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CHINA FINANCIAL MARKET DEVELOPMENT REPORT

PBC Shanghai Head Office
China Financial Market Development Report Committee

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In 2007, the Chinese economy kept steady and fast growth, and the financial performance remained sound with the financial reform steadily advanced and the financial organizational system further improved, creating a benign environment for China's financial market development. With the reform and deepening of the market being advanced, China's financial market has witnessed a faster pace of development, and played a more important role in the financial system as well as in economic development. The financial market has provided a platform for macroeconomic and financial management, a channel for investment and financing for market entities, and a place for asset-liability management and risk management for various institutions. Therefore, it is a fundamental task to vigorously nurture and develop the financial market, with a view to improving macroeconomic management mechanism, increasing risk management tools, and optimizing resource allocation. We need to continue to encourage the financial market to play a primary role in resource allocation, to safeguard overall stability of the financial market, and to guard against risks built up in the course of rapid development, with an aim to further promote healthy growth of the economy. Going forward, continued progress is expected to be made in China's financial market development along with comprehensive, sustainable and balanced development of the Chinese economy.

1. Highlights of China's Financial Market Development in 2007

In 2007, China's financial market maintained its fast and healthy development momentum, witnessing a fast-growing market size, further development of direct financing, steady progress in institutional building, accelerated financial product innovation, diversified market participants, particularly institutional investors, and greater openness.

1.1 Market Size Grew Rapidly, and Market Width and Depth Continuously Increased

The year of 2007 saw strong expansion of China's financial market, as reflected by rapid increase of market turnover. The total turnover of money market, bond market, stock market, gold market, and futures market amounted to RMB160.46 trillion yuan, a year-on-year growth of 125.8 percent, the highest in history. The volume of inter-bank lending grew very fast, by 395 percent year on year to RMB10.65 trillion yuan. The turnover of the bond market reached RMB62.91 trillion yuan, and in particular, the inter-bank bond market turnover was RMB 60.4 trillion yuan, up 63.9 percent. The total amount of bonds in custody reached RMB12.33 trillion yuan, with that of the inter-bank bond market reaching RMB11.14 trillion yuan, and accounting for 93.5 percent of total tradable bonds in custody. The stock market turnover increased by several times, with the average daily turnover of the Shanghai Stock Exchange and Shenzhen Stock Exchange hitting RMB190.3 billion yuan, up 407 percent from 2006. The total market capitalization of the two Exchanges rose to RMB32.71 trillion yuan at the end of the year from RMB8.94 trillion yuan at the end of last year, with the ratio to GDP growing to 132.6 percent from 42.7 percent. The turnover of Shanghai Gold Exchange recorded RMB316.49 billion yuan, up 62.5 percent from a year earlier.

1.2 Direct Financing Further Developed, and the Financing Structure Improved Somewhat

As the market played an increasingly larger role in financing and resource allocating, the financing structure witnessed encouraging changes. In the bond market, the issuance of various bonds by enterprises totaled RMB518.096 billion yuan in 2007. In particular, the issuance of short-term financing bills and enterprise bonds reached RMB334.91 billion yuan and 171.986 billion yuan, up 14.7 percent and 72.9 percent respectively from a year earlier, and the issuance of corporate bonds as a newly introduced product for the year amounted to RMB11.2 billion yuan. The stock market posted a record high in terms of fund raising. In 2007, the Shanghai Stock Exchange and Shenzhen Stock Exchange raised funds worth of a total of RMB 772.816 billion yuan, a year-on-year increase of 213.7 percent, the highest level in history. Enterprises raised funds up to RMB871 billion yuan[1] through direct financing, accounting for 17.5 percent of their total financing for the year, up 5.2 percentage points from a year earlier.

