2. Monetary Aggregates

The broad monetary aggregate M2 has been the Bank's intermediate target for monetary policy since 1992. For the year of 2007, the annual growth rate of M2 was 4.25 percent, lower than the 6.22 percent of the previous year, staying within the target range of 3.5 to 7.5 percent set by the Bank.

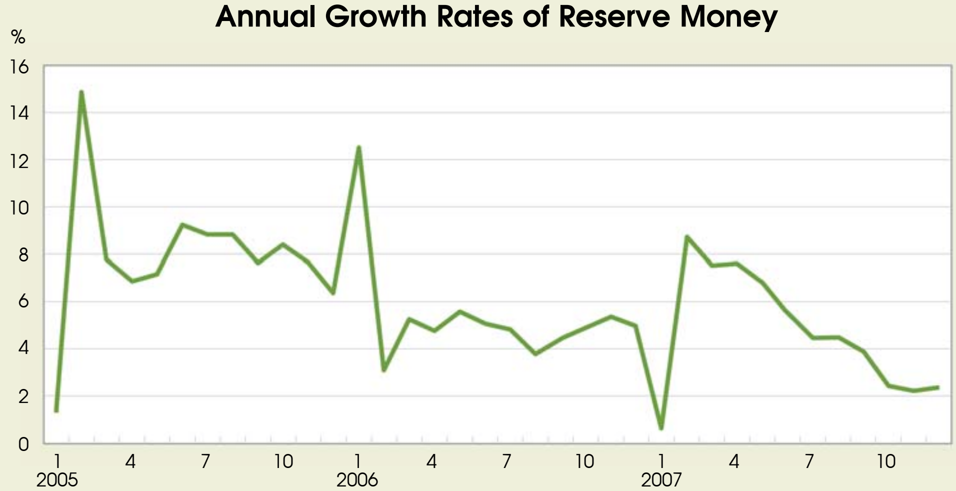
While the US subprime mortgage crisis hammered global financial markets, the domestic stock market for the whole year 2007 outperformed that of the previous year. As a result, the narrow monetary aggregate, M1B, posted a 6.44 percent growth, higher than the 5.30 percent of the previous year.

Decelerating Growth of Reserve Money

For the year 2007, reserve money grew at a slower pace, with an average annual growth rate falling from the previous year's 5.33 percent to 4.71 percent. A further breakdown of its components showed that bank reserves grew by 6.16 percent, while currency held by the non-bank public moved up moderately at a rate of 2.65 percent.

As for the monthly movements of reserve money, the annual growth rates fluctuated significantly in January and February, reflecting the seasonal demand for cash during the Chinese New Year holidays (which fell in February this year, as opposed to January in 2006). In subsequent months, growth rates generally trended downwards and hit 2.22 percent in November, the lowest level in 2007.

Annual Growth Rates of Reserve Money



Source: Financial Statistics Monthly, CBC.

On the demand side, several factors contributed to the slower growth of reserve money. For banks, slower expansion of loans translated into limited demand for reserves. However, the Rebar Group scandal had negatively affected several financially distressed banks and spurred their need for extra liquidity. As a result, these troubled banks kept more excess reserves than usual, offsetting part of the weak demand for bank reserves as noted above. As for the non-bank public, the rising interest rates on time deposits—hence the increasing opportunity cost of holding currency—as well as banks' more prudent credit policies for cash cards and cash advance loans from credit cards dampened the public's need for currency.

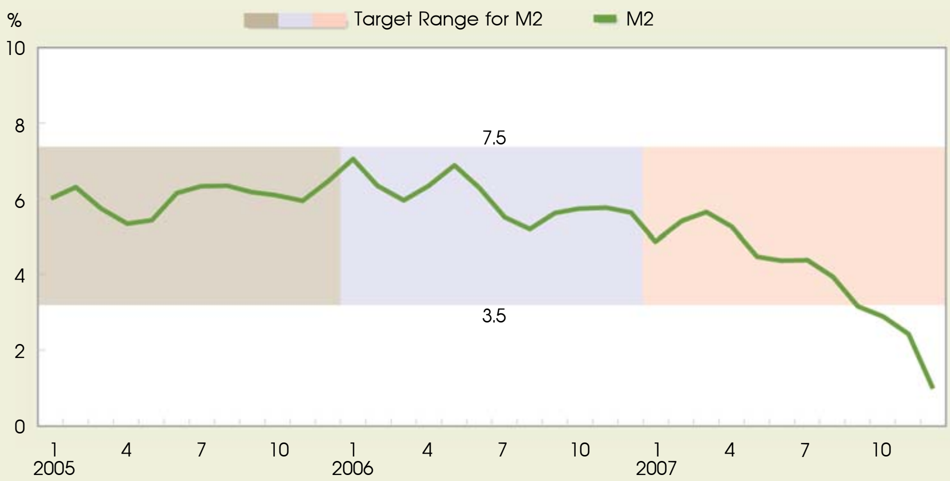
On the supply side, the Bank's balance sheet reflected the sources of reserve money. On the one hand, the increase in reserve money was mainly attributed to the reduction of the certificates of deposit (CDs) issued by the Bank. On the other hand, outward portfolio investment greatly exceeded net foreign capital inflows. The Bank's intervention to smooth excessive fluctuations in exchange rates on rising demand for foreign currencies led to a decrease in the Bank's foreign assets, which in turn partly offset the aforesaid increase in reserve money.

