

2. Monetary Aggregates

Monetary aggregates increased markedly during 2004. The strong growth in the narrow aggregate M1B largely reflected a higher demand for transactions balances associated with the low level of interest rates and with an ongoing strengthening in economic activity.

On the strength of a substantial increase in bank credit to the private sector and considerable inflows of foreign capital, the broad aggregates M2 and M2 plus bond funds grew at annual rates of 7.45 percent and 8.14 percent, respectively, both above their respective target ceilings (target ranges were 2.5 to 6.5 percent and 4 to 8 percent) set for the year.

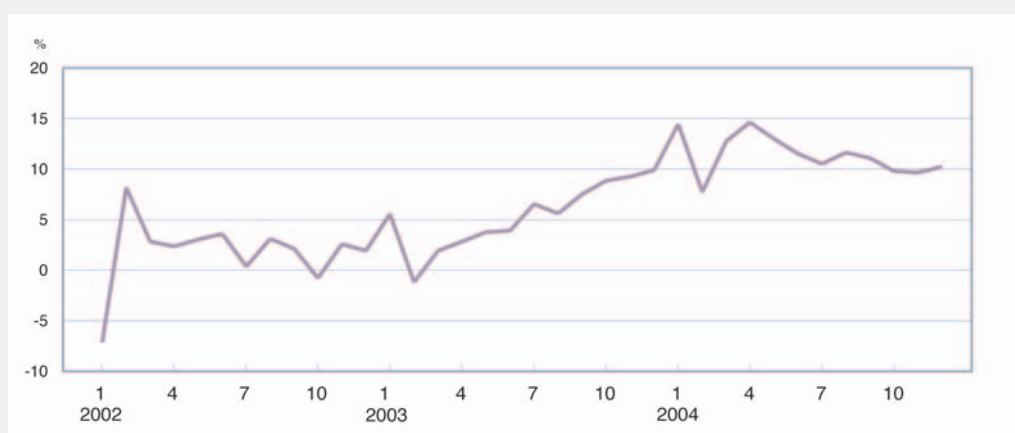
Strong Growth of Reserve Money

The average annual growth rate of reserve money rose to 11.38 percent in 2004, showing a sharp increase of 6.1 percentage points from that of the previous year. The acceleration in reserve money was mostly supported by the strong growth in net foreign assets of the Bank.

Of the various types of reserve money, currency held by the public increased by 12.44 percent and reserves held by financial institutions grew by 10.68 percent.

The annual growth rate of reserve money peaked in February, primarily reflecting the seasonal demand for currency during the Chinese Lunar New Year Holidays. In the subsequent months, except October and November, the growth rates of reserve money were higher than

Annual Growth Rates of Reserve Money



Source: *Financial Statistics Monthly, Taiwan District, the Republic of China, Department of Economic Research, Central Bank of China.*

10 percent. This mainly came from a pick up in the demand for funds associated with buoyant economic activity. Besides, the low cost of holding cash bolstered the public's demand for currency. As the interest rate spread between time deposits and transaction deposits remained at a low level, transaction deposits, which are subject to higher reserve requirements, increased at a relatively rapid pace and thus the demand for bank reserves also increased. All these factors contributed to the demand for reserve money.

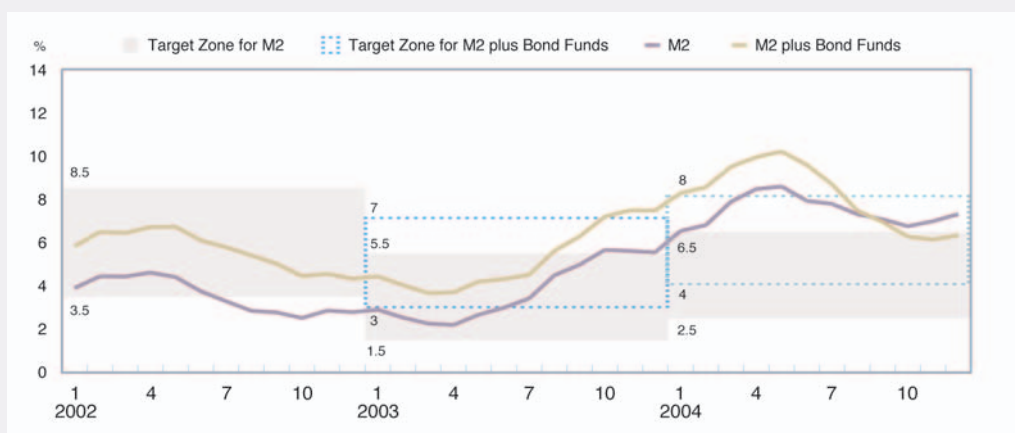
On the supply side, as Taiwan received large net inflows of foreign capital during the first and final quarters, the Bank attempted to moderate the speculative rise of the NT dollar by purchasing foreign exchange, which injected liquidity to the market. Although the Bank issued the certificates of deposit (CDs) to sterilize the resultant excess liquidity, the growth of net foreign assets of the Bank was higher than that of the CDs.

