with the principle of making it a self-initiated, controllable, and gradual process. Focusing on the role of market supply and demand, the PBC enhanced RMB exchange-rate resilience with reference to a basket of currencies and kept the RMB exchange rate basically stable at an adaptive and equilibrium level. In 2011, the central parity of the RMB against the US dollar peaked at 6.3009 per dollar and reached a trough of 6.6349 per dollar. Among the 244 trading days, the interbank foreign exchange market saw an appreciation of the RMB against the US dollar on 143 days and a depreciation on 101 days. The largest intraday appreciation in 2011 was 0.30 percent (or 187 points), whereas the largest intraday depreciation was 0.22 percent (or 139 points).The RMB exchange rate moved in both directions against the euro, Japanese yen, and other major international currencies. At end-2011, the central parity of the RMB against the euro registered 8.1625 per euro, an appreciation of 7.89 percent from end-2010, and the central parity of the RMB against the Japanese yen stood at 8.1103 per 100 Japanese yen, an appreciation of 0.19 percent from end-2010. Beginning from the RMB exchange-rate regime reform in 2005 to end-2011, on a cumulative basis the RMB appreciated 22.68 percent against the euro and depreciated 9.92 percent against the Japanese yen.

In 2011, the PBC made active efforts to promote direct trading between the RMB and the currencies of the emerging market economies in the interbank market, and encouraged market-makers for the emerging market economy currencies to improve over-the-counter businesses and to participate in interbank market trading. Trading between the RMB and the Thai baht was introduced in the regional interbank market. In 2011, the interbank foreign exchange spot market recorded 35.5 trillion yuan of transactions in RMB against the US dollar, 90.4 billion yuan in RMB against the euro, 108.1 billion yuan in RMB against the Hong Kong dollar, 30.6 billion yuan in RMB against the Japanese yen, 2.7 billion yuan in RMB against the pound sterling, 200 million yuan in RMB against the Malaysian ringgit, 5 billion yuan in RMB against the Russian ruble, and 250 million yuan in RMB against the Thai baht. RMB trading against the Russian ruble, Malaysian ringgit, Thai baht, and currencies of other emerging markets became increasingly brisk in the interbank foreign exchange market, providing direct bilateral exchange rates for micro-level market players and supporting bilateral economic and trade development.

VII. Advances in financial institution reform

Reform of large commercial banks and policy financial institutions was promoted in a steady manner. The PBC supported and guided the Agricultural Bank of China (ABC) in its reform to build a multi-divisional structure for financial services to rural areas, and worked with relevant agencies to develop favorable policies, including business tax breaks, regulatory fee cuts, and a differentiated reserve requirement, which were successful in directing the reform process. The PBC expanded the pilot reform program to cover 371 ABC county-level sub-branches in Heilongjiang, Henan, Hebei, and Anhui provinces. With the overall reform plan approved by the State Council and the availability of 20 billion yuan in capital injections, the China Export and Credit Insurance Corporation (Sinosure) worked to implement the reform plan. To reform the China Agricultural Development Bank, a coordination mechanism was established and priorities and work divisions were established after the reform working group was set up. The overall restructuring of the CITIC Group was advanced, and the CITIC Group Corporation and CITIC Limited held their inaugural meeting in December 2011.

Differentiated incentive policies were implemented. In 2011, the PBC reviewed the effect of the reforms in 2,311 RCCs in counties and county-level cities that had received special central bank bill redemptions, and put in place incentives and restrictions accordingly. On March 31, the PBC provided 19.54 billion yuan in the form of 1-year central bank lending to 425 RCCs in counties and county-level cities that met the share requirement of local lending in total new lending and the criteria for policy examination and the follow-up monitoring after redemption of special central bank bills. The PBC increased policy support in terms of central bank lending to support agricultural development and rediscounts for RCCs that satisfied the follow-up monitoring and examination criteria after the redemption of special central bank bills, and imposed a number of restrictions on those that failed to meet the criteria. These policies have played an important role in driving further RCC reforms and have encouraged a greater supply of agro-linked credit.

Concrete progress was made in reforming the rural credit cooperatives (RCCs), as reflected in the remarkably improved asset quality and operational performance, the significantly strengthened financial position, and the substantial increase in agro-linked lending. Based on the five-category loan classification, at end-2011 the NPL ratio for RCCs declined 1.9 percentage points to 5.5 percent from end-2010. The capital adequacy ratio stood at 10.7 percent, up 2 percentage points from end-2010, and the asset/profit ratio rose by 0.28 percentage points from end-2010 to 1 percent. New agro-linked loans and lending to rural households by RCCs in 2011 posted 737.4 billion yuan and 309.3 billion yuan respectively, and their outstanding amount at end-2011 expanded by 19 percent and 15 percent respectively year on year. At end-2011, outstanding agro-linked loans by RCCs accounted for 68.9 percent of all lending, a rise of 0.5 percentage points from end-2010. Moreover, steady progress was made in RCC property rights reform. As of end-2011, a total of 1,882 RCCs, 212 rural commercial banks, and 190 rural cooperative banks had been established, all with legal-person status at the county (city) level.

VIII. Deepened reform of foreign exchange administration

Action was taken to moderate the strong expansion of net purchases of foreign currencies by commercial banks and the rapid growth of foreign reserves. This includes efforts to enhance management of the banks' position for foreign exchange purchases and sales, receipts and sales of foreign exchange from exports, and foreign exchange capital surrendered by foreign-funded enterprises; to further reduce the 2011 aggregate short-term external debt quota for mainland financial institutions; to raise the transaction fees in the interbank foreign exchange market; and to encourage banks to adjust the foreign currency purchases and sales balance by improving the pricing of exchange rates. Efforts were made to strengthen verification of the authenticity of trade-based foreign exchange inflows, encourage foreign exchange purchases and payments with authentic trade and investment backgrounds, encourage exporters to deposit their proceeds in overseas banks, and introduce the “watch list” for purchases and sales of foreign currencies by individuals. These measures have been effective in discouraging speculative and arbitrage capital inflows and in eliminating the possibility of market volatility.

The reform of the verification of imports and exports was steadily promoted. On December 1, 2011, the reform was initiated in Jiangsu, Shandong, Fujian, and four other provinces (municipalities) on a pilot basis, helping improve the risk prevention mechanism and enhancing regulatory effectiveness while also improving efficiency by screening and matching the trade flows and fund flows under the current account and monitoring and carrying out category-specific supervision, instead of conducting the verification process against each import and export by enterprises complying with the relevant regulations. Experiences from the pilot program show that, as a result of the reform of foreign exchange administration for trade in goods, procedures have been streamlined and operational costs have been cut for banks and enterprises, and a new administrative model that focuses on both trade facilitation and risk management has emerged.

Measures were taken to further facilitate receipts, payments, and trading of foreign currencies, including nationwide adoption of a policy encouraging depositing export proceeds in overseas banks, streamlining foreign exchange policies under some capital account items, delegating approval authority for five kinds of businesses, and facilitating sales and purchases of foreign exchange by individuals by regulating the individuals' foreign exchange sales and purchases via online banking.

Part 3 Financial Market Analysis

In 2011 China's financial market maintained healthy and sound performance amid continuous innovations. Reform and development policies proceeded steadily, and the role of the financial market in improving the financing structure and optimizing resource allocations was put into full play. With respect to the operation of the financial market, the money market traded briskly and in general interest rates were higher than in the previous year. Bond issuances increased steadily, and bond market indices moved upward amid fluctuations. Stock indices declined amid fluctuations, and trading on the stock market decreased.

I. Financial market analysis

1. The money market traded briskly, and in general interest rates were higher than those in the previous year

Repo transactions and interbank lending on the money market were brisk, with an increase in trade volume. In 2011, the turnover of bond repos posted 99.5 trillion yuan, with a daily average turnover of 397.8 billion yuan, up 13.5 percent year on year. The turnover of interbank lending posted 33.4 trillion yuan, with a daily average turnover of 133.8 billion yuan, up 20 percent year on year. Overnight products still dominated bond repos and interbank lending transactions, accounting for 74.8 percent and 81.7 percent of their respective turnover respectively, down 5.1 and 6.2 percentage points from the previous year. The turnover of government securities repos on the stock exchanges soared 203.0 percent year on year to 20.0 trillion yuan.

In terms of financing by financial institutions, the flow of funds among financial institutions showed the following characteristics: first, although state-owned commercial banks remained net fund providers, their net lending decreased significantly and they changed from net lenders to net borrowers on the interbank lending market; second, net borrowings of other commercial banks and foreign financial institutions declined considerably; third, funding demands by securities companies and fund management companies remained stable.

Table 4 Fund flows among financial institutions in 2011

Unit： 100 million yuan

	Repo		Interbank lending	
	2011	2010	2011	2010
State-owned commercial banks	-192145	-237497	47331	-23502
Other commercial banks	51817	84212	-27958	7286
Other financial institutions	130249	121228	-9802	13599
Of which: securities companies and fund management companies	66659	74675	10237	2149
Insurance companies	24926	21869	——	——
Foreign-funded financial institutions	10079	32057	-9571	2617

Note: "Other financial institutions" in the table refer to the China Development Bank, policy banks, associations of rural credit cooperatives, finance companies, trust and investment companies, insurance companies, securities companies, and so forth. A negative sign indicates net lending and a positive sign indicates net borrowing.

Source: China Foreign Exchange Trade System

In 2011 interest rates on the money market first rose and then dropped, in general remaining higher than in the previous year. During the first three quarters, interest rates on the money market moved up amid fluctuations. In the fourth quarter, due to a number of factors, such as weakened inflation expectations and a decrease in the reserve requirement ratio, interest rates on the money market declined slightly. In December, the weighted average interest rate of bond-pledged repos and the weighted average interest rate of interbank lending was 3.37 percent and 3.33 percent respectively, down 0.38 and 0.41 percentage points from September, and up 0.25 and 0.41 percentage points from the same period of the last year. In 2011, the Shibor rates of all maturities generally moved up.

Trading of RMB interest-rate swaps grew rapidly. In 2011, the total notional principals amounted to 2675.96 billion yuan, an increase of 78.4 percent year on year. In terms of the maturity structure, RMB interest-rate swaps with a maturity of less than one year traded most briskly, and their aggregate notional principal amounted to

1999.25 billion yuan, accounting for 74.7 percent of the total. The base rates of the floating end of the RMB interest-rate swaps included the 7-day fixing repo rate and the Shibor, and their notional principal accounted for 51.5 percent and 45.5 percent of the total respectively. Transactions of bond forwards and forward interest rate agreements were lukewarm.

