

Box 2

WEAK MONEY GROWTH: A REVIEW OF PAST EPISODES

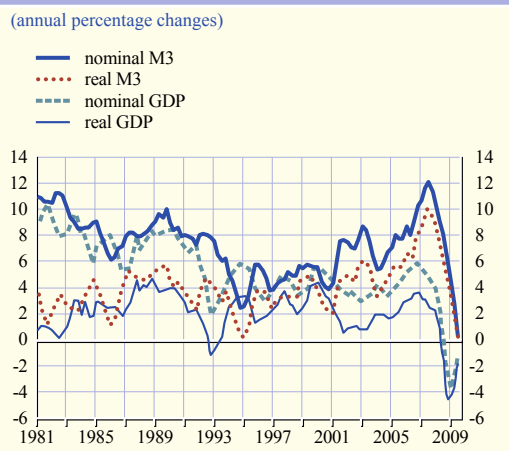
The annual growth rate of euro area M3 was negative in three of the last four months for which data are available, standing at -0.4% in February 2010. This represents the first episode of negative broad money growth at the euro area level since the beginning of the 1980s.¹ There are three main factors explaining the present historically weak M3 growth: first, the severe recession and the fact that the level of economic activity still remains low, implying limited demand for money for transaction purposes; second, the particularly steep yield curve, which implies strong incentives to shift funds from monetary to longer-term assets; and third, the strong accumulation of monetary assets over a protracted period in the years prior to this episode, which implies a possible correction of excess liquidity. This box looks at how the current episode of weak money growth compares with those observed in the past at the euro area level and at the country level.

At the euro area level

For the euro area as a whole, the only other episode in which annual M3 growth has come close to zero – and then it was only in real terms – was in the mid-1990s (see Chart A). That episode displayed both similarities and differences vis-à-vis the current period. It was similar in that the weak money growth followed a strong decline in annual real GDP growth, which entered negative territory and resulted in a recession (although that decline of around 5 percentage points from peak to trough was less strong than the decline of some 8 percentage points observed in the current episode). The weak money growth also coincided with a significant steepening of the yield curve, which was slightly stronger than that observed in 2009 (with the spread between

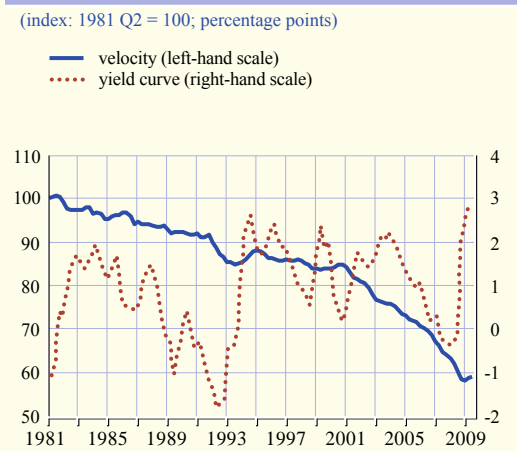
¹ Although euro area-wide data on M3 are available for the whole of this period, only data as of 1999 are based on harmonised statistics. Those covering the preceding period are synthetic euro area data.

Chart A M3 and GDP growth in the euro area
(annual percentage changes)



Sources: ECB, Eurostat and OECD.
 Notes: M3 growth rates have been calculated from notional stocks. The real M3 series has been calculated by deflating nominal M3 using the GDP deflator.

Chart B The velocity of money and the steepness of the yield curve in the euro area
(index: 1981 Q2 = 100; percentage points)



Sources: ECB, ECB calculations, Eurostat and OECD.
 Notes: Velocity is calculated as differences between the logarithms of nominal GDP and nominal notional money stocks. The steepness of the yield curve is calculated as the difference between nominal long-term government bond yields and short-term market interest rates.

long and short-term rates increasing by around 4.5 percentage points, compared with an increase of around 3.5 percentage points in the current episode; see Chart B). It was also preceded by a protracted period in which money grew in excess of economic activity, seen as velocity deviating from past trends.² However, this excess money growth was not as strong or protracted as in the run-up to the current episode.

But there are also differences between these two episodes. First, while in the mid-1990s the problems in the financial sector were restricted to individual banks in a small number of countries, in the current episode they have been much more pervasive, especially following the intensification of the financial turmoil. A second difference concerns the timing relative to the economic cycle: in the earlier period, the developments in M3 growth lagged the slowdown in GDP growth by around two years, while on this occasion the two series have declined almost simultaneously.

At the country level

By contrast with developments at the euro area level, there have been several instances of negative annual growth in nominal M3 at the country level in the last 20 years (see table).³ Ignoring the current episode, in which negative M3 growth has been recorded in seven of the twelve euro

² Changes in velocity can obviously only serve as a rough indication of excess monetary developments, as they can also reflect other factors such as financial innovation and changes in preferences as regards money holdings.