1.3 Innovation Speed Picked up, Products and Instruments Developed in a Diversified Manner

The bond market witnessed a historical breakthrough in the issuance of financial bonds by finance companies. Six finance companies of enterprise groups including the Sinopec issued financial bonds in 2007. Three corporate bonds worth of RMB11.2 billion yuan in total were successfully issued in 2007 with China Yangtze Power Co., Ltd. Bond being first launched on September 19. In the futures market, the introduction of zinc, rapeseed oil and palm oil futures contributed to increasing trading products. In the gold market, the Shanghai Gold Exchange expanded the scope of gold trading for individuals. In the fund market, the new type of closed-end fund was launched, broadening the scope of fund product innovation and development. In the inter-bank market, RMB/Forex currency swap and forward interest rate agreement were launched, adding financial derivatives to China's market. In the inter-bank foreign exchange market, RMB/Forex currency swap, which is designed for medium and long-term exchange rate risk management, was introduced in August 2007, and was formally traded on December 10 to meet the needs of domestic entities for risk management. The forward rate agreement launched in September 2007 helps enhance investors' capability in interest rate risk management, safeguard market stability, facilitate price discovery, and promote coordinated development of the overall financial derivatives market.

1.4 Institutional Building was Steadily Advanced, and Market Operational Mechanism was Further Improved

Steady progress was made in institutional building of the financial market, which refined functions of the financial market, and thus laid the foundation for sound performance of the market. In terms of the money market, the People's Bank of China (hereafter referred to as PBC) promulgated the *Administrative Rules on Inter-bank Lending and Borrowing*, which adjusts the policies related to the inter-bank lending market in line with the direction of the market-oriented reform, and with a view to expanding the width and depth of the market. In terms of the bond market, the market maker rule in the inter-bank bond market was further improved, asset-backed securities were allowed to be traded for repo, and the rules on information disclosure of asset-backed securities were established. In terms of the stock market, the new accounting rules were put into operations, *the Implementation Rules (Trial) on Securities Companies'*

1 Funds raised by enterprises through direct financing include the issuance of corporate bonds minus due redemption for the year, and plus funds raised in the stock market by those other than financial institutions in the year.

Contribution to Securities Investor Protection Fund was issued to protect legal rights and interests of investors, and the *Administrative Rules on Information Disclosure of Listed Companies, the Administrative Rules on Major Asset Restructurings of Listed Companies*, etc., were promulgated to improve the legal underpinnings of the stock market. Significant reform measures were taken with regard to the stock market auditing system. In terms of building the futures market system, the State Council promulgated the new *Regulation on the Administration of Futures Trading* followed by *the Administrative Rules on Futures Exchanges* and *the Administrative Rules on Futures Companies* to improve the legal framework for the futures market. In the field of industrial self-regulatory organizations, the National Association of Financial Market Institutional Investors (hereafter referred to as NAFMII) was set up, which will function as an industry self-regulatory organization and undertake self-regulation by mobilizing the forces of market participants themselves, and thus align regulation better with market needs. By doing so, it will promote two-way communications between market and government, effectively protect legal rights and interests of investors, and facilitate market development. NAFMII established and issued *the Master Agreement for Financial Derivatives Trading in China's Inter-bank Market*, which constitutes an important institutional arrangement for China's financial market development. In addition, PBC has actively supported issuance, trading, circulation,registration and custody of corporate bonds in the inter-bank bond market, and allowed access of the corporate annuity funds to the inter-bank bond market with a view to vigorously fostering development of institutional investors in the inter-bank bond market.