Table 5 Transactions of interest-rate derivatives, 2006-2011

	Interest-rate swaps		Bond forwards		Forward-rate agreements	
	Transactions	Amount of notional principal (100 million)	Transactions	Amount of notional principal (100 million)	Transactions	Amount of notional principal (100 million)
2006	103	355.7	398	664.5	——	——
2007	1978	2186.9	1238	2518.1	14	10.5
2008	4040	4121.5	1327	5005.5	137	113.6
2009	4044	4616.4	1599	6556.4	27	60.0
2010	11643	15003.4	967	3183.4	20	33.5
2011	20202	26759.6	436	1030.1	3	3.0

Source: China Foreign Exchange Trade System

2. Bond issuances grew steadily

The turnover of spot bond transactions on the interbank market remained stable. In 2011, a total of 63.6 trillion yuan of bonds was traded, with a daily average of 254.6 billion yuan, down 0.6 percent year on year. In terms of participants, state-owned commercial banks and foreign financial institutions were net purchasers on the interbank spot market, with net purchases of 564.5 billion yuan and 212.9 billion yuan respectively. Other commercial banks and other financial institutions were net sellers, with net sales of 551 billion yuan and 226.9 billion yuan respectively. Spot government securities transactions on the stock exchanges posted 125.3 billion yuan, 40.9 billion yuan less than in the previous year.

Bond price indices went up amid fluctuations. In the first three quarters, the bond market showed a generally weakening trend; in the fourth quarter, the bond market indices rebounded somewhat. The China Bond Composite Index (net price) rose 1.4 percent from 99.9 points at the beginning of the year to 101.3 points at year-end; and the China Bond Composite Index (full price) rose 2.3 percent, from 108.8 points early in the year to 111.3 points at year-end. The government securities index on the stock exchanges rose 4.0 percent, from 126.3 points early in the year to 131.4 points at year-end.

In 2011 the yield curve of government securities on the interbank market showed a downward and steepening trend, and their movements could be divided into three phases: in the first four months, relatively abundant liquidity in the market pushed the yields of short-term bonds down, while banks and insurance companies had a stronger demand for bond investments, the yields of medium- and long-term bonds slid slightly, and the yield curve of government securities showed a downward and steepening trend. In the second phase, from early May to end-August, affected by several factors such as the consecutive hikes in the reserve requirement ratios and heightened inflation expectations, market liquidity tightened somewhat and, given the deteriorating European debt crisis, yields of credit products generally increased and the yield curve of government securities generally shifted upward. In the third phase, from early September to year-end, as a number of macro-economic indicators indicated a slowdown in economic growth, slowing CPI and PPI growth, and relaxed expectations for tightening measures, the yield curve of government securities saw an overall downward trend.

Bond issuances grew steadily. In 2011 a total of 6.41 trillion yuan (excluding central bank bills) was issued, up 23.4 percent year on year. In particular, issuances of subordinated bonds and hybrid capital bonds issued by commercial banks, policy financial bonds issued by the China Development Bank and other policy banks, and corporate credit-type bonds increased rapidly, while issuances of government securities declined slightly. In November 2011, four provinces and municipalities, including Shanghai, Guangdong, Zhejiang, and Shenzhen, began to issue municipal bonds in a pilot program, with the volume of issuances at 7.1 billion yuan, 6.9 billion yuan, 6.7 billion yuan, and 2.2 billion yuan respectively on the interbank bond market. As of the end of 2011, a total of 21.4 trillion yuan of bonds was deposited with the China Government Securities Depository Trust and Clearing Co., Ltd., an increase of 7.5 percent year on year.

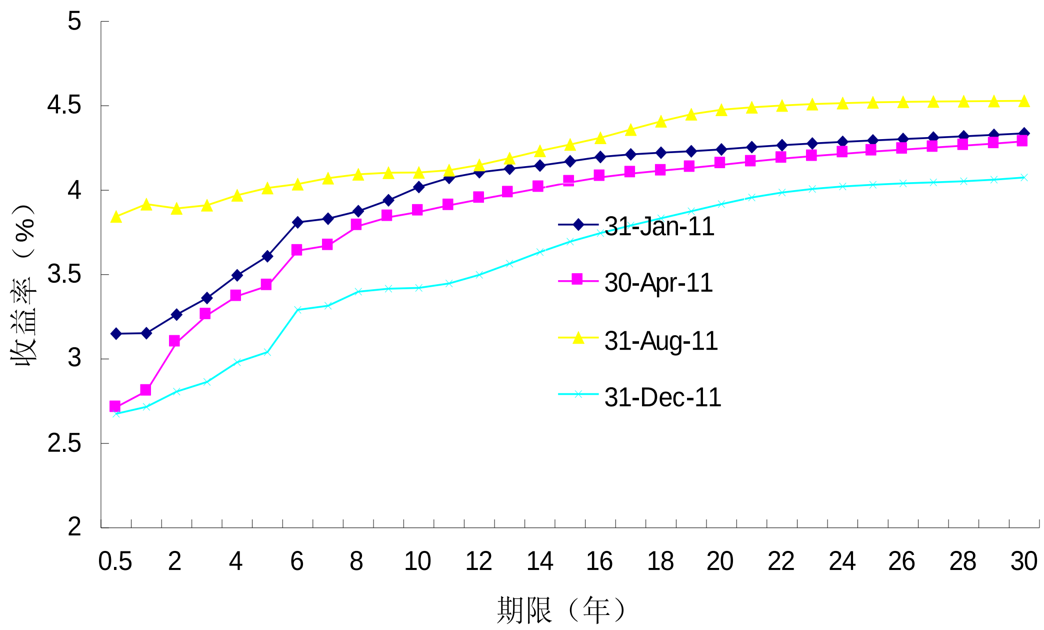

Figure 2　Yield Curves of Government Securities on the Interbank Market

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

Table 6　Issuances of major bonds in 2011

Type of bonds	Issuance (100 million yuan)	Year-on-year growth (%)
Government securities①	17100	-13.5
Of which：municipal bonds	2000	0.0
Policy financial bonds issued by the China Development Bank and other policy banks	19973	51.4
Bank subordinated bonds and hybrid bonds	3169	244.6
Bank ordinary bonds	350	3400.0
Enterprise bonds②	23103	43.5
Of which：short-term financing bills	8032	19.1
Medium-term notes	7270	47.6
Corporate bonds	1253	107.7

Notes: ①Including municipal bonds issued by the Ministry of Finance on behalf of local governments.

② Including enterprise bonds, short-term financing bills, super and short-term commercial paper, medium-term notes, collective bills of SMEs, private placement of bond-financing instruments, and corporate bonds.

Source: People's Bank of China; China Government Securities Depository Trust and Clearing Co., Ltd.

In general, bond issuance rates of all maturities showed a downward trend. The interest rate of 3-year government securities issued in December was 2.82 percent, down 40 basis points from those of the same maturity issued at the beginning of the year. The interest rate of 10-year fixed-rate bonds issued by the China Development Bank in December was 3.49 percent, down 110 basis points from those of the same maturity issued at the beginning of the year. The Shibor played a greater role in bond pricing. In 2011 fifteen floating-rate bonds based on the Shibor were issued on the primary bond market, with a gross issuance volume of 130.28 billion yuan, an increase of 128 percent year on year. In addition, a total of 244.9 billion yuan of fixed-rate enterprise bonds was issued, all based on the Shibor, and 241.8 billion yuan of short-term fixed-rate financing bills based on the Shibor was issued, at par with the previous year and accounting for 31 percent of the issuance of all short-term fixed-rate financing bills.

3. Bill financing remained stable, and interest rates first rose and then slid

The bill discounting business maintained growth momentum, but slowed down in the second half of the year. In 2011 commercial bills issued by enterprises totaled 15.1 trillion yuan, representing year-on-year growth of 23.8 percent; the total value of outstanding commercial bills at end-2011 posted 6.7 trillion yuan, representing year-on-year growth of 18.7 percent. Outstanding discounted bills increased from 5.6 trillion yuan at the beginning of the year to a historic high of 7.0 trillion yuan at end-August, but slowed down thereafter. Outstanding discounted bills increased by more than 1 trillion yuan throughout the year, rendering larger fund support to enterprises.

Bill financing increased slightly amid fluctuations, while interest rates on the bill market first rose and then slid a bit, but still remaining at an elevated level. In 2011 the volume of discounted bills of financial institutions amounted to 25.0 trillion yuan, representing a year-on-year decrease of 3.8 percent; outstanding discounted bills at end-2011 registered 1.5 trillion yuan, representing a year-on-year growth of 2.1 percent. As financial institutions strengthened control over the volume and pace of credit extensions, the balance of bill financing decreased slightly early in the year, gradually increased in the second quarter, and then hovered at around 1.5 trillion yuan in the second half of the year. The outstanding balance of bill financing at year-end accounted for 2.8 percent of all categories of loans, down 0.3 percentage points from early in the year. Affected by a number of factors such as money- market interest rates and changes in supply and demand, interest rates on the bill market generally remained at an elevated level. In particular, in the second half of the year interest rates on the bill market continued to move up amid fluctuations, reaching their highest point in October and falling slightly thereafter.

4. Stock indices declined amid fluctuations, and transaction volumes declined slightly

The stock indices declined amid fluctuations. The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index declined 21.7 percent and 28.4 percent from the end of the last year to close at 2199 points and 8919 points at end-2011, respectively. The average P/E ratio on the A-share market of the Shanghai Stock Exchange declined from 21.6 times at the end of the last year to 13.4 times at end-2011; the average P/E ratio on the A-share market of the Shenzhen Stock Exchange declined from 45.3 times to 23.5 times. The Growth Enterprise Board (GEB) Index (Chinext Price Index) of the Shenzhen Stock Exchange saw a larger decline and closed at 730 points at end-2011, down 35.9 percent from the end of the last year.

Transaction volumes on the stock markets declined slightly. In 2011, turnover on the Shanghai and Shenzhen Stock Exchanges totaled 42.2 trillion yuan, a decrease of 22.7 percent year on year, and the daily turnover averaged 172.8 billion yuan, 52.7 billion yuan less than during the last year. The turnover of the Growth Enterprise Board amounted to 1.89 trillion yuan, an increase of 20.1 percent from the end of the last year. At end-2011, the market capitalization of the Shanghai and Shenzhen Stock Exchanges had declined 14.6 percent from the previous year to 16.5 trillion yuan, while the market capitalization of the Growth Enterprise Board had increased 24.9 percent year on year to 250.4 billion yuan.

Financing on the stock markets declined substantially. In 2011, a total of 579.9 billion yuan was raised by all kinds of enterprises and financial institutions on the domestic and overseas stock markets by way of IPOs, additional offerings, and warrant exercises, 552 billion yuan less than in the previous year. Among this total, financing on the A-share market posted 507.3 billion yuan, 388.2 billion yuan less than during the previous year.

