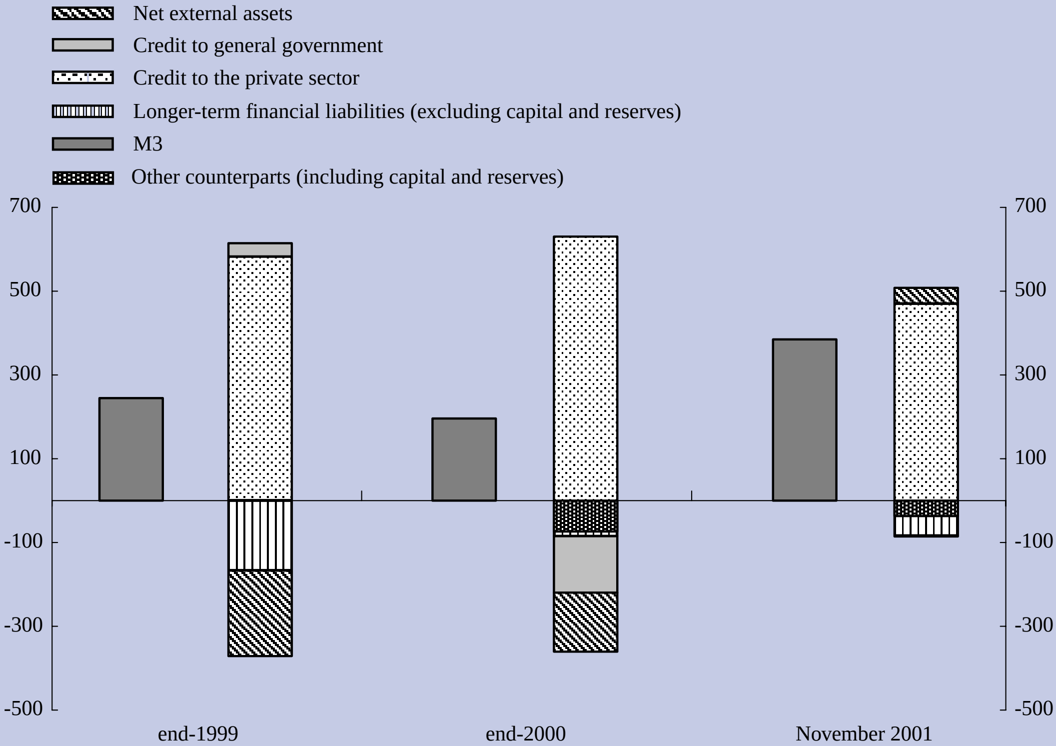
Box 1

Developments in M3 and its counterparts

The recent strong M3 growth raises the question of whether risks to price stability might be implied in the medium term or whether there are no grounds for concern as the rise can be expected to be of a transitory nature.[1] In this context, the analysis of the development of M3 and its counterparts in the balance sheet of the MFI sector, compared with past experience, may be helpful.[2] Movements in M3 are mirrored in the development of the counterparts of M3, in particular credit to euro area residents, longer-term financial liabilities of the MFI sector and net external assets of euro area MFIs. For example, shocks to monetary developments arising from uncertainty in financial markets might reflect portfolio shifts from longer-term financial liabilities into components of M3 and do not necessarily imply upward risks to future price stability. By contrast, risks to price stability in the medium term may result if M3 growth is related to more lasting changes in credit developments, as such changes often have a link to economic activity. Furthermore, the analysis of developments in the external counterparts of M3 may provide indications as to how external factors may influence domestic monetary developments. For the above reasons, the analysis of M3 and its counterparts is typically useful for the identification and assessment of shocks affecting the current economic situation, and thus for the analysis of aggregate spending and risks to price stability in the medium term.

M3 and its counterparts

(annual flows, end of period; EUR billions; not adjusted for seasonal and calendar effects)



Source: ECB.

Note: Series adjusted for non-euro area resident holdings of all negotiable instruments. M3 = credit to the private sector + credit to general government + net external assets - longer-term financial liabilities + other counterparts.

Current developments in M3 and its counterparts differ significantly from those in 1999 and early 2000

In 1999 and early 2000 rather pronounced M3 growth was paralleled by strong growth of credit granted to the euro area private sector (nearly 90% of which is made up of loans). The latter, in turn, was fuelled by low lending interest rates and the economic recovery in the euro area in the course of 1999. At the same time, there was a relatively pronounced increase in the annual growth rate of longer-term financial liabilities (excluding capital and reserves) in this period. This reflected a pronounced steepening of the euro area yield curve, which should also have had a dampening impact on M3.

In the course of 2000, M3 growth gradually fell, which was partly related to a substantial decline in credit granted to general government. At the same time, the annual rate of growth of credit to the private sector remained high. This was due to the strong economic growth and intense merger and acquisition activity, in part connected with direct investment outside the euro area, as well as the financing of UMTS licences in the autumn of 2000. The strong growth of credit to the private sector may also have been related to some extent to net portfolio and direct investment outflows from the euro area. These outflows were matched by declining net external assets of the euro area MFI sector. The annual growth rate of longer-term financial liabilities (excluding capital and reserves), while remaining relatively high until August 2000, dropped considerably in the last months of the year, to stand at 3.1% in December 2000. This followed a significant flattening of the euro area yield curve, from 2.4 percentage points in January 2000 to 0.1 percentage point in December 2000.

By contrast with 1999 and early 2000, the strengthening of M3 growth in 2001 was accompanied by a continuous decline in the annual growth rate of credit to the private sector until October 2001. At the same time, the annual rate of growth of longer-term financial liabilities was very weak throughout most of 2001. This development may indicate a substitution of assets included in M3 for longer-term financial liabilities, resulting from a relatively flat yield curve throughout most of 2001 and, notably after the terrorist attacks in September, financial market uncertainty. In the past few months growth in longer-term financial liabilities (excluding capital and reserves) has picked up slightly, to 3.0% (year-on-year) in November 2001, although remaining low by historical standards. This slight recovery was in line with a steepening of the euro area yield curve. Finally, the relatively strong M3 growth in 2001 was accompanied by significant combined net direct investment and portfolio investment inflows into the euro area from June 2001. This was mirrored by a strong increase in net external assets of the euro area MFI sector which might be partly linked to low short-term interest rates in major economies outside the euro area and the possible perception by investors of limited external investment opportunities due to heightened financial and economic uncertainty.

Overall, the movements in M3 and its counterparts during 2001 support the view that the recent strong dynamics of M3 are likely to be related mainly to temporary portfolio shifts from longer-term assets within the euro area and assets abroad into liquid short-term assets. High M3 growth in recent months has not been associated with strong credit demand and is not therefore likely to be closely linked to aggregate spending by euro area residents. This represents a major difference to the episode of strong M3 growth in 1999 and early 2000. At the same time, the ongoing process of building up liquidity, in particular if the economy recovers and the process of normalisation in financial markets continues, will require a thorough analysis of monetary developments in the coming months in order to assess whether there are any signs of inflationary pressures arising under the first pillar.

1 *See the section entitled "Monetary and financial developments" in the December 2001 issue of the Monthly Bulletin.*
2 *See the article entitled "Framework and tools of monetary analysis" in the May 2001 issue of the Monthly Bulletin.*