1.5 The Market Participants were Increasingly Diversified, and Institutional Investors Continued to Grow

The market participants continued to increase rapidly, particularly institutional investors. The increasing diversification of market participants improved the market structure by alleviating the homogenous nature of market participants. At end-2007, there were 7,095 institutional investors in the inter-bank bond market (including 30 privileged settlement members), of which 2,125 investors were financial institutions and 4,940 investors were non-financial legal entities. There were 717 members in the inter-bank lending market, with banking institutions and non-banking institutions 609 and 108 respectively. The market participants in the inter-bank lending market and the bond market covered 10 types of institutions in the banking, insurance and securities sectors. The number of the members in the inter-bank foreign exchange market (the spot market) reached 268, including 139 foreign financial institutions, 126 domestic financial institutions and 3 domestic enterprises. There were 139 million securities accounts in the Shanghai Stock Exchange and Shenzhen Stock Exchange, an increase of more than 70.02 million from 68.8408 million at end-2002, and an increase of more than 60.33 million from 78.54 million at end-2006. The base of institutional investors in the stock market was further broadened. There were 346 funds in the stock market at end-2007, 39 more than that of the previous year, with total units of 2,234 billion, 3.58 times that at end-2006, and net assets of RMB3,276.2 billion yuan, 3.82 times that at end-2006. The outstanding balance of insurance fund investment amounted to RMB267 million yuan, a growth of 37.2 percent from the beginning of the year. The assets of National Social Security Fund at market value exceeded RMB500 billion yuan to hit RMB516.182 billion yuan, a year-on-year growth of near 60 percent.

1.6 The Financial Market Opened up to the Outside World at a Faster Pace and the Degree of International Participation Continued to Rise

The opening up of the financial market was advanced in an orderly manner, and the pace of "Going Global" speeded up. Domestic financial institutions successfully issued RMB financial bonds in Hong Kong China, with China Development Bank (hereafter referred to as CDB), the Export-Import Bank of China (hereafter referred to as EIBC), and the Bank of China (hereafter referred to as BOC) issuing a total of RMB10 billion yuan bonds in Hong Kong China. The qualified domestic institutional investor (hereafter referred to as QDII) scheme continued to be pushed forward. By end-2007, the regulators had licensed 59 institutions for the QDII scheme, including 23 banks, 20 insurance companies, 12 fund management companies, and 4 securities companies, with the total approved QDII quota of USD45.588 billion. Steady headway was made in the area of introducing foreign investors in. The futures market witnessed increasing presence of foreign members. Five foreign banks including Hong Kong and Shanghai Banking Corp. (HSBC for short), Standard Chartered, Scotiabank, United Bank of Switzerland (UBS for short), and Banque Societe Generale (SocGen for short) obtained licenses of the Shanghai Gold Exchange as the first group of foreign members. Following cooperation between China Foreign Exchange Trade System (hereafter referred to as CFETS) and the Chicago Mercantile Exchange, China Government Securities Depository Trust & Clearing Co., Ltd. (hereafter referred to as CGSDTCC) and the Shanghai Stock Exchange (hereafter referred to as SSE) conducted effective cooperation with foreign institutions as well.

2. Macroeconomic Environment Analysis for China's Financial Market Development

2.1 The Analysis of the Domestic Macroeconomic Environment

Chinese economy kept steady and rapid growth in 2007. Fixed asset investment registered strong growth, with property development investment accelerated markedly. Total sales increased rapidly, showing a trend of acceleration. Consumer prices rose fast, with a surge in housing sale prices. Money supply and financial institutions lending continued to expand. Trade surplus kept growing, and foreign exchange reserves continued to increase.

The national economy continued to grow at a steady and fast pace, with GDP amounting to RMB24.67 trillion yuan in 2007, growing by 11.4 percent over the previous year and accelerating by 0.3 percentage point, marking the fifth consecutive year of growth above 10 percent. In 2007, total investment in fixed assets reached RMB13.72 trillion yuan, a year-on-year growth of 24.8 percent, and 0.9 percentage point higher than that in the previous year. Real estate development investment grew by 30.2 percent with RMB2.53 trillion yuan, an acceleration of 8.4 percentage points. Total retail sales of consumer goods reached RMB8.92 trillion yuan, a growth of 16.8 percent, and an acceleration of 3.1 percentage points over the previous year. CPI rose by 4.8 percent in 2007, 3.3 percentage points higher than in 2006. Housing sales prices in 70 large and medium-sized cities increased by 7.6 percent, up 2.1 percentage points. Foreign trade expanded strongly, and foreign direct investment (FDI) continued its growth. Total imports and exports for the year of 2007 reached RMB2,173.8 billion yuan, up 23.5 percent over the previous year, decelerating by 0.3 percentage point. Trade surplus recorded USD262.2 billion, up USD84.7 billion. At the end of the year, China's foreign exchange reserves reached USD1.53 trillion, a growth of 43.3 percent from last year.

