Box 1

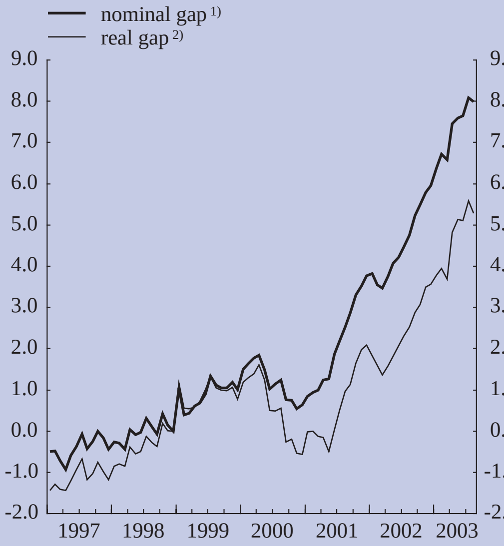
What could happen with the accumulated excess liquidity in the euro area?

Ample liquidity in the euro area

Over recent years, M3 has grown significantly above the reference value of 4½% which has been set by the Governing Council of the ECB and which refers to the annual growth rate of M3 compatible with price stability over the medium term. As a consequence of the strong M3 growth, there is now significantly more liquidity in the euro area economy than is needed to finance non-inflationary growth. This can be illustrated by constructing measures of money gaps which show the cumulative deviations of M3 growth from the reference value over a number of years. The nominal money gap measure in the chart refers to the difference between the actual level of M3 and the level of M3 which would have resulted from M3 growth at its reference value (4½%). The chart uses December 1998, the month before the start of the single monetary policy, as the base period. The real money gap measure shows the difference between the actual level of M3 deflated by the HICP and the level of M3 in real terms which would have resulted from nominal M3 growth at the reference value and HICP inflation in line with the definition of price stability, again using December 1998 as the base period. The latter indicator takes into account the fact that part of the excess liquidity which has accumulated over the past few years has in the meantime been absorbed by higher prices, reflecting upward deviations of inflation rates from the price stability objective. For this reason, the measure of the real money gap shows a lower amount of excess liquidity. Although the choice of base period for these indicators is rather arbitrary, there is clear evidence that very large amounts of excess liquidity have accumulated over the past two years (see the chart).

Estimates of the nominal and real money gaps

(as a percentage of the stock of M3)



Source: ECB.

1) *Deviation of the actual stock of M3 from the level consistent with monetary growth at the reference value, taking December 1998 as the base period.*

2) *Nominal money gap minus the deviation of consumer prices from a level compatible with the definition of price stability, taking December 1998 as the base period.*

Motives underlying the accumulation of excess liquidity

The question thus arises as to what will happen with these high amounts of excess liquidity. In this respect the motives underlying the build-up of liquidity can provide an initial indication. First, the current situation of ample liquidity in the euro area is to a significant extent associated with past portfolio shifts, most of which occurred between mid-2001 and early 2003 in the context of high stock market volatility and the continuous decline in stock prices. These parked funds could in general be expected to be reallocated to longer-term financial assets or real estate once the financial market uncertainty recedes. Second, the low level of interest rates and thus opportunity costs of M3 have fuelled the holding of liquid funds. Part of these funds may be used for transaction purposes in the future. Finally, increased precautionary savings in view of uncertain economic and employment prospects also appear to have played a role. This part of the accumulated money holdings could be expected to be either reallocated to longer-term financial assets or real estate or used for spending once the outlook for employment improves.

It is difficult to identify the amounts held for each of these three purposes, as economic agents obviously do not "earmark" the various parts of their money holdings according to these motives. Furthermore, it can be assumed that the use of liquid assets depends on the underlying economic conditions, with the result that e.g. liquid assets initially held for portfolio reasons may be used for transaction purposes when the economic outlook improves. The rest of this box describes in more detail the possible macroeconomic impacts of the different uses of the accumulated excess liquidity.

Macroeconomic effects of possible uses of excess liquidity

As noted above, one possibility is that part of the accumulated excess liquidity will be invested in longer-term financial assets, in equity or debt securities, either directly or indirectly via investment funds. If the non-MFI sector as a whole were to reallocate its portfolio, either the resident MFI sector or agents outside the euro area would have to act as counterparts. If this happens, excess liquidity would decline. While this would weaken concerns for price stability, the readjustment of portfolios may, under certain circumstances, have an impact on asset prices. The subsequent influence on spending (via wealth effects or a possible improvement in financing conditions) should, however, be limited. How quickly a reversal of portfolio shifts would lead to a decline in excess liquidity depends crucially on whether the private non-MFI sector only adjusts its investment behaviour in terms of new savings or also adjusts the amounts outstanding of the different components of its investment portfolio. Given the high degree of liquidity of portfolios, the reversal of past portfolio shifts could easily relate to both new savings and level adjustments. Thus, in principle, the decline in excess liquidity could be relatively steep. However, the experience of the past few months, in which the reallocation of liquid funds to equity remained limited, indicates that the adjustment may also be rather slow. One reason for this could be that households are now more reluctant to invest in equity markets since they experienced substantial losses in these markets from mid-2000 to early 2003.

An alternative to investing excess liquidity in financial assets is buying real estate. In this case, basically the same considerations apply as above. However, as it is highly likely that real estate would be traded between resident non-MFIs, excess liquidity is unlikely to decline (and might even increase if additional loans are taken up to finance housing), and there will most probably be a positive impact on housing prices, which could then, via wealth effects, also affect spending.

The excess liquidity could also lead directly to higher spending, in particular once the economic recovery gains momentum. While this is obvious for the part of the accumulated excess liquidity held for transaction purposes, part of the money holdings originating from speculative or precautionary motives could also, over time, become transaction balances. Since it is most likely that the private non-MFI sector would increase its demand mainly for domestic goods and services, the resulting rise in aggregate spending would not only contribute to a gradual absorption of the excess capacity in the euro area economy but might also pose a risk to HICP inflation in the medium term.

Finally, it cannot be entirely ruled out that the current situation of ample liquidity to some extent reflects a change in the money demand behaviour of economic agents, i.e. an increase in the desired level of money holdings. Such a structural shift in money demand would mean that, at present, the money gap measures are overestimating the excess liquidity in the euro area. However, it is difficult to identify factors which could have induced such an upward shift in money demand over the last two years. (For example, there is little evidence that specific financial innovations or changes in the tax treatment of particular financial instruments have increased the attractiveness of money holdings during this time.) Therefore, it seems rather unlikely that a large part of the excess liquidity can be attributed to such a structural change.

Conclusions

In sum, whether or not inflationary pressures will stem from the excess liquidity in the euro area depends on the purposes for which this excess liquidity is used. Should most of the accumulated money holdings be reallocated towards equity or longer-term debt security markets before economic activity strengthens significantly, there would be less cause for concern regarding the inflationary outlook, although asset prices might increase more strongly. However, if there is still considerable excess liquidity at a time of strong economic growth, the likelihood of it being used, over time, for transaction purposes would increase, and the resulting higher aggregate demand may imply inflationary risks in the medium term.

Recent developments do not yet allow us to assess which use of excess liquidity will dominate in the future. Despite a tendency towards a normalisation of stock market conditions and the decline of geopolitical tensions in recent months, the reallocation of portfolios towards equity and equity funds has remained limited. Moreover, developments in bond markets over most of this year may have also reduced – at least temporarily – the attractiveness of longer-term fixed income investments. Overall, this analysis confirms that a close monitoring of developments in excess liquidity and its possible uses is needed in order to detect possible inflationary pressures and take appropriate monetary policy decisions in a timely manner.