BRIEFING PAPER

Excess Liquidity –Is there a Danger for the Euro Area?

by

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Executive Summary

There are a lot of fears mentioned also by the ECB that there exists an excess liquidity in the Euro area that in the end may lead to an accelerated inflation rate violating the ECBs target for price stability severely. In the following some statistics will be outlined and it will be argued that inflation fears resulting from these observations may be exaggerated. As long as capacity utilisation is idle no immediate inflation fears are justified. However monetary aggregates should be kept under close surveillance in order to detect any early sign of inflation feeding into the monetary system. Then a tightening of monetary policy would be recommendable.

1. The Actual Situation

There are a lot of fears mentioned also by the ECB that there exists an excess liquidity in the Euro area that in the end may lead to an accelerated inflation rate violating the ECBs target for price stability severely. In the following some statistics will be outlined and it will be argued that inflation fears resulting from these observations may be exaggerated. However monetary aggregates should be kept under close surveillance in order to detect any early sign of inflation feeding into the monetary system.

Monetary growth has been very strong during recent years in the Euro area. This applies in particular to those monetary aggregates that indicate the development of liquidity assets – money easy to mobilise for immediate spending. If one looks at the different monetary aggregates from M1 to M3, the former one denoting the most liquid asset and the latter one longer term assets, one can realise that M1 has been growing much stronger since almost three years than M3. Looking even deeper into the statistics, it turns out that it was in particular money in circulation that has expanded much stronger in recent years than previously, whilst the other components of M1 show a fairly constant pattern. This applies even more so for M2 and in particular for M3 components not part of M2. The growth rate of these monetary aggregates even has slowed down significantly since 2002. The overall picture emerging from this is that growth of M3 that includes all components mentioned above, is hovering slightly below 6 % since spring 2004 coming down from a rate of about 7 % in 2002. Hence it is liquidity that is booming while longer term aggregates are still rather flat.

2. The Reference Value

In order to assess monetary growth in its impact on growth or inflation the ECB has given herself a reference value that serves as yardstick. Its present value is that M3 should grow by about 4.5 % pa. The reasoning behind the setting of this value is that the ECB estimates potential growth in the Euro area to around 2 ¼ % plus an inflation target rate of about 1 ¾ % and a decline of money velocity of about ½ % pa. This reference value is supposed to be met in the medium run, not in a short term and nor in a mechanical sense. After some misunderstanding in this respect, the ECB has now well established a proper interpretation of this value.

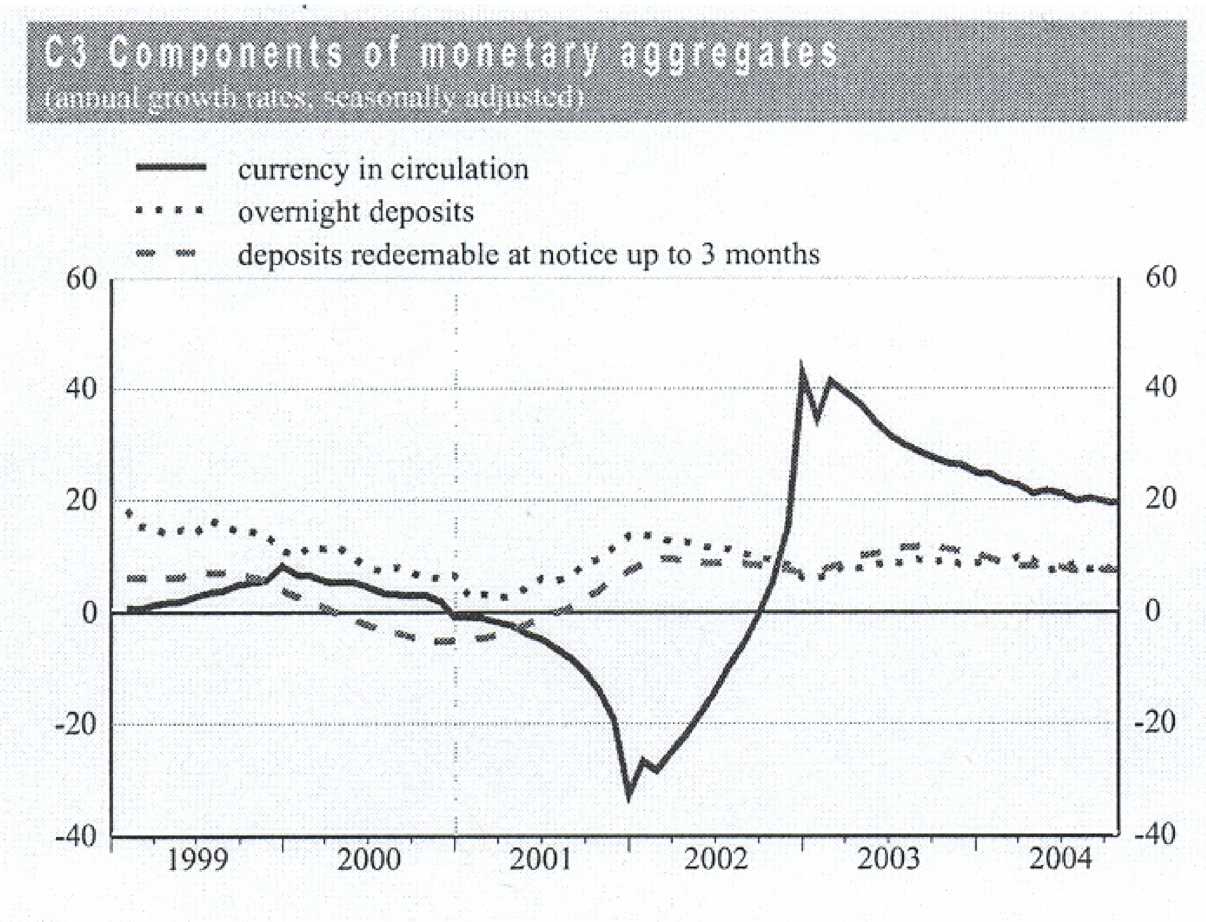
Given the valid reference value one can argue that the present figures for money growth are well above the yardstick. Since this is happening already since some time already it is fair to state the existence of a monetary overhang. In a mechanical interpretation it would mean there is a high potential for future inflation to which the ECB should react with a tighter monetary stance.