5. Total assets in the insurance industry maintained their steady growth

In 2011, total premium income in the insurance industry amounted to 1.43 trillion yuan, and total claim and benefit payments increased 22.8 percent year on year to 392.9 billion yuan. Specifically, total claim and benefit payments in the property insurance sector increased 24.5 percent, whereas those in the life-insurance sector increased 20.6 percent.

Total assets in the insurance industry maintained steady growth. At end-2011, total assets in the insurance industry posted 6.0 trillion yuan, an increase of 19.1 percent year on year. Among this total, bank deposits increased 27.5 percent, while investment-type assets increased 17.4 percent.

Table 7 Use of insurance funds, end-2011

	Outstanding balance (100 million yuan)		As a share of total assets (%)	
	End-2011	End-2010	End-2011	End-2010
Total assets	60138	50482	100.0	100.0
Of which: Bank deposits	17737	13910	29.5	27.6
Investments	37737	32137	62.8	63.7

Source: China Insurance Regulatory Commission

6. The foreign exchange market traded briskly and currency swap transactions increased rapidly

In 2011, the turnover of spot foreign exchange transactions totaled USD3553.8 billion, representing an increase of 16.7 percent year on year. The turnover of RMB foreign exchange swap transactions totaled USD1771 billion, representing an increase of 38.0 percent year on year; among this total, overnight RMB foreign exchange swap transactions amounted to USD1022 billion, accounting for 57.7 percent of the total. The turnover on the RMB foreign exchange forward market totaled USD214.6 billion, an increase of 556.8 percent year on year. In 2011, the turnover of foreign currency pair transactions amounted to USD94.67 billion, an increase of 42.1 percent year on year. In particular, USD/HKD pairs accounted for the lion's share, or 45.2 percent, yet down 15.2 percentage points from the previous year. The number of participants on the foreign exchange market further expanded. At end-2011, there were 318 members on the foreign exchange spot market, 73 members on the foreign exchange forward market, 71 members on the foreign exchange swap market, 27 members on the foreign exchange options market, 26 market-makers on the foreign exchange spot market, and 20 market-makers on the foreign exchange forward market.

7. The gold market saw large price volatility and the volume of transactions increased rapidly

The price of gold first increased and then fell and was characterized by large volatility. In early 2011, the price of gold on the international market was USD1419.5 per ounce; it reached a historic high of USD1920.5 per ounce in September and then went down amid fluctuations, closing at USD1561.8 per ounce at end-2011, up 10.0 percent from the beginning of the year. The movement of domestic gold prices kept pace with that on the international market. During the year, the highest price on the Shanghai Gold Exchange (AU9995） was 396 yuan per gram, and the price closed at 319.8 yuan per gram, up 5.9 percent from the beginning of the year. The weighted average price of gold was 327.5 yuan per gram, up 61.7 yuan from the previous year.

The volume of transactions on the Shanghai Gold Exchange increased rapidly. In 2011, the trading volume of gold was 7438.5 tons, an increase of 22.9 percent year on year, and its turnover posted 2.48 trillion yuan, an increase of 53.5 percent year on year. The daily trading volume of gold averaged 30.5 tons, an increase of 22 percent year on year. The trading volume of silver was 247,000 tons, an increase of 235.6 percent year on year, and its turnover posted 1.94 trillion yuan, an increase of 402.2 percent year on year. The trading volume of platinum was 65.0 tons, an increase of 18.9 percent year on year, and its turnover posted 20 billion yuan, an increase of 20.5 percent year on year.

II. Institutional building in the financial market

1. Strengthening regulation on the interbank bond market

Efforts were made to promote the building of a proper debt financing mechanism for local governments. In November 2011, the People's Bank of China released the *Notice on Issues Concerning Issuance of Municipal Bonds by Pilot Provinces and Municipalities* to regulate the debt-financing behavior of local governments.

Launching a net clearing business for spot bonds. The People's Bank of China guided the Shanghai Clearing House to develop a net clearing scheme of spot bond transactions, and released the *Official Reply to Rules (Trial) on the Net Clearing Business for Spot Bond Transactions by the PBC General Administration Department*, listing specific requirements on market entry for clearing members, a risk management system, a real-time monitoring mechanism and asset segregation, and so forth. On December 19, 2011, the net clearing business for spot bonds deposited with the Shanghai Clearing House was formally launched. Realization of the net clearing business for spot bonds was a major innovation in the clearing system of the interbank bond market and represented significant progress in the building of a market infrastructure on the interbank market.

2. Promoting the healthy development of the gold market

First, in order to strengthen regulation and supervision of intermediaries on the gold market, the People's Bank of China promulgated the *Administrative Measures on Regulation and Supervision of the Business of the Shanghai Gold Exchange*. Second, in order to gradually improve market trading rules, the People's Bank of China guided the Shanghai Gold Exchange in releasing guidelines on the handling of business by commercial banks on behalf of individuals and guidelines on IT management of agent commercial banks to handle such businesses for individuals, and amended six rules, including on spot gold transactions, so as to prevent transaction risks on the gold market. Third, the People's Bank of China, jointly with other ministries and commissions, released the *Notice on Strengthening Regulation on the Gold Exchange and Other Gold Trading Platforms*, to close illegal trading platforms for gold and gold derivatives.

3. Improving institutional arrangements on the securities market

Further improving the inside information management system of public companies. In October 2011, the China Securities Regulatory Commission issued the *Rules for Listed Companies in Establishing a Registration and Management System for Persons Familiar with Inside Information*, requiring listed companies to build records for persons familiar with inside information and to make relevant registration and confidentiality arrangements for inside information. Such an arrangement raises the listed companies' confidentiality awareness, as well as that of relevant persons familiar with inside information and provides evidence and clues for investigating insider trading; therefore, it is essential and fundamental for preventing and striking against insider trading.

4. Improving institutional arrangements on the insurance market

Strengthening capital management and reducing risks in the insurance sector. In October, the China Insurance Regulatory Commission amended the *Administrative Measures on Subordinated Term Debts of Listed Companies*, which increased the qualification requirements for fund raisers,, stipulating that subordinated bonds as a percentage of supplementary capital could not exceed 50 percent of net assets and that the raised funds should not be used for investment in equity, real estate, infrastructure, and so forth. The amended *Measures* are of great importance in regulating insurance companies using subordinated bonds to increase their capital, in strengthening the core capital of the insurance industry, and in improving capital quality and reducing industry risks.

Regulating the behavior of insurance companies and protecting the interests of policyholders. Efforts were made to expedite the sharing of motor insurance information across the nation, and a national motor insurance information platform, including regarding compulsory motor insurance and commercial motor insurance, was put into place. In order to regulate the behavior of insurance companies and to better protect the interests of policyholders and beneficiaries, a number of regulations were released, such as rules on the operation of life insurance businesses, administrative measures regarding insurance salesmen, and promulgating the *Guidelines for Regulation of the Bancassurance Business of Commercial Banks*. In addition, the *Interim Rules on Administration of Portfolio Transfers of Insurance Companies* were promulgated, laying out an initial institutional framework and a basic procedure for portfolio transfers in the insurance business.

Part 4 Macro-economic Analysis

I. Global economic and financial developments

In 2011 the global recovery stalled due to the escalating sovereign debt crisis and the intensified downside risks. In the United States, there were signs of recovery in the latter half of the year. Fiscal and financial risks in the euro area mixed with one another and escalated, indicating dimmed growth prospects. Shocked by the earthquake and the tsunami, the Japanese economy slid into recession but later rebounded. Growth momentum in most emerging market economies moderated and some countries even faced risks caused by sharp inflation and volatile short-term capital flows. In the January 2012 *World Economic Outlook Update*, the IMF revised down its forecast for global growth in 2011 by 0.2 percentage point to 3.8 percent. Output of the United States, the euro area, Japan, and the emerging and developing economies expanded by 1.8 percent, 1.6 percent, -0.9 percent, and 6.2 percent respectively in 2011, down 1.2, 0.3, 5.3, and 1.1 percentage points from the previous year.

1. Economic developments in the major economies

The economy of the United States saw positive dynamics, reflected in improved inflation and employment conditions. GDP growth picked up pace during Q4 2011. The unemployment rate stood at 8.5 percent in December, down 0.2 percentage points month on month and the total unemployment claim was 13.1 million, the lowest level since 2009. Year-on-year CPI edged up by 3.0 percent in December, representing a slowdown for three consecutive months and indicating somewhat eased inflationary pressures. The trade deficit dropped steadily since July, climbed in November, and ended at USD47.75 billion. The fiscal deficit still posed great challenges. The U.S. federal deficit for fiscal year 2011 was USD1.3 trillion, accounting for 8.7 percent of GDP. Though lower than the 9.0 percent registered in 2010, the deficit share of GDP still ranked the third highest since 1945.

Table 8 Macro-economic and financial indices of the major economies

Country	Index	2010Q4			2011Q1			2011Q2			2011Q3			2011Q4		
		Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.
United States	Real GDP Growth Rate (annualized quarterly rate, YOY, %)	3.1			0.4			1.3			1.8			2.8（beginning number）		
	Unemployment Rate (%)	9.5	9.8	9.4	9.1	9.0	8.9	9.0	9.0	9.1	9.1	9.1	9.0	8.9	8.7	8.5
	CPI (YOY, %)	1.2	1.1	1.5	1.6	2.1	2.7	3.2	3.6	3.6	3.6	3.8	3.9	3.5	3.4	3.0

	DJ Industrial Average (closing number)	11118	11006	11578	11892	12226	12320	12811	12570	12414	12143	11613	10913	11955	12045	12218
	NASDAQ(closing number)	2507	2498	2653	2700	2782	2781	2874	2835	2774	2756	2579	2415	2684	2620	2605
Euro Area	Real GDP Growth Rate (quarterly YOY, %)	2.0			2.4			1.6			1.3					
Euro Area	Unemployment Rate (%)	10.1	10.1	10.0	10.0	10.0	10.0	9.9	10.0	10.0	10.1	10.1	10.2	10.3	10.4	10.4
Euro Area	HICP (YOY, %)	1.9	1.9	2.2	2.3	2.4	2.7	2.8	2.7	2.7	2.5	2.5	3.0	3.0	3.0	2.7
Euro Area	EURO STOXX 50(closing number)	2543	2478	2601	2654	2713	2583	2661	2632	2561	2511	2238	2160	2318	2299	2370
Japan	Real GDP Growth Rate (annualized Quarterly rate, QOQ, %)	-2.4			-3.7			-2.1			5.6					
Japan	Unemployment Rate (%)	5.1	5.1	4.9	4.9	4.6	4.6	4.7	4.5	4.6	4.7	4.3	4.1	4.5	4.5	4.5
Japan	CPI (YOY, %)	0.2	0.1	0.0	-0.6	-0.5	-0.5	-0.4	-0.4	-0.4	0.2	0.2	0.0	-0.2	-0.2	-0.2
Japan	NIKKEI225(closing number)	9202	9937	10229	10238	10624	9755	9850	9694	9816	9833	8955	8700	8988	8435	8455

Source: Statistical bureaus and central banks of the respective economies

The recovery in the euro area lost momentum due to diverse growth rates across the member states. According to the ECB, the euro area was projected to expand by –0.4 to 1 percent and likely to recede into another round of recession. Inflation remained above the 2 percent target for thirteen consecutive months and the year-on-year HICP increased by 2.7 percent in December. With respect to the various member-states, in Q3 GDP in Germany picked up by 2.6 percent year on year, marking a second quarterly decrease but still significantly higher than that of the other countries in the euro area. France experienced a 1.6 percent year-on-year GDP growth in Q3. However, conditions in the heavily indebted countries such as Greece and Portugal continued to deteriorate, and GDP in these two countries contracted by 5.2 percent and 1.7 percent respectively in Q3. To fight the sovereign debt crisis, the EU launched a series of reform plans, whose effect have yet to be tested by the market. In December, Standard & Poor's and Fitch cut the sovereign rating outlook of several euro area countries.

