

2. Monetary Aggregates

The broad monetary aggregate M2 has been the Bank's intermediate target for monetary policy since 1992. It grew at an annual rate of 6.22 percent in 2005, lower than that of 7.45 percent in 2004, but within the target range of 3.5 to 7.5 percent set for the year.

The growth of the narrow monetary aggregate, M1B, plunged to 7.10 percent in 2005 from 18.98 percent of the previous year as domestic economic conditions slackened, stock transactions eased, and transaction deposits shifted to time deposits as interest rate differentials between them widened.

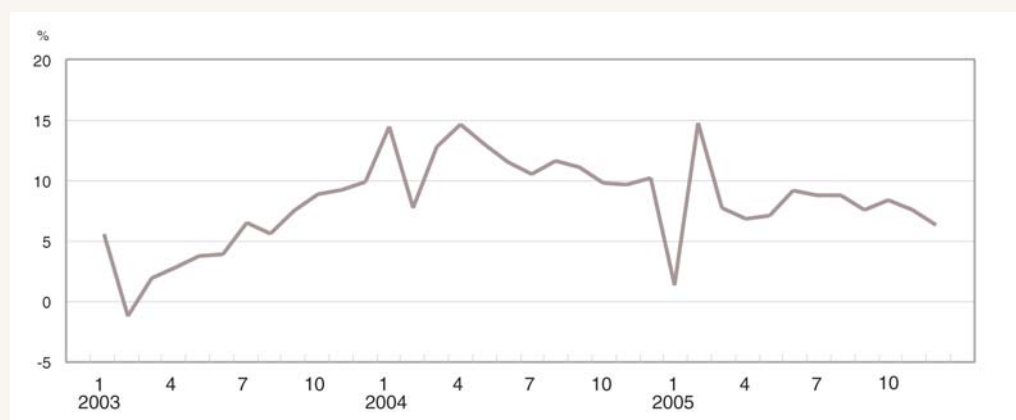
Moderate Growth of Reserve Money

After hitting a ten-year high of 11.38 percent in 2004, the average annual growth rate of reserve money – bank reserves plus currency held by the non-bank public – fell to 7.84 percent in 2005. Within reserve money, bank reserves grew by a mild 6.03 percent, while currency held by the non-bank public grew by 10.50 percent.

For the monthly movements of reserve money growth, the annual growth rates fluctuated excessively in January and February, reflecting the seasonal demand for currency during the Chinese Lunar New Year Holidays. In the subsequent months, this rate remained broadly stable.

On the demand side, several factors influenced the growth of reserve money in 2005. For

Annual Growth Rates of Reserve Money



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

banks, the reduced momentum in economic growth and credit expansion limited demand for bank reserves. Meanwhile, the shift from transaction deposits to time deposits induced by the widening interest rate spread lessened banks' demand for reserves as time deposits were subject to lower reserve requirements. For the non-bank public, the strong demand for currency largely mirrored the low level of interest rates and thus relatively low opportunity costs of holding cash.

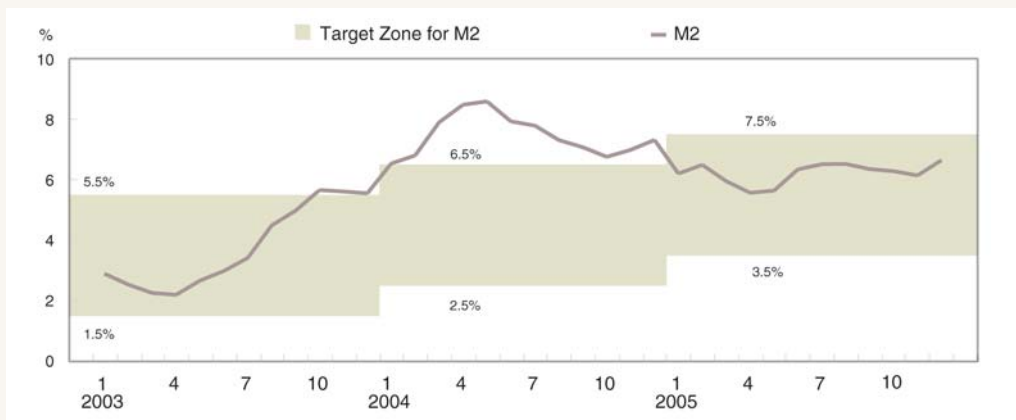
On the supply side, the Bank's balance sheet reflected the sources of reserve money. The expansion of the Bank's foreign assets, which reflected the efforts made by the Bank to absorb massive inflows of foreign capital, was the foremost source of the increase in reserve money. Although this successfully reduced the volatility of the exchange rate, it simultaneously led to a rise in reserve money. To sterilize the resultant excess liquidity, the Bank took redeposits from financial institutions, swapped out foreign currency for NT dollars, and issued certificates of deposit (CDs), which brought about a rise in the sum of these three liability-side items. Overall, this rise offset the increase in foreign assets to a degree, leading to a smaller increase in reserve money than the increase in foreign assets.

Tepid Growth of M2

M2 is the Bank's intermediate target for conducting monetary policy. M2 grew at an annual rate of 6.22 percent in 2005, lying within the target range of 3.5 to 7.5 percent.

The monthly changes of M2 growth were as follows. In January and February, M2 grew by

Target Range and Annual Growth Rates of M2



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

over 6 percent as the amount of consumer credit granted by financial institutions picked up and a considerable amount of foreign capital flowed in. From March to May, M2 growth slipped below 6 percent due to an upsurge in foreign portfolio investment by local residents and the high base of the same period last year. From June onwards, M2 growth climbed back up to above 6 percent due to substantial foreign capital inflows, above-eight-percent growth in banks' loans and investments, and a lower base effect.

A Decline in M1B Growth

In 2005, the average annual growth rate of M1B was 7.10 percent, much lower than the 18.98 percent posted in the preceding year. The sharp decline in this rate reflected, to a large extent, somewhat moderated economic growth and a decline in stock trading volume, as well as limited growth in transaction deposits. Following the Bank's four consecutive rate hikes during 2005, financial institutions gradually lifted interest rates on time deposits while they kept those on transaction deposits unchanged. The widened spread caused a shift out of transaction deposits toward time deposits, deepening the drop in M1B growth.

For the beginning of the year, with the exception of February, the growth of M1B followed a declining growth trend, tailing off to 5.91 percent in May. From June to August, M1B rebounded to above 7 percent due to regained strength in the stock market and recurrent foreign capital inflows. From September to November, the growth rate of M1B fell and bottomed at 5.39 percent in October due to a higher base in the previous year and the attenuation of the stock market. In December, M1B rose to 6.56 percent as foreign capital poured in *en masse*.

Annual Growth Rates of M1B



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