Vigorous Growth of M2 and M2 plus Bond Funds

The monetary aggregates M2 and M2 plus bond funds served as the Bank's two intermediate targets for monetary policy. After reviewing factors such as economic growth and price movements, the spread between domestic and foreign interest rates, and the impact of financial asset diversification on money demand, the Bank set the target range for M2 growth at 2.5 to 6.5 percent and for M2 plus bond funds growth at 4 to 8 percent for 2004.

The annual growth rate of M2 started to accelerate in January and peaked at 8.58 percent in May, mainly reflecting the rapid expansion in bank credit and massive foreign capital inflows.

Target Ranges and Annual Growth Rates of M2 and M2 plus Bond Funds



Source: *Financial Statistics Monthly, Taiwan District, the Republic of China, Department of Economic Research, Central Bank of China.*

After that, the M2 growth rates drifted downward due to foreign capital outflows and the high base of the same period last year. From August onwards, foreign capital inflows resumed. However, the M2 growth rates continued to decline as a result of the base effect and hit a low for the year in October as the foreign exchange expense for imports exceeded the foreign exchange income earned from exports. The annual growth rate of M2 edged higher in November owing to a surge of foreign capital inflows and increased to 7.31 percent in December, primarily reflecting seasonal demand for funds and banks' efforts to extend loans.

The annual growth rate of M2 plus bond funds kept rising from January to May in accordance with growth of M2 and steady demand for bond funds. The rising streak for the growth rates of M2 plus bond funds petered out as bond funds came under massive redemption pressure in the second half of July. The marked reduction in bond funds occurred as investors rushed to withdraw their money from a local securities investment company on fears of a technology company's possible default on its bond payment. This led to the local securities investment company to halt redemptions of its bond funds when it ran out of finances, which further triggered widespread redemptions affecting other bond funds. In addition, concerns over rising interest rates acted as another catalyst for investors' pulling money out of bond funds.

As investor confidence was gradually restored, the redemption pressure eased by December and helped push the annual growth rate of M2 plus bond funds a bit higher to 6.33 percent for the month.

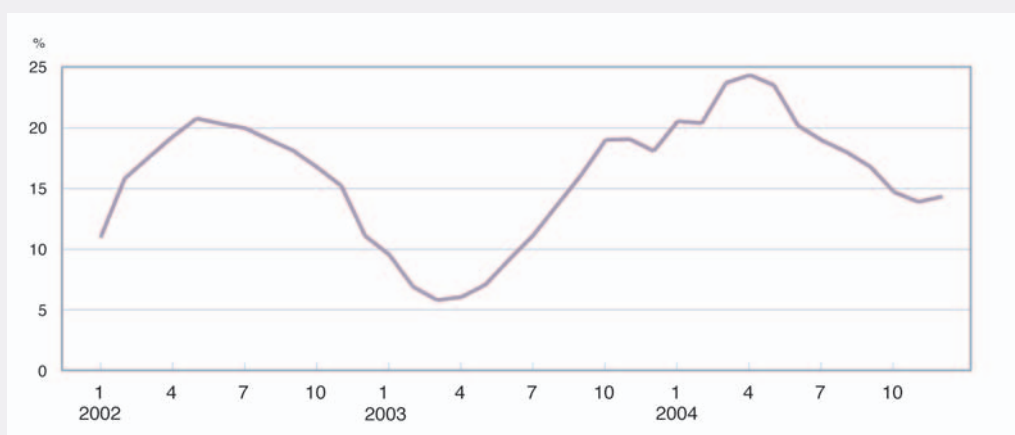
For 2004 as a whole, the annual growth rates of M2 and M2 plus bond funds both were above their respective target ceilings. This was partly attributable to the higher realized values of economic growth and price movements compared to their projected values forecast in December 2003 when setting the target ranges of M2 and M2 plus bond funds for 2004. Therefore, after taking into account such differences, the annual growth rates of M2 and M2 plus bond funds both would be within their revised target ranges.

Double-digit Growth of M1B

In 2004, the average annual growth rate of M1B reached 18.98 percent, higher than the 11.82 percent posted last year. Reflecting active stock market trading and large foreign capital inflows, the annual growth rates of M1B kept climbing and soared to a high of 24.39 percent in April. Largely because of a lackluster stock market and a reversal of capital flows, M1B growth rates followed a downward trend thereafter.

Although there was a surge in investors shifting funds out of bond funds holdings into transaction deposits from July, a higher base effect and a gradual shift of funds from transaction deposits to time deposits following the Bank's raising rates on October 1 were among the factors that pushed M1B growth rates lower. The annual growth rate of M1B hit a low of 13.90 percent for the year in November before bouncing back mildly in December.

Annual Growth Rates of M1B



Source: *Financial Statistics Monthly, Taiwan District, the Republic of China, Department of Economic Research, Central Bank of China.*