Hit hard by the earthquake and the tsunami, Japanese economic activity weakened, putting a drag on the already crumbling trade and debt conditions. In 2011 the Japanese economy initially contracted due to the impact of the earthquake and the tsunami in March, but it later rebounded. The CPI continued at a low level, and the December core CPI declined by 0.2 percent year on year. Due to many factors such as the appreciation of the Japanese yen, the major earthquake, and the decline in external demand, Japan's exports dropped sharply in 2011, leading to a trade deficit of 2.5 trillion yen and ending the record thirty-one years of a trade surplus. Due to the earthquake and the disaster, fiscal expenditures soared, adding to the government's fiscal woes. At the end of Q3, the debt balance reached a historic high of 954 trillion yen, accounting for 199 percent of GDP. Estimated expenditures for fiscal year 2012 are 90 trillion yen, among which 44 trillion yen should be financed through debt.

The pace of expansion in the major emerging market economies cooled down against the backdrop of a tighter domestic policy, a downward cyclical impact, and declining external demand. These countries faced challenges to stabilize growth, curb inflation, and tame volatile short-term cross-border capital flows. GDP growth in India increased by 6.9 percent year on year in Q3, a slowdown for six consecutive quarters. The Q3 GDP growth in Brazil was zero month on month, or 2.1 percent year on year, a record low since Q1 2009. Furthermore, emerging market economies such as South Africa, Turkey, Indonesia, and Vietnam also experienced moderate growth. The dimmed growth outlook shook investors' confidence in the assets of the emerging market economies as euro area banks were also selling assets of these countries to replenish capital. As a result, some emerging market economies saw capital outflows and a currency depreciation, making it more difficult for them to make proper macro-economic decisions.

2. Global financial market development

The exchange rates of the major currencies fluctuated with large swings. At the end of 2011, the exchange rate of the US dollar against the euro was 1.2945 dollar per euro, a depreciation of the US dollar by 3.23 percent compared with the last year. From January to April, the euro continued to strengthen against the dollar as stable economic performance in the euro area heightened market expectations of an interest rate increase. From May, with the deterioration and spread of the debt crisis, the euro fell against the US dollar. The Japanese yen due to risk-aversion demand was pushed higher against the US dollar. At the end of the year, the exchange rate of the Japanese yen against the US dollar stood at 76.94 yen per dollar, an appreciation of 5.47 percent from the last year. The Trade Weighted US Dollar Index, which is published by the Federal Reserve, rose by a cumulative 1.65 percent in 2011.

International money-market interest rates fluctuated within a large range. The US dollar Libor picked up after an initial dip. In the first half of the year, the US dollar Libor drifted lower under the influence of the quantitative easing monetary policy implemented by the US Federal Reserve, but it rapidly recouped its losses as the sovereign debt crisis intensified and safe-haven demand picked up. On June 13, the 1-year Libor plummeted to the year's low of 0.72 percent but it rebounded and rallied up to 1.13 percent on December 30, 0.35 percentage points higher than that at the beginning of the year. The Euribor fluctuated upwards, driven by the ECB's interest rate increases in April and July. On July 8, the 1-year Euribor reached the year's high of 2.2 percent and remained at that level amidst a handful of small corrections. As the sovereign debt crisis rippled through the banking system and the real economy, the ECB cut its interest rates twice, in November and December. As a result, the Euribor retreated from its high level. On December 30, 2011, the 1-year Euribor was 1.95 percent, up 0.44 percent from the beginning of the year.

The yields of government securities in the major countries were depressed by hedging demand. In the first half of the year, the yields of bonds in Greece, Ireland, and Italy rocketed and risk-aversion demand rose, as the international rating companies reduced the credit ratings of the euro area countries in succession. Though Standard & Poor's and Moody's slashed the sovereign ratings of the United States and Japan, their yields of Treasury bonds bucked the trend in an upward movement. The yields of German Treasuries fluctuated downwards. In Q4, the yields of US and German bonds declined further after the Europe debt summits held on October 26 and December 9 as the debt talks dragged on. On December 31, the yields of 10-year Treasury bonds in the U.S., euro area, and Japan closed at 1.88 percent, 1.83 percent, and 0.99 percent respectively, down 1.48, 1.14, 0.13 percentage points from the end of the last year.

The major stock indices experienced large fluctuations. In the first half of the year, global stock markets remained stable amidst the relatively good performance of the major economies, tentatively easing the sovereign debt crisis. However, in the middle of March, the major earthquake in Japan triggered an avalanche in global stock markets. In Q3, against the backdrop of stalled global recovery and intensified market panic caused by the deteriorating debt crisis in the United States and the EU, the major stock markets slumped and remained at low level. In Q4, boosted by changes in expectations about the debt crisis and the pickup of the economic performance of the United States and the EU in Q3, the stock markets in these countries squeezed up. On December 31, the Dow Jones Industrial Average, the NASDAQ, and the STOXX50 closed at 12,218, 2,605, and 2,370 respectively, up 5.5 percent, 1.8 percent, and down 8.9 percent respectively from the end of the last year. Influenced by the twin dangers of a sluggish recovery and the devastating earthquake and tsunami, the Japanese stock market continuously moved downward in 2011, with the Nikkei 225 closing the year at 8455, down 17.3 percent year on year.

3. Development of the housing market in the major economies

There were positive signs for a recovery in the U.S. housing market, but the outlook still remained uncertain. According to the U.S. Department of Commerce, sales of new homes registered 302,000 in 2011, down 6.2 percent year on year; the median price of new homes decreased by a large margin to US$210,300 per unit in December, down 12.9 percent year on year; the start of new housing edged up by 1.2 percent year on year. According to the National Association of Realtors, in 2011 sales of existing homes rebounded after an initial decline, reaching 4.26 million units by the end of year, an increase of 1.7 percent compared with the last year. At the same time, the median price of existing homes also moved upwards after falling a bit at the beginning of the year, reaching US$1,645,000 per unit, a decrease of 2.5 percent compared with the last year.

The recovery of the housing market proceeded at different paces across the various member states of the EU. In 2011, housing prices continued to rise in Germany and France, while in Britain they first climbed up a bit but soon settled onto a downward track. The Halifax Index declined by 0.9 percent month on month in December and dropped by 1.3 percent year on year in Q4. Dimmed growth prospects weighed on British housing prices. And the housing markets in the EU peripheral countries saw no improvement, due to the stalled global recovery and the spread of the EU debt crisis.

The Japanese housing market was bolstered by demand for post-disaster reconstruction but housing prices remained flat. According to the Ministry of Land, Infrastructure, Transport, and Tourism, starts of new housing in 2011 went up by 4.2 percent compared with the same period of the last year and construction orders received by the 50 big construction companies increased by 10.3 percent year on year. The benchmark land price fell by 3.4 percent over the previous year, marking twenty consecutive declines.

4. The monetary policies of the major economies

Financial and fiscal risks alternated and escalated, adding uncertainties to the global recovery. In response, the major central banks of the advanced countries adhered to an extremely accommodative monetary policy and unconventional policy measures such as quantitative easing. The U.S. Fed kept the Federal Fund rate unchanged within the range of 0 to 0.25 percent and hinted at the beginning of 2012 that the extremely low benchmark interest rate could be sustained until at least the end of 2014. The Bank of Japan maintained its "zero interest rate" policy, keeping the range of the overnight call rate unchanged at 0-0.1 percent. To counter the EU debt crisis, after interest rate boosts in April and July, the ECB reduced the interest rate of the main refinancing operations from 1.5 percent to a historic low of 1 percent on November 3 and December 8, loosening its monetary policy from a relatively tight stance. In addition, by the end of June the Federal Reserve as planned had completed the second round of its asset purchase program. On September 21, the Federal Reserve launched a "reverse operation," a bold attempt to sell USD400 billion in short-term government bonds to raise the necessary funds and at the same time to buy the equivalent amount of long-term bonds. The Bank of England left the bank rate unchanged at a record low of 0.5 percent. To inject liquidity into the market as a countermeasure to the EU debt crisis, the Federal Reserve, together with the Bank of Canada, the Bank of England, the Bank of Japan, and the European Central Bank, announced on November 30 that it would lower the rate for US dollar liquidity swap arrangements by 50 basis points and extend authorization of these swap arrangements until February 1, 2013. Starting from November, the ECB kicked off a new round of covered bond purchases totaling 40 billion euro, provided low-price backstop liquidity to the banking system through LTROs, lowered the rating threshold for certain asset-backed securities to increase the availability of collateral, and reduced the reserve requirement ratio from 2 to 1 percent. Against the volatile external environment and in order to relieve the impact of the earthquake, the Bank of Japan unveiled a 500 billion yen lending program to support small- and medium- sized enterprises and gradually expanded the scale of its asset purchase program from 40 trillion yen to 55 trillion yen. In addition, it continued to offer a maximum of one trillion yen in loans at very low rates to financial institutions in the earthquake-hit areas. Such lending would be extended until April 30, 2012. On October 6, the Bank of England announced that to stimulate the economy it would increase the size of its asset purchase program by ￡75 billion to a total of ￡275 billion.

