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**Playing chicken in times of turbulence:  
M3 overshooting and  
the ECB monetary stance**

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## Playing chicken in times of turbulence: M3 overshooting and the ECB monetary stance

Miriam L Campanella \*

### Abstract

This summer subprime crisis and the subsequent credit crunch have placed central banks again on the spot. In the USA and Europe, central banks have made significant steps to calm down financial turbulence by engineering liquidity injections, and interest rate shift. In Europe, following a recent Banking Lending Survey (October 2007) signaling a tightening of the credit standards for loans to enterprises, the ECB, in a counter-cyclical effort, has managed to leave on hold interest rate. As sound as sensible the ECB move can be seen, it appears the bank set to delay action on excess of liquidity, as shown in the persisting overshooting of M3. The ECB rates halt, or a likely near-term cut, as some would suggest, could only send the wrong signal. A neglect of M3 overshooting while accelerating inflationary pressures reveals the bank's weakness in front of eurozone politicians claiming a more accommodative policy to offset the euro's trend appreciation. In order to escape being entrapped into the rate dilemma, this paper suggests the bank has just to make a clear-cut choice: carry out the objective of cracking down on M3 overshooting, or hand over M3 quantitative target. If not, it will be seen playing chicken in the game.

*Key-words: ECB two-pillar strategy; M3 overshooting; chicken game.*

### EMU and the game of the chicken.

*"In a game of chicken, the loser is the player who swerves first out of the way of the other driver's car"* (Martin Wolf, Financial Times, September 21 2007:11).

As global economy faces a downturn in the credit cycle, monetary policy is again on the spot. The shift in monetary policy in the USA and Europe is a key reason for assessing the consistency of trend monetary policy, and the banks' effectiveness in facing financial turbulence.

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At odds with their previous public statements, central banks are striving to change course while saving credibility. Alan Ruskin, strategist at RBS Greenwich Capital, the day after the Fed cut main interest rate by 50 basis points<sup>1</sup>, called it the “brave opening gambit in the easing cycle from a Fed chairman that for credibility reasons was expected to err on the side of caution”. (FT, September 19:1)<sup>2</sup>. Some weeks later<sup>3</sup>, at the Governing Council in Vienna (4<sup>th</sup> October 2007), was up to Jean-Claude Trichet, the ECB President, to join the peer group. The ECB left unaltered euro’s interest rate bringing to a standstill the restrictive stance, and opening even to a small 25 basis point cut later this year.

Is this a sign that the subprime crisis and the credit crunch are eventually acting as the intervening variable supportive of major monetary co-ordination? Nearly synchronized interventions and large amounts of liquidity injected by the US Fed and the ECB have indeed calmed down the liquidity dearth. These operations, namely banks’ current account holdings with the central bank, are not expected to alter M3, the monetary aggregate that measures the amount of money available to the entire economy. As Gonzales-Paramo, member of the ECB Executive Committee, would reassure “Those concepts [M3 developments], which are the ones relevant for price developments in the long run, are not affected by the ECB’s recent operations” (Gonzales-Paramo, 2007).

Though, excess of liquidity is an issue central banks cannot further ignore. This sounds imperative especially for the ECB since it makes monetary growth, a pillar “reference value” in its monetary assessment. For this reason, M3 is expected to play a higher relevance in the ECB monetary policy than in the US Fed. A circumstance making the ECB more liable than its sister US Fed for the build-up of excess of liquidity. In fact, while the Fed has dismissed to publish M3 figures since 2006 (Chapman 2005), in the Monthly Bulletin published on July 2007, the ECB has taken an unusual rigid posture on M3 overshooting. Figures over M3 at 12% growth on yearly basis well beyond the 4.5% benchmark found the bank concerned. The Monthly Bulletin wrote: “the Governing Council will monitor closely all developments in order to ensure that risks to price stability over the medium term do not materialise and medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability.” (ECB, MB July 2007:6).