3. Will the Present Monetary Overhang Induce Inflation?

There are several reasons why the ECB should be careful in reacting too mechanically to the supposed overhang. First of all the reference value seems to be rather low for two reasons. The inflation target has been moved slightly upwards since the introduction of the reference value. The ECB now tolerates rather 1.9% instead of 1 ¾ %. Secondly the estimation of the potential growth rate seems to be rather low. This figure more or less reflects trend growth of the Euro area in recent years. But potential growth should be understood as a growth that is feasible without triggering inflation. The development in 2000 contains some lessons with regard to that question. Then production capacities were much better used than presently and growth in the Euro area was 3.5 %. Nevertheless it did not lead to a domestically induced inflation. That speaks in favour of a higher potential rate than presently from the ECB assumed. Given all that, the deviation from the reference value should be smaller than indicated by mechanical computations.

More important for a proper assessment of the present monetary expansion and the resulting potential for higher inflation is a close look on the nature of that expansion. As mentioned above it is in particular money in circulation that has expanded so strongly. On the one side this is certainly an expression of an expansionary monetary policy. On the other side growth rates of other components of monetary aggregates are relatively low. In particular components of long term nature show a very moderate growth. These developments indicate a substitution of assets. People try to avoid supposedly more risky long term assets and demand short term and thus secure money, even if interest rates in this market segment are comparatively low. There seems to be a very high preference for secure assets.

This interpretation of monetary developments is corroborated by the timing of monetary movements. Until mid 2001 money circulation showed rather low growth rates and even started to decline very dramatically. This can be attributed to the then still very cautious monetary policy that had even been restrictive earlier and particular to the slow down of the Euro area economies. But there was a dramatic turn around in the second half of 2001. Then money circulation changed from deeply double digit negative figure to a plus of 40 % growth in annualised rates. It happened without any major change in economic activity. This dramatic event had its roots in the attacks of September 11.



Source : ECB

Firstly monetary policy then had recognised that the recovery of all major economies was at stake and switched to a decisively expansionary stance. But more important as also surveys showed people became very uncertain on future global economic development. This is reflected by their demand of short money monetary assets. They switched to a very large extent from long term assets to liquid money. These included assets from outside M3. For example people sold their shares. It was this very strong movement that determined the dramatic change.

In the meantime growth rates have climbed down. But still money in circulation is growing at a rate of around 20 %. That means apart from a certain economic recovery and also higher share prices there still seems to continue some economic uncertainty. If that is the case present monetary growth is no problem since M3 growth will decrease further along with people re-shifting their money again into long term assets outside M3. Then there is no danger of an inflation generating expenditure. Even if people start to spend more, capacity utilisation is still very low compared to 2000 and 2001. Since 2002 almost no progress has been achieved to increase the utilisation of production capacities. An increased spending therefore would meet idle capacities leading to higher production and not to higher inflation at least in the medium run. Only if capacities are fully employed inflationary dangers occur but that is still a far way to go.

4. Recommendations for Monetary Policy

Monetary policy should not be too much concerned about the present liquidity overhang. No immediate action is required for this reason. As long as capacities are idle and M3 growth is declining on tendency there is no need to worry. In addition to that the still prevailing insecurity on a sound economic upturn is a strong argument for monetary policy to stick to its expansionary stance. The actual appreciation of the Euro that will hamper economic growth in the Euro area makes it even easier to follow this line of wait and see.

Action is required only if capacity utilisation recovers strongly and M3 growth continues to be well above 5 %. In that case there be would inflationary dangers at the horizon. Then a tightening of monetary policy is recommendable. Otherwise an excessive monetary growth would create a potential for inflation in the long run.