There were differences in the monetary policy stances of the various emerging market economies. Under the mixed impact of tepid growth and eased inflationary pressures, the major emerging economies chose to loosen their monetary policy stance due to worries about the worsening external conditions. South Korea, Philippine, Peru, Malaysia, and Chile raised their benchmark rates in the first half of the year and kept the rates unchanged throughout the year; Russia, Brazil, Thailand, and Indonesia cut their rates in Q4 to promote economic growth. Specifically, the Bank of Thailand lowered the overnight repo rate by 25 basis points to 3.25 percent on November 30, the first rate cut during the past two years; to boost economic activities, the Bank of Brazil reduced its benchmark rates on three occasions, in August, October, and November; and the Reserve Bank of India announced that it would keep the repo rate at 8.5 percent, ending the cycle of nineteen consecutive months of a rate hike.

5. World economic outlook

In its *World Economic Outlook Update* published in January 2012, the IMF projected that global growth would decelerate in 2012 and downside risks would intensify. Global output was projected to slow down to 3.3 percent in 2012, with U.S. output expanding by 1.8 percent, the same level as that in 2011, the euro area contracting by 0.5 percent, Japan rebounding to 1.7 percent as its industrial chain gained strength in the aftermath of the disaster, and the emerging economies moderating to 5.4 percent.

Looking into the future, the major risks facing a global recovery stem from several sources: first, the sovereign debt crisis, which is spreading across the entire euro area, might trigger a new round of worldwide systemic risks if it is not handled properly; second, the lack of a credible fiscal consolidation plan for the major advanced economies might curb a medium-term recovery; third, growing risks in the world banking system and protracted bank deleveraging might depress the real economy; fourth, further moderation of economic activities in the emerging market economies and risks from rising inflation and the possibility of a reverse in capital flows will increase the macro-management difficulties in those countries; and fifth, trade protectionism could come to the fore.

II. Analysis of China's macro-economic performance

In 2011, while shifting from stimulus-driven to endogenous growth, China's economy continued to perform well in the direction intended by the macro-economic policies. Consumption and investment grew steadily, foreign trade became more balanced, agricultural and industrial production registered robust growth, and the momentum for a rapid price hike was contained. In 2011, the Gross Domestic Product (GDP) registered 47.2 trillion yuan, up 9.2 percent year on year in terms of comparable prices. In the fourth quarter, GDP grew 8.9 percent year on year, or 2.0 percent quarter on quarter. The Consumer Price Index (CPI) was up 5.4 percent year on year for the whole year, representing an acceleration of 2.1 percentage points from the previous year, and up 4.6 percent year on year in the fourth quarter, representing a deceleration of 1.7 percentage points from the previous quarter. In 2011, the trade surplus posted USD155.1 billion, a reduction of USD26.4 billion from 2010.

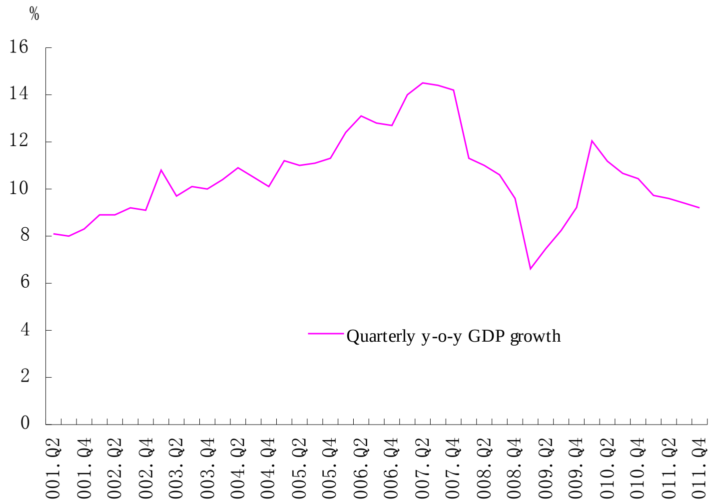

Figure 3 Stable and Rapid GDP Growth

Source: National Bureau of Statistics

1. Consumption and investment grew steadily and foreign trade became more balanced

Supported by the stable income gains of urban residents and the rapid income gains of rural residents, domestic consumer demand remained stable. In 2011, the per capita disposable income of urban households posted 21,810 yuan, representing year-on-year growth of 14.1 percent and price-adjusted real growth of 8.4 percent. The per capita cash income of rural households registered 6,977 yuan, up 17.9 percent in nominal terms or 11.4 percent in real terms. The PBC survey of urban depositors in the fourth quarter shows that the residents' income index rebounded by 0.5 percentage points from the previous quarter to 50.9 percent, thus ending the drastic downward trend in the previous two quarters; the propensity to consume remained stable. In 2011, retail sales of consumer goods totaled 18.1 trillion yuan, representing a year-on-year increase of 17.1 percent, or 11.6 percent in real terms and a deceleration of 3.2 percentage points from 2010. Consumption growth in the urban areas slightly outpaced that in the rural areas. In 2011, retail sales in the urban areas registered 15.7 trillion yuan, up 17.2 percent year on year, whereas retail sales in the rural areas grew 16.7 percent year on year to 2.4 trillion yuan.

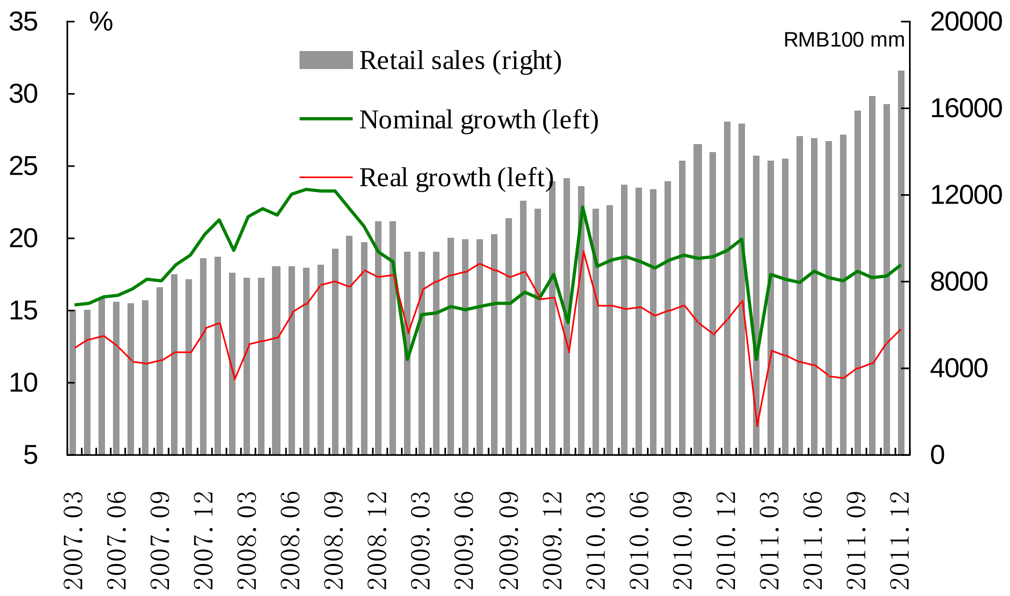

Figure 4　Consumer Demand Remained Stable

Sources: National Bureau of Statistics; PBC

The growth of fixed-asset investments remained relatively rapid, with growth in central and western China notably outpacing that in the east. In 2011, fixed-asset investments (excluding investments by rural households) totaled 30.2 trillion yuan, up 23.8 percent year on year, or 16.1 percent in real terms. Among this total, investments by state-owned and state-shareholding enterprises registered 10.7 trillion yuan, up 11.1 percent year on year. Broken down by region, growth in the eastern, central, and western regions registered 21.3 percent, 28.8 percent, and 29.2 percent respectively. Broken down by industry, fixed-asset investments in the primary, secondary, and tertiary industries grew 25.0 percent, 27.3 percent, and 21.1 percent respectively. Total planned investment in new projects grew by 22.5 percent year on year to 24.0 trillion yuan, and total planned investment in projects under construction grew 18.7 percent year on year to 63.2 trillion yuan.

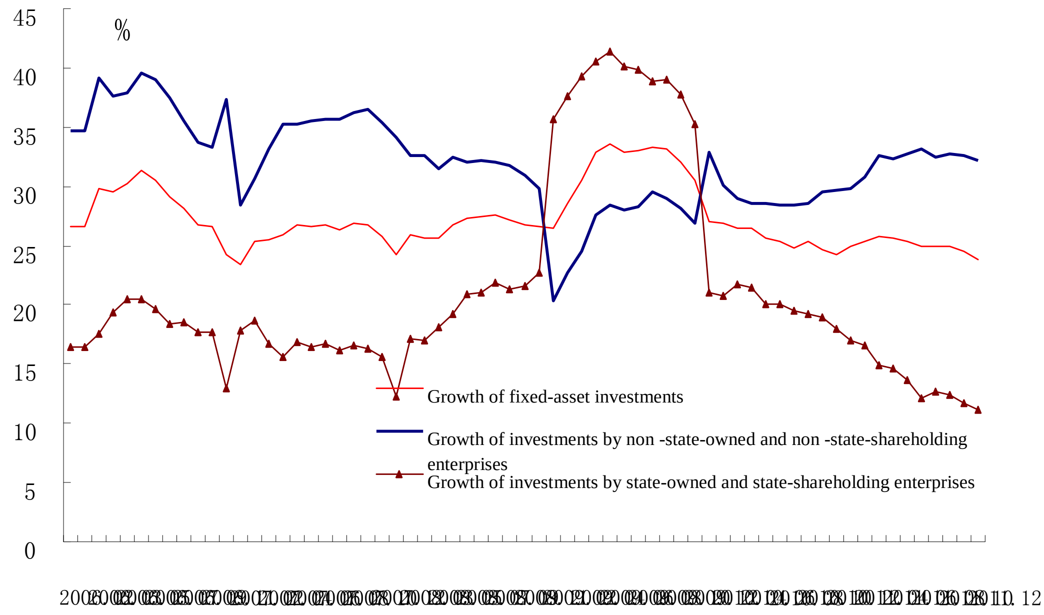

Figure 5 Fixed-asset Investments Grew Relatively Rapidly

Source: National Bureau of Statistics

The trade surplus continued to decrease due to slower growth in imports and exports. In 2011, imports and exports posted USD 3,642.1 billion, up 22.5 percent year on year, representing a deceleration of 12.2 percentage points from 2010; exports registered USD 1,898.6 billion, up 20.3 percent year on year, a deceleration of 11 percentage points from 2010; imports posted USD 1,743.5 billion, up 24.9 percent year on year, a deceleration of 13.8 percentage points. The trade surplus declined for the third straight year, from USD155.1 billion in 2010 to USD26.4 billion in 2011. Trade with the EU, the U.S., and Japan grew steadily, and trade with the emerging market economies registered rapid growth. In 2011, the value of trade with the EU, the U.S., and Japan increased by 18.3 percent, 15.9 percent, and 15.1 percent respectively, while the total value of bilateral trade with the ASEAN nations, Brazil, Russia, and South Africa jumped by 23.9 percent, 34.5 percent, 42.7 percent, and 76.7 percent respectively. Trade modalities continued to improve, with general trade growing rapidly and the share of processing trade falling markedly. In 2011, there was a hike in general trade imports and exports of 29.2 percent, reaching USD1.9 trillion and accounting for 52.8 percent of the total trade volume, 2.7 percentage points more than that in the previous year. Processing trade grew by 12.7 percent to USD1.3 trillion, accounting for 36.1 percent of the total and down by 2.8 percentage points from a year earlier. In 2011, actually utilized foreign direct investment grew by 9.7 percent year on year to USD116 billion, representing a deceleration of 7.7 percentage points from the previous year.