Financial performance remained sound. At end-2007, broad money supply(M_2) was RMB40.34 trillion yuan, a year-on-year growth of 16.72 percent, down 0.22 percentage point. Narrow money supply(M_1) was RMB15.25 trillion yuan, a year-on-year growth of 21.01 percent, up 3.53 percentage points. Deposits of financial institutions denominated in both domestic and foreign currencies reached RMB40.11 trillion yuan, increasing by 15.22 percent year on year. In particular, RMB deposits reached RMB38.94 trillion yuan, a growth of 16.07 percent. Outstanding loans of financial institutions in both domestic and foreign currencies reached RMB 27.77 trillion yuan, increasing by 16.42 percent year on year.

In general, Chinese economy kept steady and rapid growth, characterized by strong expansion, optimized structure, increased efficiency and improved livelihood of the public. With the continuing strong growth of economic activities providing significant driving forces, China's financial market showed a favorable development momentum featuring brisk trading, growing size, accelerated innovation and sound performance.

First, the current macroeconomic developments laid the foundation for faster growth of China's financial market. With steady and rapid growth of the economy and increase of household income, the size of fund supply and demand kept growing, driving continuous expansion of the financial market. The financial market has witnessed increasing products, improved market system, and expanding width and depth.

Second, along with robust growth of the economy and improved efficiency, profits and profitability of financial institutions and enterprises as major participants in the financial market have been on the rise. Their enhanced capital strength and strong growth allowed them to provide abundant funds to the market, tamping the foundations of the market operations to some extent.

Third, in response to excessively rapid growth of fixed asset investment and credit, macroeconomic management measures have been taken to control investment and credit expansion. Therefore, some enterprises' demand for funds may turn to financial market, presenting opportunities for innovation and development of the financial market. We shall take a holistic approach to macroeconomic management and financial market development, step up efforts in product innovation and institutional building, so as to create a better market environment for macroeconomic management and push ahead with health development of the financial market.

At the same time, China's financial market development is also facing a more challenging economic environment. The risks of the economy evolving from rapid growth to overheating are yet to be effectively addressed. The strong growth has been accompanied by rising structural imbalances. The contradictions of lagged consumption growth and high savings rate are more acute. High dependency on external demand and the related problem of excessive liquidity have brought vulnerability to the economy. Due to various factors related to cost push, external inputs and inflation expectation, prices are likely to rise in the period to come. Affected by the sub-prime mortgage turmoil in the U.S., pressures of global growth slowdown are mounting. A weakening growth of external demand might result in gradual slowing of trade surplus growth. The snowstorm that hit the South China in the beginning of 2008 might have impact on inflation and growth in the short run. After years of robust growth, some deep-rooted problems in the economy that have been built up for long might unfold at a faster pace. Facing the new situation of China's economic and financial developments, we need to speed up reform and advance financial product innovation to promote the financial market development.

2.2 The Analysis of the International Economic and Financial Environments

Following the first three quarters' strong expansion in 2007, the global economic growth weakened, affected by persistent financial market turbulence, while the fundamentals of the global economy remained sound. Monetary policies showed a trend of relaxation following early tightening in major economies. Since the eruption of the U.S. sub-prime mortgage crisis, the global financial market experienced great volatility. Although various initiatives were taken, particularly by major central banks, to help stabilize the market, market confidence is yet to be fully recovered. Systemic risks of the international financial system are rising, adding uncertainties about the prospects of global economic growth.

