

2. Monetary Aggregates

The broad monetary aggregate M2 has been the Bank's intermediate target for monetary policy since 1992. For the year 2010, the annual growth rate of M2 registered 4.59 percent, lower than the previous year's 7.21 percent, but close to the median of the Bank's target range from 2.5 percent to 6.5 percent. M2 growth was mainly attributable to the increase in bank credit extended to the private sector against the backdrop of the undergoing economic recovery as well as a net inflow of foreign investment.

The narrow monetary aggregate M1B continued to trend upwards and registered a growth rate of 14.93 percent for the year 2010, slightly lower than the previous year's 16.54 percent. The continued growth in M1B was mainly attributable to an increase in the transaction demand for money during the economic recovery as well as the booming stock market.

Growth in Reserve Money Decelerated

Reserve money growth decelerated for the year 2010, recording a growth rate of 5.43 percent, and was 6.12 percentage points lower than the previous year's figure. The drop in reserve money growth was mainly attributable to the sharp decline in excess reserves. Broken down by the components of reserve money, bank reserves posted slower growth of 2.74 percent when compared to the previous year's 13.04 percent, while the growth of currency held by the non-bank public increased to 9.64 percent from 9.31 percent one year earlier.

Because the exact timing of the Chinese new year shifts on the Gregorian calendar each year, the annual growth rates of reserve money for January and February are more volatile. In 2010 they posted a combined growth rate of 4.69 percent during this period. Afterwards, the annual growth rates generally trended up and reached an all-year high of 7.23 percent in August, before trending down for the following months of the year.

On the demand side, currency held by the non-bank public grew faster because the low opportunity cost of holding currency given the low interest rates paid on bank deposits encouraged the willingness to hold cash. The sustained economic recovery also helped to stimulate demand for money for transactions

Annual Growth Rates of Reserve Money



Source: Financial Statistics Monthly, CBC.

motives. Banks' demand for reserves decreased when compared with the previous year as the Bank started to adjust its monetary policy stance in order to guide market interest rates back to normal levels. The Bank also issued long-term certificates of deposit to mop up excess liquidity in the financial system.

From the supply side perspective, the balance sheet of the Bank revealed, against the backdrop of continued net capital inflows, the Bank's intervention in the foreign exchange market to smooth excessive fluctuations in exchange rates. This action led to a net increase in the Bank's foreign assets and a simultaneous rise in reserve money. On the other hand, reserve money declined mainly because the Bank increased the issuance of certificates of deposit (CDs) to conduct open market operations in order to mop up excess liquidity in the banking sector.

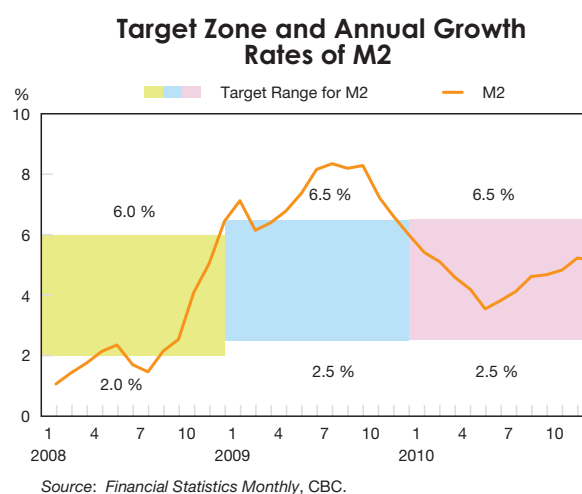
Steady Increase in M2 Growth

The monetary aggregate M2 comprises currency in circulation, deposits in banks' checking and demand accounts, and quasi money. The annual growth rate of M2 in 2010 was 4.59 percent, 2.62 percentage points down from the previous year's figure and was close to the median of the Bank's target range.

In terms of M2's monthly movements for 2010, all were within the Bank's target range and generally trended downward for the first five months before starting on a mostly upward trend for the rest of the year. Due to the effect of a higher base and the slow growth in banks' loans and investments, M2 growth rates exhibited a downward trend from the 5.40 percent recorded in January to its all-year low of 3.54 percent in May. From June onwards, M2 growth rates gradually trended up due to the increase in banks' loans and investments, continued net foreign capital inflows, and the lower base of the corresponding period in the previous year. The M2 growth rate reached its second highest figure of 5.20 percent in November and slightly slid to 5.14 percent in December because the growth of banks' loans and investments started to slow.

Decline in M1B Growth

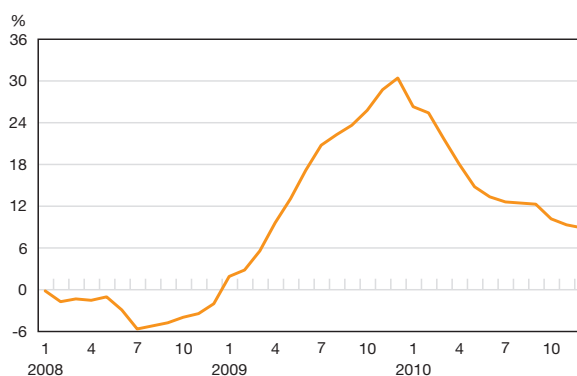
As the robust recovery in the economy led to the rise in the transaction demand for money, coupled with the relatively low opportunity cost of holding demand deposits as well as continued net capital inflows aiming to reap returns from the bullish stock market, the average annual growth rate of M1B recorded 14.93 percent, slightly lower than the previous year's 16.54



percent due to the higher base effect.

The level of M1B generally exhibited an upward trend except in March and June. Factors causing the volume of M1B to decline were attributable to the increase in bank deposits after the Chinese new year in March, and the decrease in demand deposits resulting from the bearish stock market amid European sovereign debt woes in June. However, if compared on a year-over-year basis, the M1B annual growth rates gradually trended down due to the higher-base effect, from 26.17 percent in January to 8.77 percent in December.

Annual Growth Rates of M1B



Source: *Financial Statistics Monthly*, CBC.