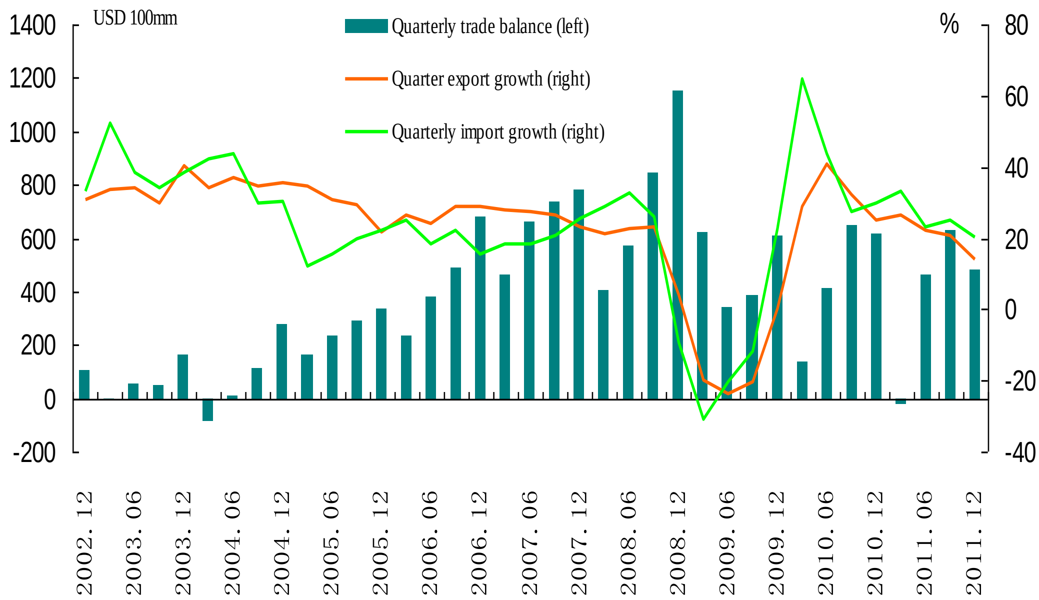

Figure 6 Foreign Trade Became More Balanced

Sources: General Administration of Customs; PBC.

2. Agricultural production performed well and industrial production grew steadily

In 2011 the value-added of the primary, secondary, and tertiary industries reached 4.8 trillion yuan, 22.1 trillion yuan, and 20.3 trillion yuan respectively, up 4.5 percent, 10.6 percent, and 8.9 percent. The shares of the three industries in GDP were 10.1 percent, 46.8 percent, and 43.1 percent respectively.

The year 2011 witnessed stable growth of agricultural production and another bumper grain harvest. Grain output in 2011 posted 571.21 million tons, up 4.5 percent from the previous year. The total output of meat (including pork, beef, mutton, and poultry) posted 78.03 million tons, up 0.3 percent year on year.

Industrial production posted stable growth, and production and sales of industrial products were well matched. In 2011 the value-added of statistically large enterprises grew 13.9 percent year on year. Production and sales of industrial products were well matched, and 98 percent of manufactured goods were sold. The profitability of industrial enterprises continued to improve, with the profits of statistically large enterprises posting 5.5 trillion yuan, up 25.4 percent year on year. The survey of 5,000 industrial enterprises conducted by the PBC in the fourth quarter reveals that the business index dropped to 67.5 percent. The market demand index posted 57.4 percent, a decline of 3.2 percentage points from the previous quarter. Among this total, the domestic orders index dropped for a fourth consecutive quarter to 53.2 percent; the export orders index declined further by 2.9 percentage points to 48.7 percent, entering the below 50 percent slump zone for the first time since the fourth quarter of 2009. The raw materials supply index climbed by 1.0 percentage points to 63.5 percent, the second successive quarterly increase.

3. The rapid price increase momentum was initially contained

Since the beginning of 2011, due to the combined effects of various factors such as rising energy, resource, and labor costs, strong inflationary expectations, and rapid growth in domestic demand, pressures of a price hike mounted. In the latter half of the year, with the economic growth gradually stabilizing, the unfolding of the effects of the prudent monetary policy, and the falling commodity prices, the pressures of a price hike were eased and the major price indices started to retreat; as a result, the momentum of an excessive growth in prices was initially contained.

Growth in the CPI accelerated in year-on-year terms in the first half of the year, but decelerated month by month from July. In 2011, the CPI grew 5.1 percent, 5.7 percent, 6.3 percent, and 4.6 percent year on year in the four quarters respectively, averaging 5.4 percent and accelerating by 2.1 percentage points from a year earlier. Broken down by food and non-food items, food prices gained 11.8 percent year on year, an acceleration of 4.6 percentage points from the previous year; prices of non-food items increased by 2.6 percent, an acceleration of 1.3 percentage points from 2010. Broken down by consumer goods and services, the prices of consumer goods grew by 6.2 percent year on year, up 2.5 percentage points from the previous year, and the prices of services were up 3.5 percent, representing an acceleration of 1.5 percentage points from the previous year.

Growth of producer prices remained at an elevated level in the first three quarters, but fell significantly in the fourth quarter. In 2011, ex-factory producer prices of industrial products during the four quarters grew 7.1 percent, 6.9 percent, 7.1 percent, and 3.1 percent respectively year on year, averaging 6.0 percent and accelerating by 0.5 percentage points from the previous year. Producer purchasing prices in the four quarters increased by 10.2 percent, 10.4 percent, 10.5 percent, and 5.5 percent respectively year on year, averaging 9.1 percent and decelerating by 0.5 percentage points from the previous year. In 2011, the Corporate Goods Price Index (CGPI) was up 7.6 percent in year-on-year terms, representing an acceleration of 1.1 percentage points from 2010. Broken down by the application of the goods in the CGPI basket, the prices of investment goods and consumer goods rose 7.0 percent and 9.0 percent respectively. Broken down by categories within the CGPI basket, the prices of agricultural produces, mineral products, coal, oil, and electricity, and processed products were up 14.4 percent, 11.4 percent, 9.5 percent, and 5.6 percent respectively year on year. Growth of producer prices of agricultural products (the prices at which farmers sell their agricultural products) outpaced that of the prices of agricultural capital goods. In 2011, the producer prices of agricultural products increased by 16.5 percent, an acceleration of 5.6 percentage points, whereas the prices of agricultural capital goods gained 11.3 percent, up 8.4 percentage points from 2010.

The increase in import prices outpaced that of export prices. In 2011, import prices gained 14.6 percent, 15.1 percent, 15.1 percent, and 11.1 percent year on year in the four quarters respectively, averaging 14.0 percent and accelerating by 0.3 percentage points from the previous year. Export prices increased 10.0 percent, 10.4 percent, 9.7 percent, and 10.1 percent in the four quarters respectively, averaging 10.0 percent and accelerating by 7.6 percentage points from 2010. In 2011, the average price of crude oil futures on the New York Mercantile Exchange increased by 10.9 percent, 8.2 percent, -12.5 percent, and 5.0 percent in the four quarters, or by a cumulative 10.4 percent. The spot copper prices on the London Metals Exchange grew 11.7 percent, -5.3 percent, -1.7 percent, and -16.6 percent in the four quarters respectively, or -13.3 percent in cumulative terms. The average price of aluminum on the London Metals Exchange rose by 6.8 percent, 3.9 percent, -7.7 percent, and -12.9 percent in the four quarters respectively, or -10.9 percent in cumulative terms.

The GDP deflator fell modestly. GDP registered 47.2 trillion yuan in 2011, up 9.2 percent year on year. Movement of the GDP deflator (as a ratio of the nominal GDP versus the real GDP) was 7.6 percent, up 0.9 and 0.1 percentage points from the previous year and from the first three quarters respectively.

The resource products pricing reform made new progress. First, the reform of the resources tax was advanced. An ad valorem tax was added to the existing specific tax levied on resource products, and the tax rate on items such as crude oil and natural gas was adjusted. Second, the State Council, making it clear that it would pursue environmentally friendly economic policies, promoted the reform of the environment tax and explored the possibility of levying an environmental protection tax. Third, a new aviation fuel pricing mechanism was implemented, whereby buyers and suppliers negotiated to determine that in principle the ex-factory price should not exceed the CIF price in Singapore. Fourth, after price hearings a progressive electricity tariff for the household sector was implemented on a pilot basis. Fifth, a pilot program to reform the pricing mechanism for natural gas was conducted in Guangdong Province and Guangxi Autonomous Region in order to establish a dynamic price adjustment mechanism reflecting market supply and demand and the scarcity of resources, to streamline the share of natural gas versus renewable energies, and to accumulate experience so to implement the natural gas price reform nationwide.

Box 4 Producer price index

The Producer Price Index (PPI), as a measurement of the trend versus the magnitude of the movement in industrial producer prices, is an important economic indicator reflecting the movement of producer prices during a given period of time. The PPI includes the ex-factory producer prices, the prices at which industrial products are sold for the first time, and the producer purchasing prices, the prices at which industrial enterprises purchase intermediate inputs.

In the PPI basket, capital goods account for about 70 percent; therefore, movements of capital goods play a determining role in PPI movements. Specifically, commodity prices in international markets and domestic investment demands are the two basic elements influencing the prices of capital goods and, in turn, the PPI movements. First, with its further opening-up and the sustained and rapid economic development, China is increasingly relying on imported crude oil, iron ore, and other energy and resources; therefore, commodity price volatility is increasingly passed through trade and expectation channels to the domestic PPI. The prices of crude oil, iron ore, and other commodities soared in the first half of 2008 and then tumbled in the second half of the year, as China's PPI experienced volatile movement of 10 percent during the same period. Second, a change in investment demand during the transition of economic cycle would also impact the prices of capital goods and in turn the PPI. During the period from 2007 to the first half of 2008 and in 2009 when policies were taken in response to the global financial crisis, investment growth rapidly rallied and the price index of fixed-asset investments rallied, and then the PPI grew markedly; since the beginning of 2011 as investment growth has slowed down, the PPI has declined in tandem.