In 2007, the world economy kept the momentum of steady growth on the whole, although the expansion slowed somewhat. Affected by the sub-prime mortgage turmoil, the U.S. economy growth slowed sharply, the euro zone was facing downside risks, and Japan's economic growth slowed down. Rapid growth continued in major emerging markets and developing countries, offsetting the negative impact of slowdown in advanced economies on the world economy to some extent. On January 29, 2008, the International Monetary Fund (IMF for short) issued updated forecasts, which expected the world economic growth to be 4.9 percent in 2007, 0.2 percentage point upward adjustment from its forecasts in October, 2007, and 0.1 percentage point lower than the real growth rate in 2006. Monetary policies in major economies showed a trend of relaxation following early tightening. In the first eight months, major central banks focused on inflationary pressures and hiked interest rates successively. After the U.S. sub-prime mortgage crisis broke out in August, the Federal Reserve, European Central Bank, Bank of England, and Bank of Japan suspended interest rate hikes and even switched to cut interest rates. Furthermore, they injected liquidity into the market to address the credit squeeze caused by the financial market turbulence.

The international financial market experienced greater volatility. Due to the sub-prime mortgage crisis, the international financial market witnessed big swings around August, 2007. In the foreign exchange market, the exchange rate of the U.S. dollar continued to fall against the Euro and the Pound Sterling, weakened following some firming against the Yen, and generally weakened against currencies of emerging market economies. The short-term interest rate of the U.S. dollar declined substantially, while that of the Euro, the Pound Sterling and the Yen kept rising. The medium and long-term government bond yields in major economies saw a rise followed by a decline. Major stock indices experienced greater volatility, and climbed up amid large fluctuations, posing record highs. The international gold price was stable in the first half of the year, and then surged in the second half of the year, setting the record high in history. The international commodity futures market witnessed general surge, with the Commodity Research Bureau Futures Price Index (CRB Index), which reflects the volatility of futures prices, soaring and approaching the highest level in history.

With China's economy increasingly integrated into the world economy, the impact of changes in the global economic and financial environments on domestic financial market development warrant greater attention. In general, the baseline of continued global growth will not change dramatically, however, the uncertainties and risks are rising, and the possibilities of fluctuation and slowdown are increasing. At present, the international economic situation remains favorable to China's economic and financial market developments, although some uncertainties and risks deserve vigilance.

How the U.S. sub-prime mortgage crisis will play out is still not clear, and continuous revelations of asset losses have shaken the confidence in the financial market. The chain reaction of the market further amplified risks, aggravating the global financial market turbulence. The sub-prime mortgage crisis may spread to other regions through various channels including behavior of international investors, impacts on market expectations and the real economy. Since China's financial market is in the process of accelerated integration into the world, the unclear outlook related to the sub-prime mortgage crisis may negatively affect the financial market performance. The deep-rooted causes of the sub-prime mortgage crisis are the weakening of market discipline and risk awareness of financial institutions in the context of global abundant liquidity, from which warning should be drawn for risk prevention in the process of accelerated financial market development in China.

Strong expansion of industrial and economic activities against the backdrop of globalization resulted in strains in global energy and bulk commodities markets, with their prices keeping soaring. The international primary commodities prices may hover at high levels, and the grain prices may continue to surge, posting global inflationary pressures. The high and volatile prices of primary commodities and energy in the international markets have direct impact on the performance of relevant financial markets in China, and will add China's inflationary pressures through external inputs, thus affecting China's macroeconomic and financial market performance.

Protectionist sentiment triggered by the persistent global trade imbalance has continued. Trade frictions have escalated, in both product and policy dimensions. A few countries seek to gain economic advantages by meddling in other countries' exchange rate policies. Conflicts related to the global imbalance might increase risks in the international financial market. And the risks in the financial markets are more difficult to be identified, and more likely to materialize in an unexpected way and spread easily. Some advanced financial markets have been able to use their advantages to transfer risks to emerging markets, increasing instability of the global financial markets. The volatility in China's financial market may also go up accordingly.

Therefore, it is necessary to properly analyze and assess the world economic developments as well as the impacts on China's economy and financial market, and pay full attention to the complexity and volatility of external economic environments. We shall deepen the financial market reform, speed