³ Only twelve euro area countries are considered, owing to a lack of historical data. The assessment is based on nominal (rather than real) M3, as the aim is to compare the current episode of negative nominal money growth with equivalent historical episodes and the data cover a period of time (i.e. the period of convergence and Stage Three of EMU) with limited distortion as a result of inflation. National M3 developments depend more on variations in net external assets than developments for the euro area as a whole, given the significant capital flows between the individual euro area countries. As a result, those national developments are, for most countries, considerably more volatile and prone to produce negative growth rates.

Negative annual growth in nominal M3 in selected euro area countries since 1990: developments in selected indicators

(timing relative to the episode of negative annual growth in M3)

	Negative annual M3 growth	Negative annual real GDP growth	Excess money growth	Steepening of the yield curve in percentage points
BE	94 Q4-95 Q3	Before	Before	Before (4.1)
DE	95 Q1-95 Q2; 00 Q4	Before; after	Before; before	Before (4.1); no
	09 Q4	Before and during	Before	Before and during (3.3)
IE	No			
GR	No			
ES	No			
FR	93 Q3-94 Q3; 96 Q4	Before; no	Before; before	Before and during (6.2); before (2.6)
	09 Q4	Before and during	Before	Before and during (3.4)
IT	97 Q4; 99 Q2	Before; before	Before; no	No; before (1.9)
LU	99 Q1-99 Q4; 09 Q1-09 Q4	No; before and during	No; before	During (1.6); before and during (3.3)
NL	95 Q1-95 Q2; 09 Q4	No; before and during	Before; before	Before and during (3.8); before (3.3)
AT	97 Q4-98 Q3; 09 Q2-09 Q4	No; before and during	Before; before and during	No; before and during (3.5)
PT	02 Q3-02 Q4; 09 Q4	During and after; before and during	No; before	Before (1.5); before (3.5)
FI	94 Q1	Before	Before	Before, during and after (7.0)
	96 Q4	No	Before	Before (1.3)
	97 Q2; 98 Q1	No; no	Before; before	No; no
	00 Q4-01 Q1; 09 Q2-09 Q4	No; before and during	No; before and during	No; before and during (3.2)

Source: ECB estimates and calculations.

Notes: The terms “before”, “during” and “after” indicate the timing of the developments in the selected indicators relative to the negative annual growth in nominal M3. “No” indicates that there was no particular change in the indicator in question around the time of the episode of negative annual growth in nominal M3. The figures in brackets in the last column indicate the magnitude of the steepening of the yield curve in percentage points. M3 data refer to national monetary aggregates in which the money-holding sector consists of national residents, so they are not necessarily comparable with the national contributions to euro area M3 growth reported since 1999 as part of the harmonised euro area statistics. Excess money growth is defined as nominal M3 growth exceeding nominal GDP growth.

area countries under consideration, these events can be grouped into three periods: i) the period from the ERM crisis to the mid-1990s; ii) the second half of the 1990s, which coincided with the period of convergence in the run-up to Stage Three of EMU; and iii) a few sporadic cases in the early 2000s. In the first period, four of the five countries registering negative M3 growth had previously witnessed negative real GDP growth. All of them had also registered excess money growth and a steepening of the yield curve. In the second period, negative annual M3 growth was preceded in four of the five cases by a steepening of the yield curve and excess money growth, but real GDP growth had been negative in only one case. Finally, in the early 2000s, three countries registered negative money growth, while real GDP growth was negative in two of those cases. However, by contrast with the previous two periods, the contraction in economic activity occurred during and after the negative money growth, not before it. Only in one case does excess money growth appear to have played a significant role in monetary dynamics, with the same being true of the steepening of the yield curve.

Implications for the current situation

In all of the countries discussed above, the negative annual growth of M3 was short-lived, with money growth returning to positive territory within approximately one year following an economic recovery and the flattening or stabilisation of the yield curve. However, what makes it difficult to gauge the extent to which the pattern will be repeated at the euro area level is the fact that on this occasion the scale of developments (i.e. the previous accumulation of monetary imbalances, the problems in the banking sector and the decline in economic activity) has greatly exceeded those of earlier periods.

In qualitative terms, the factors currently at work imply countervailing forces. On the one hand, the signs of stabilisation in the banking system (supported by the various policy responses), the stabilisation of the yield curve and the strengthening of real GDP growth should all help annual M3 growth to return to positive territory in a relatively short period of time. On the other hand, the strong money and credit growth registered over the past few years, which is also apparent in the high level of private sector indebtedness, may mean that money holders' balance sheets need to be reduced further. This may continue to dampen M3 growth, keeping it in negative territory or at very modest levels for some time to come. Were the accumulated liquidity to be "absorbed" through gradual deleveraging and not used for additional spending on consumer goods, this would be consistent with a continuation of the low inflationary pressures stemming from the current monetary developments.