The PPI and CPI, as the upstream and the downstream price indices with a basic corresponding relationship, can pass from one to the other; however, due to apparent differences in the baskets and in the data collection, the two differ in terms of the timing and magnitude of the fluctuations. Specifically, the CPI basket is mainly comprised of consumer goods, including the prices in the services industry, whereas the PPI basket is mainly made up of capital goods, excluding the prices of the services industry. When collecting price data, the PPI focuses on price movements from the perspective of producers, whereas the CPI measures price changes from the perspective of consumers. Historically, the PPI has moved in advance of the CPI and in a more volatile manner. In the recent price hike episodes, the PPI decelerated before the CPI and by a larger margin. The major reasons include commodity prices were declining since April 2011 and the price index of CRB futures reversed to a year-on-year decrease of 6.7 percent in December, having a greater impact on the PPI mainly comprised of capital goods. With respect to the CPI, though prices of non-food items more closely related to the PPI have dropped in year-on-year terms, to some extent the CPI decline has been contained by the still rapid hike in the prices of food and services that are heavily influenced by raw material and labor costs. However, due to the slower domestic demand and the decreasing external demand, the oversupply has put a lid on the scope for a price hike of most industrial products.

4. Fiscal revenue grew faster than in 2010, and fiscal expenditures maintained rapid growth

In 2011, fiscal revenue (excluding debt income) surged by 24.8 percent year on year to 10.4 trillion yuan, representing an acceleration of 3.5 percentage points from the previous year, whereas fiscal expenditures registered 10.9 trillion yuan, up 21.2 percent year on year, representing an acceleration of 3.4 percentage points from the previous year. As a result, revenue was 519 billion yuan less than expenditures.

As for the structure of fiscal revenue, tax revenue posted 9.0 trillion yuan for the whole year, up 22.6 percent year on year and representing a deceleration of 0.4 percentage points from the previous year. In particular, the domestic VAT, business tax, consumption tax, the VAT and excise tax on imported products, the corporate income tax, and the personal income tax were up 15 percent, 22.6 percent, 14.2 percent, 29.3 percent, 30.5 percent, and 25.2 percent respectively year on year.

As for the structure of fiscal expenditures in 2011, spending for housing subsidies, transportation, and medical services registered relatively rapid growth of 60.8 percent, 36.1 percent, and 32.5 percent respectively year on year. In the expenditure basket, the three largest items were education, social security and employment, and general public services, posting 1,611.6 billion yuan, 1,114.4 billion yuan, and 1,110.9 billion yuan respectively, accounting for 14.8 percent, 10.2 percent, and 10.2 percent.

5. Pressures from the imbalance in the balance of payments eased

In 2011 China's balance of payments (BOP) continued to post a twin surplus in the current account and the capital and financial account, and foreign exchange reserves continued to build up. The current account surplus declined by 30.7 percent year on year to USD141.2 billion, the capital and financial account surplus was up 92.2 percent year on year to USD250.1 billion, and foreign exchange reserves increased by USD375.4 billion. Since the beginning of the fourth quarter, affected by the debt crisis in Europe and the U.S., changes in market expectations, adjustments in the foreign administration policies oriented toward surplus reductions and economic rebalancing, the net flows of cross-border funds moderated and bank-intermediated foreign exchange sales posted deficits for several months, thus easing pressures from the BOP imbalance. As of end-2011, foreign exchange reserves amounted to USD 3,181.1 billion.

It is expected that the current foreign exchange receipts and sales momentum will last for some time, in general foreign exchange funds will be net inflows in 2012, but notably fewer than during the past several years. The import and export surplus and FDI will remain the major channels for foreign exchange inflows. On the one hand, domestic savings exceed investments in the domestic market during the current period, the pattern in the current account, in particular the trade surplus, will not be reversed given the existing division of labor in the international market. On the other hand, the domestic market enjoys tremendous potential as China’s economy continues to grow in a sustainable and relatively rapid manner, which is likely to continue to attract inflows of long-term capital. Moreover, the impact of the debt problems in Europe and the U.S. and developments in international financial markets on China's BOP remain to be seen.

The volume of external debt increased. As of end-September 2011, the stock of China's external debt stood at USD697.16 billion, up 27.6 percent year on year. Among this total, the stock of registered external debt posted USD440.56 billion, up 34.9 percent year on year and accounting for 63.2 percent of the total; short-term external debt posted USD507.63 billion, a year-on-year increase of 37.4 percent and accounting for 72.8 percent of the total.

6. Sectoral analysis

Industrial profits grew steadily. In 2011, 37 out of the 39 industrial sectors reported a year-on-year growth in profits, whereas two sectors experienced a year-on-year decline in profits. Among the industries, the profits of oil and natural gas exploration, the ferrous metals mining industry, the chemical raw materials and chemical products manufacturing industry, and the oil refinement, coking and nuclear fuel-processing industry grew by 44.8 percent, 53.0 percent, 32.1 percent, and -92.8 percent respectively. In 2011, power generation increased 12.0 percent year on year to 4,603.7 billion kilowatt hours, crude oil output grew by 0.3 percent year on year to 203.65 million tons, and the output of crude coal was up 11.6 percent year on year to 3.46 billion tons. A total of 33.03 billion tons of cargo was transported, up 14.3 percent year on year.

(1) The real estate sector

In January 2011, the General Office of the State Council issued the *Notice of the General Office of the State Council on Issues Relating to Further Improvements in Regulating the Real Estate Market* (Guo-Ban-Fa [2011] No. 1), aimed at strengthening regulation over the real estate market through land, tax, financial, and other policy measures. With the various policies put into place, the real estate market gradually stabilized, construction of low-income housing accelerated, and real estate loans by major financial institutions slowed down.

More cities witnessed month-on-month declines in housing prices. In December, the prices of newly built commercial residential housing dropped month on month in 52 out of 70 large- and medium-sized cities, 49 more than in January, and remained flat in 16 cities; and among the cities with month-on-month price hikes, no cities reported growth higher than 0.1 percent. The price of pre-occupied residential housing fell in month-on-month terms in 51 cities, 48 more than in January, and remained flat in 16 cities; among the cities with month-on-month price hikes, no cities reported an increase higher than 0.2 percent.

Sales of commercial real estate decelerated. In 2011 the sold area of commercial real estate posted 1.099 billion square meters, up 4.9 percent year on year, a deceleration of 5.7 percentage points from the previous year. Sales of commercial real estate were up 12.1 percent year on year to 5.9 trillion yuan, representing a deceleration of 6.8 percentage points from 2010. In particular, the sold area and sales value of commercial residential housing accounted for 88.3 percent and 82.2 percent of the sold area and sales value of commercial housing. Growth of sales of office buildings and commercial business premises considerably outpaced that of commercial residential housing.

Investment in real estate development slowed down gradually from an elevated level. In 2011 investment in real estate development totaled 6.2 trillion yuan, up 27.9 percent year on year, representing a deceleration of 5.3 percentage points from the previous year. In particular, investment in residential housing reached 4.4 trillion yuan, accounting for 71.8 percent of the total. The growth of floor area of newly built housing slowed down gradually. In 2011 the floor area of newly built housing grew 16.2 percent to 1.901 billion square meters, a deceleration of 24.4 percentage points from the previous year. The floor area of housing under construction grew 25.3 percent to 5.08 billion square meters, a deceleration of 1.2 percentage points from the previous year. The floor area of completed housing stood at 892 million square meters, up 13.3 percent year on year and representing an acceleration of 5.0 percentage points from 2010.

Growth of real estate loans decelerated across the board. Year-on-year growth of outstanding real estate loans peaked at 46.4 percent in April 2010 and decelerated thereafter until a slight rebound in December 2011. As of end-2011, the real estate loans of the major financial institutions (including foreign financial institutions) posted 10.73 trillion yuan, an increase of 13.9 percent year on year and a deceleration of 13.5 percent from end-2010. Among this total, outstanding land development loans were down 7.9 percent year on year to 768 billion yuan, whereas as of end-2010 they had registered a year-on-year increase of 24.7 percent. Outstanding housing estates development loans grew by 17.1 percent year on year to 2.72 trillion yuan, representing a decelerating by 5.9 percent from the end of the previous year. Outstanding mortgage loans registered 7.14 trillion yuan, up 15.5 percent year on year and a deceleration of 14.0 percentage points from end-2010. As of end-2011, outstanding land and housing loans accounted for 20.1 percent of the total outstanding loans. In terms of new loans, new real estate loans in 2011 reached 1.26 trillion yuan, a decrease of 770.4 billion yuan year on year.

Credit support for low-income housing was gradually reinforced. In 2011, over 10 million units of low-income housing and renovations of shanty housing broke ground in the urban areas, meeting the target set at the beginning of the year. As of end-2011, outstanding loans for low-income housing reached 340.9 billion yuan, accounting for 12.5 percent of the total real estate development loans. Among this total, new loans in 2011 posted 175.1 billion yuan, accounting for 50.1 percent of the total new real estate development loans and representing an acceleration of 31.7 percentage points from the beginning of the year. Moreover, the pilot program of using the housing provident fund loans to support the construction of low-income housing was advanced steadily. As of end-2011, loans to approved projects amounted to 40.029 billion yuan, out of which 26.588 billion yuan in loans was issued by commercial banks in 29 cities on behalf of the Housing Provident Fund Management Center. Financial institutions also provided active support for the building of low-income housing through a variety of financial instruments, such as trust products, wealth management products, insurance investment, all types of bonds, commercial bills, and financial leasing.

In an effort to implement the *Notice of the General Office of the State Council on Issues Relating to Further Improvements in Regulating the Real Estate Market* and to put into play the role of finance in supporting the building of public rental housing and other types of low-income housing, the PBC and the China Banking Regulatory Commission (CBRC) jointly issued the *Circular on Providing Quality Financial Services for Public Rental Housing and Other Low-Income Housing Projects* (PBC Document No. 193 [2011]), which explicitly establishes financial policies to support public rental housing and requires that banking financial institutions actively provide loans to various low-income housing projects in line with the prevailing policies. Going forward, the PBC will make earnest efforts to provide quality financial services, promote the healthy development of the real estate market, and improve the people's livelihood in line with the requirements raised by the Central Economic Work Conference.

(2) The iron and steel sector

As a fundamental sector in the national economy, the iron and steel sector plays an important role in China's industrialization and urbanization drive. During the 11th Five-Year Plan period, the iron and steel sector developed rather rapidly, making obvious progress in energy conservation and pollution reduction, and therefore satisfied the demands for economic and social development. However, it is worth noting that the iron and steel sector is facing grave challenges, such as increasing losses of profits in 2011, the lower end of the value chain, a fragmented industrial organizational structure, large-scale outdated production capacity and other structural problems, as well as increasing resource and environmental constraints.

