

## 2. Monetary Aggregates

The broad monetary aggregate M2 has been the Bank's intermediate target for monetary policy since 1992. In 2006, M2 grew at an annual rate of 6.22 percent and fell within its target range of 3.5 to 7.5 percent set for the year.

The growth of the narrow monetary aggregate, M1B, declined to 5.30 percent in 2006 from 7.10 percent of the previous year, despite the favorable performance of the stock market. This development mainly reflected the shift from transaction deposits into foreign currency deposits due to widened interest rate differentials, which made the latter more attractive to depositors.

### Slower Growth of Reserve Money

The average annual growth rate of reserve money fell from the previous year's 7.84 percent to 5.33 percent this year. As for the components of reserve money, bank reserves grew by 5.41 percent, and currency held by the non-bank public expanded at a rate of 5.23 percent.

As for the monthly movements of reserve money, the annual growth rates fluctuated excessively in January and February, reflecting the seasonal demand for currency during the Chinese New Year holidays (For this year, the new year holidays fell in January as opposed to February in 2005). In subsequent months, growth rates remained broadly stable and were below 6 percent.

### Annual Growth Rates of Reserve Money



Source: *Financial Statistics Monthly*, CBC.

On the demand side, several factors influenced the growth of reserve money over the course of 2006. For banks, the slower expansion of loans to the private sector – notably consumer credits – depressed banks' demand for reserves. In addition, the shift of money from transaction deposits to foreign currency deposits induced by the widened interest rate differentials also reduced banks' demand for reserves. For the non-bank public, the feeble demand for currency largely mirrored the flagging private consumption caused by the deterioration of the problem of delinquency in card debts. Overall, the demand for reserve money was modest by historical standards.

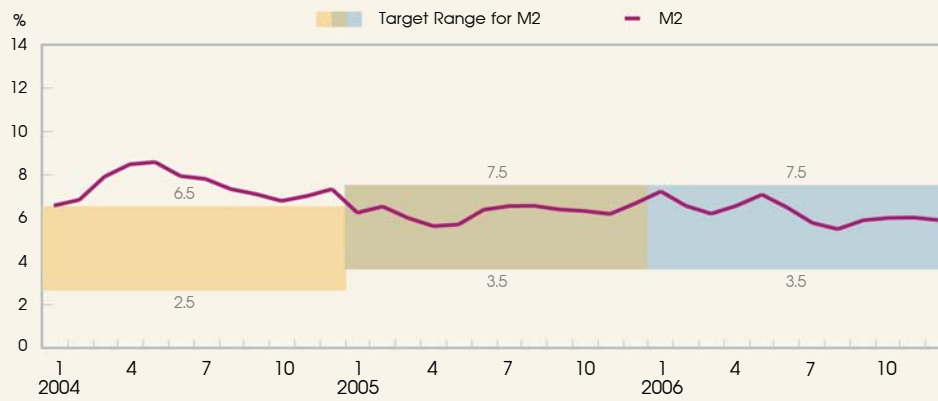
On the supply side, the Bank's balance sheet reflected the sources of reserve money. On the one hand, the reduction in both re-deposits placed by financial institutions and government deposits were the foremost sources for the increase in reserve money. On the other hand, to drain the glut of liquidity in the market, the Bank conducted open market operations, mainly through issuing certificates of deposit (CDs). As a result, the increase in the issuance of CDs partly offset the above-mentioned increase in reserve money, causing the annual growth rate of reserve money to decrease when compared to that of the previous year.

### **Mild Growth of M2**

M2 is the Bank's intermediate target for conducting monetary policy. In 2006, M2 grew by 6.22 percent from a year earlier, lying within the target range of 3.5 to 7.5 percent.

The monthly changes of M2 annual growth rates were as follows. In January, M2 growth peaked at 7.2 percent as credit extended by financial institutions picked up and a considerable amount of foreign capital flowed in. The Chinese New Year factor also contributed to the high growth rate as the holidays fell in this month. By contrast, the annual growth rate of M2 decreased in February due to the “base effect” (The Chinese New Year fell in February a year earlier). In March, M2 declined further to 6.15 percent, pulled down by a slowdown in the growth of bank loans and investments. In April and May, M2 growth rebounded somewhat due to an upswing in credit growth and a surge in foreign capital inflows. The rate slipped again in June, however, as a result of massive capital outflows and a moderation in bank credit growth. From July onwards, following the continued decline in the growth of bank loans and investments, M2 growth slid to below 6 percent and hit an all-year low of 5.43 percent in August. M2 growth then edged up to around 5.9 percent during the rest of the year.

### Target Range and Annual Growth Rates of M2



Source: Financial Statistics Monthly, CBC.

### Decelerating M1B Growth

In 2006, the average annual growth rate of M1B was 5.30 percent, lower than the 7.10 percent posted in the preceding year. The decline mirrored, in large part, the subdued transactions demand of money as interest rate differentials between transaction deposits and foreign currency deposits widened and business activity remained sluggish.

### Annual Growth Rates of M1B



Source: Financial Statistics Monthly, CBC.

The monthly changes of M1B annual growth rates were as follows. This rate topped at the beginning of the year as the amount of currency issuance sharply increased due to the Chinese New Year holidays. In contrast, M1B plummeted in February as the higher base of comparison in the same month of 2005. In March, due to capital outflows and the lackluster performance of the stock market, M1B growth declined further. In April and May, a rebound on the stock market as well as large foreign capital inflows helped strengthen the M1B growth, and pushed the figure up to 7.08 percent in May. From June to August, M1B growth continued to fall and bottomed at 2.77 percent in August due to the loss of momentum in the stock market and foreign capital outflows. From September to November, the growth rate of M1B bounced back steadily. However, owing to the high-base effect, the M1B growth rate slipped again in December.

