2. Monetary Aggregates

The broad monetary aggregate M2 has been the Bank's intermediate target for monetary policy since 1992. The annual growth rate of M2 was 2.67 percent in 2008, lower than the previous year's 4.25 percent and remaining within the Bank's target range of 2 percent to 6 percent.

The narrow monetary aggregate M1B, on the other hand, registered a negative 2.94 percent growth for the year 2008, which was far behind the 6.44 percent growth posted in the previous year. The laggard growth in M1B was mainly attributable to the limited demand for liquid funds resulting from economic downturns both at home and abroad as well as the gloomy stock market.

Moderate Growth in Reserve Money

Reserve money growth slowed for the year of 2008, with an annual growth rate (after adjusting for changes in reserve requirement ratios) falling down by 1.47 percentage points to 3.24 percent from the previous year's figure. Broken down by the components of reserve money, bank reserves posted slower growth of 3.02 percent when compared to the previous year's 6.16 percent, while the growth of currency held by the non-bank public increased to 3.57 percent from 2.65 percent one year earlier.

In terms of the monthly movements of reserve money, the annual growth rates generally trended up except in July and November. The temporary decline in growth of the two months was mainly owing to a larger shift from demand to time deposits, which reduced banks' required

Annual Growth Rates of Reserve Money

Source: *Financial Statistics Monthly*, CBC.

reserves. The annual growth rate of reserve money reached a yearly high of 7.68 percent in December.

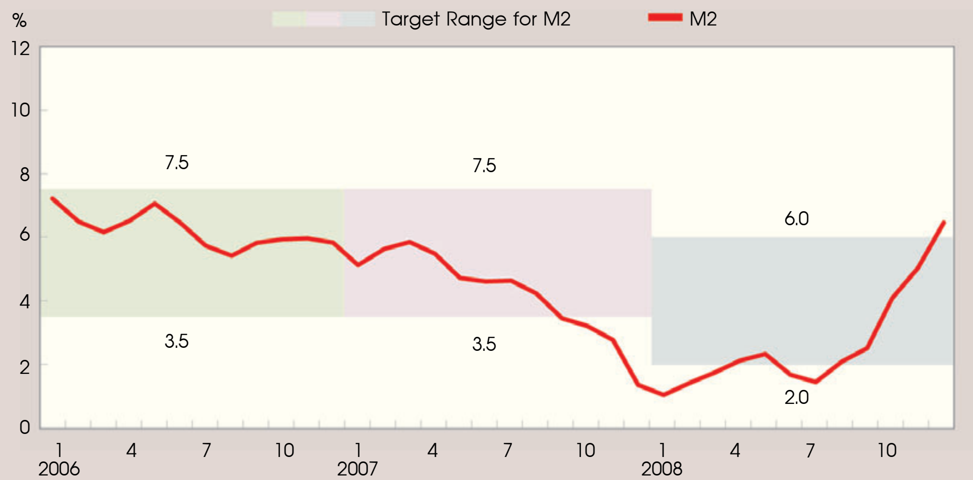
On the demand side, several factors contributed to the slower growth of reserve money. For the public, the low opportunity cost of holding currency given the low interest rates paid on bank deposits enhanced their willingness to hold currency. For banks, lackluster domestic demand and unfavorable economic outlook caused credit growth to slow down, which then translated into very limited demand for reserves. However, in response to the disruptions in the global financial system, the Bank's monetary policy stance turned loose after September 2008, leaving the banks with more excess reserves, which partly offset the weak demand for bank reserves.

From the supply side perspective, the Bank's balance sheet revealed the sources of changes in reserve money. On the one hand, the Bank's intervention in the foreign exchange market to smooth excessive fluctuations in exchange rates 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 largely 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.

Slight Increase in M2 Growth

M2, which comprises currency in circulation, deposits in banks' checking and demand accounts, and quasi money, is the Bank's intermediate target for conducting monetary policy. The M2 target zone for 2008 was 3 percent to 7 percent initially, and was adjusted downward

Target Range and Annual Growth Rates of M2



Source: *Financial Statistics Monthly*, CBC.