The problem of relative overcapacity has become more acute. China's crude steel output reached 627 million tons in 2010, accounting for 44.3 percent of the world's total and exceeding the combined output of all countries ranking between the second and the twentieth. In 2011 production of the iron and steel sector increased in the first half of the year and then decreased. The oversupply situation has not yet been reversed. In 2011, the output of crude steel grew by 8.9 percent year on year to 680 million tons; the output of steel products registered 880 million tons, up 12.3 percent in year-on-year terms. During the same period, fixed-asset investments in the ferrous metals smelting and rolling industry grew by 14.6 percent year on year, including steel plates and strips whose production capacity was already relatively in oversupply, thus, going forward, heightening the risks of a price war.

The prices of iron and steel products fluctuated greatly. Affected by the output growth and the weakening demand from the downstream industries, the prices on the iron and steel market fluctuated dramatically. According to the China Iron and Steel Association, the composite steel product price index was up by 12.34 percent, 15.97 percent, and 10.78 percent respectively in the first three quarters, but the end-of-year figure was -6.11 percent; in particular, the price index of long products fell 6.13 percent year on year, whereas the price index of plate products dropped by 6.61 percent.

The hike in production costs has squeezed corporate profits. In 2011 the average FOB price of imported iron ore grew 28.1 percent year on year to USD 163.8 per ton, making iron and steel enterprises pay USD25 billion more to purchase iron ore and thus becoming an important factor in shoring up production costs. In the first eleven months of the year, the cumulative realized profits of large- and medium-sized iron and steel enterprises posted 85.3 billion yuan, up 8.07 percent year on year; however, the average sales revenue profitability in October and November was merely 0.48 percent and 0.43 percent respectively. Over one-third of the enterprises suffered losses, which, after deducting for investment returns, stood at 920 million yuan in November.

The 12th Five-Year Plan period is critical for the transformation of the development pattern in China’s iron and steel industry. Slow growth and razor-thin profits are direct results of the pains of labor transformation. The iron and steel industry needs to rise to the challenge and speed up structural adjustments and upgrading. First, expansion of production capacity should be rigorously contained, and outdated capacity should be scraped, in order to meet the target of scraping 48 million tons of iron smelting capacity and 48 million tons of steel smelting capacity. Second, mergers and acquisitions should be promoted, as before, so as to increase the industrial concentration. According to China’s Iron and Steel Association, industrial concentration in 2011 was a mere 49 percent. The 12th Five-Year Plan for the iron and steel industry requires that the share of steel output of the top 10 company groups be raised from 48.6 percent at the end of 2010 to around 60 percent by 2015. Third, self-initiated innovation and technological upgrading should be leveraged to improve product quality and to expand the types of high-performing steel products in order to further save on energy and to cut emissions.

Part 5 Monetary Policy Stance for the Next Period

I. Outlook for the Chinese economy

China is still at a stage of important strategic opportunities for socio-economic development and there are many favorable conditions to support stable and fairly rapid economic growth. With the localities keen to promote urbanization, industrialization, and balanced regional development, the good momentum in consumption expansion and the large potential in service-sector development, the fundamentals for long-term growth remain unchanged. As the sovereign debt crisis further deepened in Europe, global recovery slowed down and downward pressures e intensified in China, macro-economic management will require preemptive adjustments and fine-tuning. In Q4 2011, GDP growth was 8.8 percent year on year and the major economic indicators registered higher month-on-month growth after seasonal adjustments, indicating fairly strong endogenous drivers of economic growth.

At the same time, it should be acknowledged that the economic environment, both at home and abroad, is very complicated. The global recovery by and large has been tepid and the sovereign debt problem in Europe remains unresolved. As such, the global outlook is uncertain, with financial-market fluctuations and global capital flows frequently changing directions. Unstable and uncertain factors are abundant and may affect China through channels such as trade, capital, and expectations. The uneven, unbalanced, and unsustainable problems remain obvious in China's economic performance and potential risks in the real economy and financial sectors should not be neglected. The pace and dynamism of macro-economic policies should be properly managed and efforts should be made to step up management of systemic and regional risks. In addition, with external demand fairly weak and the growth pattern and factor structures being adjusted at home, the potential growth of the Chinese economy is gradually decelerating. Maintaining stable and reasonable growth will be conducive to price stability and job creation and will provide a good basis for economic restructuring and sustainable development.

A series of macro-economic policies adopted by the Chinese government are gradually having an effect. Growth in the overall price level is moderating, but we still need to closely watch future inflationary risks. As domestic demand remains relatively stable, monetary conditions are normalizing and the outlook for grain production is fairly good, and with global growth on the decline, movements in demand and supply relationships are supporting price stability. Since August 2011, month-on-month CPI growth has been lower than the average in the past many months, and the year-on-year CPI is likely to decline further. In addition, with the excessive housing price hikes being contained, housing prices in some regions are declining to varying degrees. According to the PBC's survey of urban depositors in Q4 2011, expectations of future price declines were down 9.4 and 16.3 percentage points respectively from the previous quarter and the corresponding period of the last year and expectations of future housing price hikes declined as well. Yet, with regard to price movements, upward pressures will remain. The CPI reading in January 2012 is higher than market expectations, and current inflation expectations are not stable, given the structural factors such as the growing shortage of labor supply and the yet-to-be completed resource price reform that are likely to solidify inflation expectations and increase the sensitivity of prices to aggregate changes in demand. In addition, domestic drivers for expansion of the Chinese economy, a continued generous supply of global liquidity, and inflationary pressures on global commodities all point to the possibility of future price hikes in China. In brief, we cannot expect unconditional stability in the overall price level in China and it is thus necessary to manage the strength and pace of macro-economic policies in the period ahead.

II. Monetary policy during the next stage

In 2012, in line with the overall arrangements of the Central Economic Work Conference and the National Financial Work Conference, the PBC will follow the theme of sustainable development and transformation of the growth pattern, properly handle the relationship among supporting stable and fairly rapid economic growth, economic restructuring, and managing inflation expectations, continue to implement a prudent monetary policy, maintain the continuity and stability of policies, closely monitor economic and financial developments at home and abroad, enhance the targeted, flexible, and forward-looking nature of the measures of macro-economic management, initiate fine-tuning and preemptive adjustments as appropriate, improve the quality of financial services to the real sector, effectively mitigate systemic financial risks and keep the financial sector stable, keep overall price levels generally stable, and contribute to stable and fairly rapid economic growth. In 2012, the projected growth of broad money M2 supply will be about 14 percent.

First, through a mix of various monetary policy instruments and improvements in the macro-prudential policy framework the credit structure will be further optimized on the basis of proper aggregate volume, proper adjustments will be made to money and credit supply, and all-system financing aggregate will be kept at proper volumes. Liquidity management will continue to be optimized; the instrument mix, maturity structure, and operation strength will be properly arranged in view of developments in the real economy, the financial sector, and capital flows to keep banking-sector liquidity at reasonable levels and to guide interest-rate movements on the money market. Price tools such as interest rates will be used flexibly to adjust the demand for credit as well as investment and savings behavior and to preserve stability in economic performance and overall price levels. The macro-prudential policy framework will be improved so that enhanced macro-prudential regulation will work together with measures to manage money, credit, and liquidity to adjust the aggregates of these indicators; moreover, the relevant parameters of the dynamic adjustment mechanism of the differentiated deposit reserve requirement ratio will be properly adjusted in response to changes in the performance of the macro-economy, the soundness of financial institutions, and monetary and credit conditions.

Second, the credit structure will be optimized to provide good services to the real sector. The coordination of credit and industrial policies will be enhanced, and an evaluation of the effect of credit policy will be promoted to guide financial institutions to properly manage the pace and structure of credit extensions and to earnestly implement the differentiated credit policy. Innovation in financial products and services will be encouraged to increase effective credit inputs into enterprises that comply with industrial policies, in particular micro and small enterprises and follow-up projects of key national projects. A multi-layered, diversified rural financial service system featuring adequate competition will be built to better support the agricultural sector and rural borrowers. Emphasis will be placed on supporting people's welfare projects, especially government-subsidized housing projects, under-developed regions, innovation in science and technology, emerging strategic industries, and technological upgrading of enterprises. Lending to high energy-consuming and highly polluting industries and those with excess capacity will be strictly controlled.

Third, the market-based interest rate reform and the RMB exchange-rate regime reform will be advanced. Measures will be taken to develop a system of market base rates to encourage financial institutions to enhance their risk-pricing capability, and to explore an effective approach for furthering the market-based interest rate reform. The RMB exchange-rate regime will be further improved to enhance RMB exchange-rate flexibility in both directions and to keep the exchange rate basically stable at an adaptive and equilibrium level. Development of the foreign exchange market will be advanced and innovation in exchange-rate risk-management instruments will be promoted. To respond to market demand, the product variety and range of cross-border RMB businesses will be expanded. With regard to RMB settlement of cross-border trade and investment transactions, monitoring and supervision of cross-border RMB flows will be conducted earnestly, and individuals as parties to the transactions will be examined, and further progress will be made in the listing and quotation of RMB trading of RMB and other emerging market currencies in the inter-bank foreign exchange market. The impact of changes in the international situation on capital movements will be closely monitored and early warnings on cross-border capital flows will be enhanced.

Fourth, the sound development of the financial market will be promoted and the reform of financial institutions will be deepened. Efforts will be made to develop financial markets, optimize the financing structure, encourage financial innovation, broaden the financing channels of small and micro enterprises, step up the building of infrastructure in the financial markets, and gradually advance the opening up of the inter-bank bond market. Large commercial banks will be encouraged to improve their modern enterprise mechanisms and to speed up the transformation of their growth pattern. The development of policy finance will be considered comprehensively; the market reform of the China Development Bank will be deepened, while the reform of the Export-Import Bank of China and the Agricultural Development of China will be advanced based on the principle of one set of specific policies for one bank and differentiated guidance.

Fifth, effective measures will be adopted to mitigate systemic financial risks and to preserve stability in the financial system. Macro-prudential regulation will be enhanced to guide financial institutions to run their businesses soundly. Monitoring and analysis of informal lending, the real estate sector, government financing platforms, and so forth will be strengthened to identify risks promptly and to manage the relationship between reasonable loan growth and higher loan quality from a long-term, comprehensive, and systemic perspective, and to provide risk warnings and to manage risks. Measures will be adopted to prevent cross-sector, cross-market risks, to prevent risks from spreading from the informal financial sector and related sectors to the financial system. It is necessary to prevent financial risks from spreading and at the same time to prevent a moral hazard and to guard against the bottom line of allowing no systemic risks to occur in a region.