

## 2. The Dual Monetary Targets

### Monetary Aggregate M2 as An Intermediate Target

Monetary aggregates have been used as the intermediate target for monetary policy in the Central Bank of China. Starting from the early 1990s, the CBC chose the broad monetary aggregate M2 as the intermediate target and specified the annual M2 growth target range at the end of each year for the upcoming year. The Bank sets the target range of monetary growth according to money demand, which is derived from the dynamic simulation of a money demand function, encompassing real GDP growth, price levels, and financial market conditions, etc. as explanatory variables. Once the target range is determined, the Bank then uses operating instruments to lead the M2 growth to hit the target, and in turn, indirectly attain its final goals of maintaining price stability and promoting economic growth.

Over the past few years, booming direct finance and diversification of financial assets weakened M2 growth. In particular, the combination of falling interest rates on bank deposits and institutional factors such as tax incentives have caused the size of bond funds to expand at a fast pace in the recent two years. In contrast, M2 growth has significantly slowed down. From a monetary policy maker's point of view, this development has challenged the indicator properties of M2 as a policy guide and made M2 growth less predictable, hindering the Bank's ability to set the target range for M2.

### Three Criteria for Choosing an Intermediate Target

On concerns of changing financial structure mentioned above, the CBC conducted an analysis to assess the appropriateness of M2 and M2 plus bond funds as the intermediate targets for monetary policy. To eliminate double counting, the aggregate of M2 plus bond funds excludes bank deposits that are part of bond fund's portfolios and bond funds held by banks. Three criteria were used when comparing the appropriateness of M2 and M2 plus bond funds as an intermediate target in the Bank's investigation:

1. The Bank should be able to rapidly retrieve the concise value of the intermediate target variable;

2. The Bank must be able to affect or even control the behavior of the intermediate target variable; and
3. The intermediate target should have a stable or predictable relationship with the ultimate policy goals.

### **Reasons for Setting the Dual Monetary Targets**

The Bank's empirical study indicated that, both M2 and M2 plus bond funds aggregates are largely equipped with the above three features. In other words, empirical evidence showed that both M2 and M2 plus bond funds could be used as the Bank's intermediate target for monetary policy. However, based on the following reasons, the Bank decided to set target ranges for both M2 and M2 plus bond funds:

1. M2 has become a less reliable indicator of economic conditions due to the shift of funds between bank deposits and bond funds by local investors. M2 plus bond funds, a broader measure of money, internalizes the portfolio shifts between bank deposits and bonds funds, therefore providing the Bank with alternative information contents.
2. Beginning in January 2003, the Ministry of Finance no longer refunds pre-deducted tax payments for interest earnings on bond funds, which should narrow the spread between the real yield rate of bond funds and bank deposits rate and may hold off investors' shifting of savings funds away from depository institutions toward bond funds. In addition, as the market value of bond funds fluctuates according to the changes in interest rates, the indicator property of M2 plus bond funds might be influenced. The Bank hence decided to continue targeting M2.
3. Incorporating more than one monetary aggregate in the Bank's policy-making process shall offer the Bank with more valuable information against the backdrop of increasing diversification of financial assets.

Based on these reasonings, the Bank decided to set target ranges for both M2 and M2 plus bond funds. After taking into account the factors such as economic growth, price conditions, and diversification of financial portfolios through an empirical model, and consulting with experts from

outside, the Bank decided to set the target range for the growth of M2 and M2 plus bond funds for the year 2003 between 1.5% and 5.5% and between 3.0% and 7.0%, respectively.

If M2 and M2 plus bond funds do not hit their target ranges at the same time, the Bank will further investigate factors behind the dispersions of M2 and M2 plus bond funds, coupled with information obtained from other financial indicators, to take policy actions when necessary.