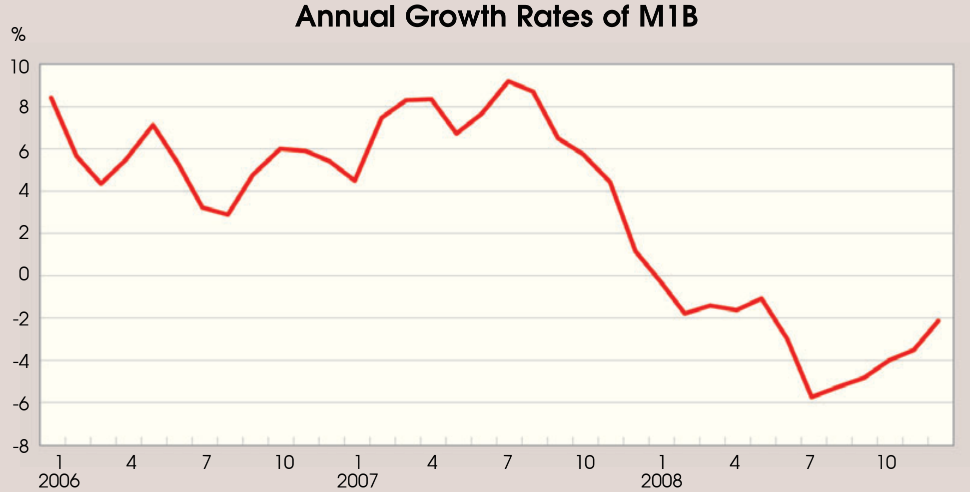
to between 2 percent and 6 percent in mid-year, reflecting weaker demand for money due to residents' portfolio diversification behavior and a significant rise in the public's inflation expectations. The midpoint of the revised target range, therefore, dropped to 4 percent, 1.5 percentage points lower than in the previous year. The annual growth rate of M2 in 2008 was 2.67 percent, down from the previous year's 4.25 percent, and stayed within the Bank's target zone while falling below its target midpoint.

In terms of M2's monthly movement, the growth rates in the first three months of the year were generally below 2 percent because the growth in bank loans and investment were still sluggish. As bank loans and investment started to pick up pace afterwards, the M2 growth rate rose to 2.34 percent in May. However, the rising trend of M2 growth reversed in June and moderated to 1.7 percent due to a significant increase in government's bank deposits. The large outflow of foreign equity capital and the sagging stock market led the M2 growth rate in July to fall further to 1.45 percent. Beginning in August, M2 growth rates trended up as the global financial turmoil triggered a reversal of resident capital outflows. Combined with the continuous growth in bank loans and investment as well as the lower base effect, the M2 growth rate reached a yearly high of 6.45 percent in December.

Negative Growth in M1B

In the first half of 2008, the global economic slowdown and the rising interest rates on time deposits in local banks helped drive funds to shift from demand deposits to time deposits, leading the M1B growth rates to enter negative territory. As the global economy rapidly

Annual Growth Rates of M1B



Source: Financial Statistics Monthly, CBC.

deteriorated in the second half of the year, falling stock markets dragged down the transactions demand for money and led the M1B growth rates to dive further. The average annual growth rate of M1B plummeted to negative 2.94 percent, lagging far behind the previous year's 6.44 percent.

The M1B's monthly movements were as follows: Because local stock markets remained sluggish and interest rates paid on time deposits trended higher since earlier 2008, the M1B annual growth rates were all in negative territory with a floor of negative 2 percent. As the stock market plummeted in June and July, transaction volume shrank largely. Coupled with a higher base effect, the M1B growth rate hit a yearly low of negative 5.77 percent in July. From August onwards, the unfolding turmoil in the global financial markets spurred capital outflows by foreign equity investors, deepening the downside pressure on local bourse. However, with a large repatriation of residents' overseas investment as well as lower bases of comparison, M1B growth rates reversed its downward trend and gradually moved up to negative 2.16 percent in December.