M2 Growth Easing Off

M2 is the Bank's intermediate target for conducting monetary policy. In 2007, M2 grew by 4.25 percent from a year earlier, lower than the mid-point of its target range of 3.5 to 7.5 percent.

In January, M2 grew by an annual rate of 5.11 percent mostly due to the base effect as the Chinese New Year fell in January in the previous year. The M2 growth rate in February rose

Target Range and Annual Growth Rates of M2



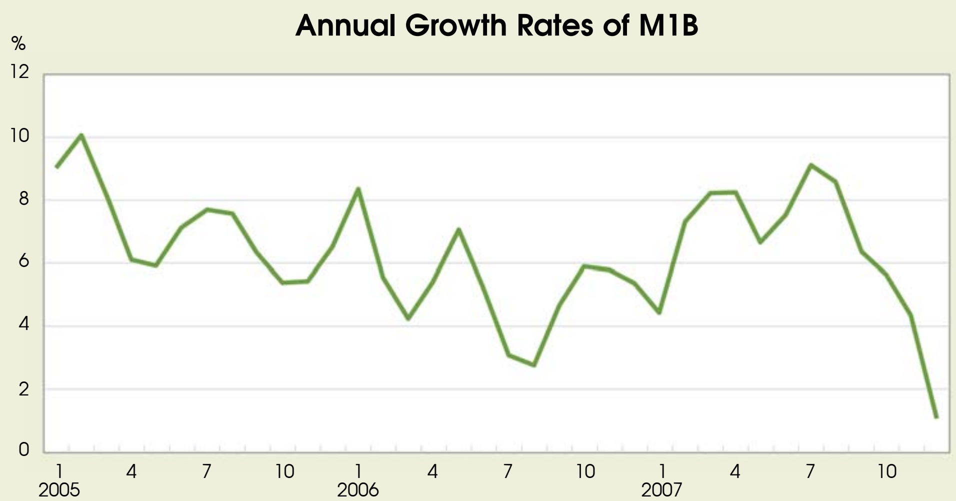
Source: Financial Statistics Monthly, CBC.

to 5.64 percent thanks to a pickup in bank credit growth and the seasonal factor of the Chinese New Year holidays. As bank loans and investment continued to climb in March, the M2 annual growth rate peaked at 5.86 percent. The moderation of bank credit growth and a higher base effect brought monthly M2 growth down to 4.63 percent in June. In July, the M2 annual growth rate rebounded slightly to 4.65 percent. From August onwards, however, net capital outflows and slack credit growth on top of a higher base of comparison resulted in falling M2 growth that hit an all-year low of 1.36 percent in December.

Descending M1B Growth Rates

The continued momentum of economic recovery sent the transaction demand for money on a steady rise during 2007. Additionally, despite higher volatility triggered by the US subprime mortgage woes in the second half of the year, the overall performance of the stock market outshined that of the previous year. The average annual growth rate of M1B stepped up from 5.30 percent in 2006 to 6.44 percent in 2007.

In an environment of improved economic activity, the stock market reacted favorably compared with that of the previous year. As a consequence, except in January when M1B registered a 4.44 percent growth due to a higher base effect, M1B growth exhibited a steady accretion from February to April. A cooling stock market along with a higher base dragged M1B growth down to 6.65 percent in May. In the next two months, the reinvigorated stock market and net foreign capital inflows pushed M1B up to its all-year high of 9.14 percent in July. However, the subdued stock market plagued by the evolving US subprime mortgage crisis,



Source: Financial Statistics Monthly, CBC.

as well as capital outflows, both contributed to falling M1B growth from August onwards. Further dampened by a higher base effect, M1B dropped to an all-year low of 1.07 percent in December.