

II. FINANCIAL DEVELOPMENTS

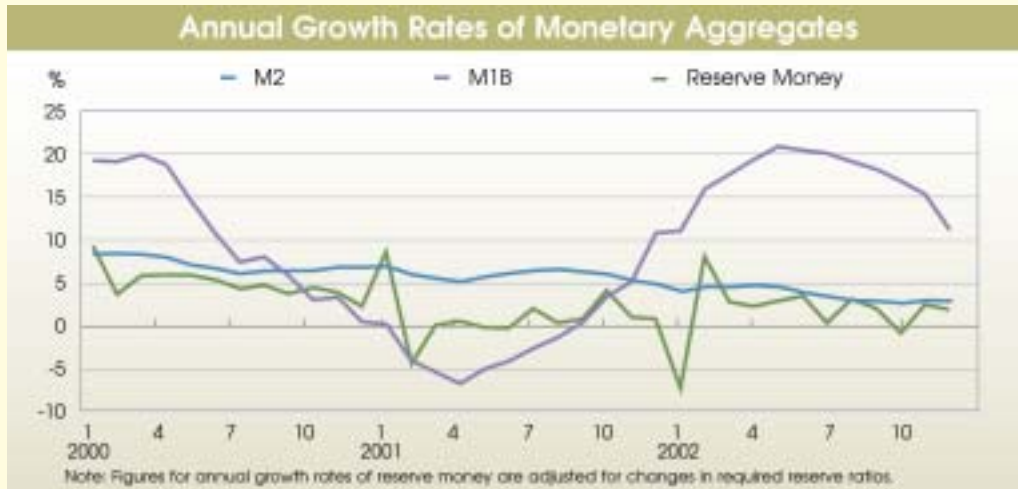
6. Monetary Aggregates

Given the precondition of price stability, the Bank continued the accommodative monetary policy with an aim to encourage bank credit expansion and foster economic recovery. However, mainly due to the rising demand for bond funds in place of bank deposits, monetary aggregates were characterized by sluggish growth during the year of 2002. For the year as a whole, the broad monetary aggregate, M2, measured on a daily average basis, expanded at a slow pace with an annual growth rate of 3.55 percent, which was still within the target zone of 3.5 to 8.5 percent set for the year.



Sluggish Growth of Reserve Money

In 2002, the annual growth rate of daily average reserve money (adjusted for changes in required reserve ratios) was 1.78 percent, slightly higher than that of the preceding year. Although economic activities bottomed out in the first quarter, domestic demand remained weak throughout the year. Consequently, banks' demand for reserves grew moderately during the year. Apart from the impact of the seasonal factor of the Chinese Lunar New Year in January and February, the growing pace of reserve money was mild in the rest of the year. The year-over-year growth of reserve money was 1.93 percent in December.



Decelerating Growth of M2 and M2 Plus Bond Funds

The monetary aggregate M2 serves as the intermediate target of the Bank's monetary policy. In line with the final goals of price stability and economic growth, the Board of Directors of the Bank sets the annual target zone for M2 growth for the coming year at its December meeting. By taking into account the economic outlook and price conditions, the spread between domestic and foreign interest rates, the impact of financial asset diversification on money demand, and opinions from scholars, the target corridor for M2 growth in 2002 was between 3.5 and 8.5 percent, with both bounds lower than those of the previous year by 1.5 percentage points.

For 2002 as a whole, the average annual growth rate of M2 fell to 3.55 percent, remaining within the target range set for the year. Over recent years, M2 growth has persistently decelerated, mainly attributable to the rising demand for bond funds in place of bank deposits, economic slowdown, and banks' conservative attitudes towards lending. Above all, the brisk development of bond funds, as seen by funds shifting from bank deposits to bond funds by local investors, has become a weighty factor in determining M2's sluggish growth. As interest rates on bank deposits continued to fall, depositors' demand for bond funds increased with a view to pursuing higher yields. The continuous expansion in demand for bond funds substantially replaced bank deposits, curbing bank's credit creation function and discouraging M2 growth. At the end of the year, the size of domestic bond funds reached NT\$1,847 billion, and the net asset value held by the nonbank private sector (excluding bond funds deposited in banks in



order to avoid double counting in the monetary aggregates) was NT\$1,124 billion, approximately 5.55 percent the size of M2. M2 plus bond funds held by the nonbank private sector, the broader concept of monetary aggregates, grew by an annual rate of 5.64 percent in 2002, lower than the 6.47 percent of the previous year.

M2 growth rates remained steady at the beginning of the year before falling along with the increase in bond funds as well as the shrinkage in bank credit. Between February and May, M2 growth rates were around 4.5 percent, but the momentum decelerated due to a surge in shifting funds from bank deposits to bond funds and a decline in bank credit. In July, the above-mentioned factors together with the sharp appreciation of the NT dollar from the corresponding month last year led to the rapidly shrinking balance of foreign currency deposits in terms of NT dollar value and, in turn, caused M2 growth to fall below the lower bound of the target zone. From August onwards, the increase in foreign capital outflows further suppressed M2 expansion. Owing to M2's higher comparison base of the previous year and the weak domestic demand, the annual growth rate of M2 slightly went down to 2.79 percent in December.

Strong Rebound of M1B Growth

M1B posted an average annual growth rate of 17.01 percent, which was significantly higher than the preceding year's negative 1.02 percent. The rising growth rate mainly reflected increasing demand for transaction balances, depositors' reluctant attitudes toward holding time deposits due to the lower interest rate spread between time deposits and demand

deposits, as well as the lower base of the previous year. In the first two months of the year, M1B surged rapidly along with robust transactions in the stock market and the increased demand for currency before the Chinese Lunar New Year. Thereafter, M1B growth rates were further pushed up following the massive foreign capital inflows and increased replacement of foreign currency deposits by demand deposits in view of strong expectations of an NT dollar appreciation. Coupled with the lower base of the previous year, M1B growth soared to over 20 percent between May and July. However, due to the lackluster performance in the stock market as well as the continuous outflow of foreign funds resulting from the hesitant outlook of the domestic economy, demand for transaction balances started to contract from July and M1B growth slowed down. In December M1B growth further dropped to 11.08 percent.