Yet, this posture could reveal a tough test for the Frankfurt policymakers, as they could find themselves limited to face the current credit crunch, which requires large amounts of liquidity injected into the market. Still, this summer financial turbulence caught the two banks in divergent policy cycles. While at the outbreak of the crisis the Fed had almost reached the peak of interest rate rise, the ECB was midway of a rising cycle, following a long accommodative cycle (2001-2005). In these circumstances, the halt to interest rate increase on October 4<sup>th</sup>, which follows the results of the Bank Lending Survey (ECB, BLS 2007), sends a confusing signal over the ECB trend monetary policy, and the relevance of M3 overshooting in the bank’s monetary assessment. In fact, the Survey indicates a net tightening of the credit standards for loans to enterprises from a net easing of -3% in the second quarter of 2007 to 31% in the third quarter of 2007. The net

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<sup>1</sup> While writing (October 31), the US Fed has made a further cut by 25 basis points, leaving its main rate at 4.50.

<sup>2</sup> Financial Times “Fed Slashes rates to 4.75” 19 September 2007.

<sup>3</sup> Bernanke’s policy change arrived just few days after the Bank of England bail-outed the Northern Rock, near to collapse. The bank’s intervention contravened the Marvin King’s wording that “the provision of (...) liquidity support (...) encourages excessive risk-taking, and sows the seeds of a future financial crisis”.

tightening of the credit in the eurozone follows a long period of standards remaining basically unchanged or being slightly eased. As the Survey asserts “The net tightening most likely reflects the worsening of global credit market conditions”(2007: 5-6). In the third quarter of 2007, banks also reported a net tightening of credit standards for housing loans to households (from a net easing of -1% in the second quarter of 2007 to 12% in the third quarter of 2007), following a slight net easing in the previous quarter. Credit standards for consumer credit and other lending to households were eased slightly, compared with basically unchanged standards in the previous quarter (ECB, BLS 2007 ibd.).

In theory, the credit tightening would require a monetary easing. A policy that conflicts with the pledge of crackdown on M3 overshooting. The ECB faces clearly a rate dilemma. How can the bank justify a cut in the presence of an overshooting M3? And, at the same time: How can it justify an interest rate increase in the midst of a credit crunch hitting small-medium sized enterprises (SMEs), and rising house mortgages? If the ECB makes for a rate increase to crack down on M3 and eurozone creeping inflation, the move could work as an asymmetric shock on those economies particularly vulnerable to interest rate increase.

- Spain, which is now running a current account deficit worth more than 9% of GDP, could witness major free fall into housing sector as euro’s rates rise.
- Ireland, where the central bank warned in April that the Celtic Tiger’s own real estate bubble can’t bear further interest-rate hikes.
- Italy, with failing productivity, has pushed labor cost competitiveness down by between one-fifth and one-third compared with Germany in the last decade.

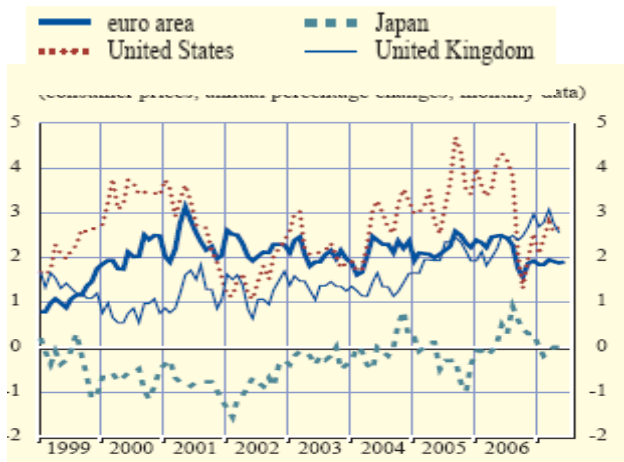
#### **The ECB and M3. How one can fall into its own net.**

In line with the Bundesbank monetary policy, there is a widespread consensus among euro policymakers that monetary growth and inflation are linked over the longer term. So it is not surprising that the ECB stated since its onset that the euro monetary policy strategy would have the following three components:

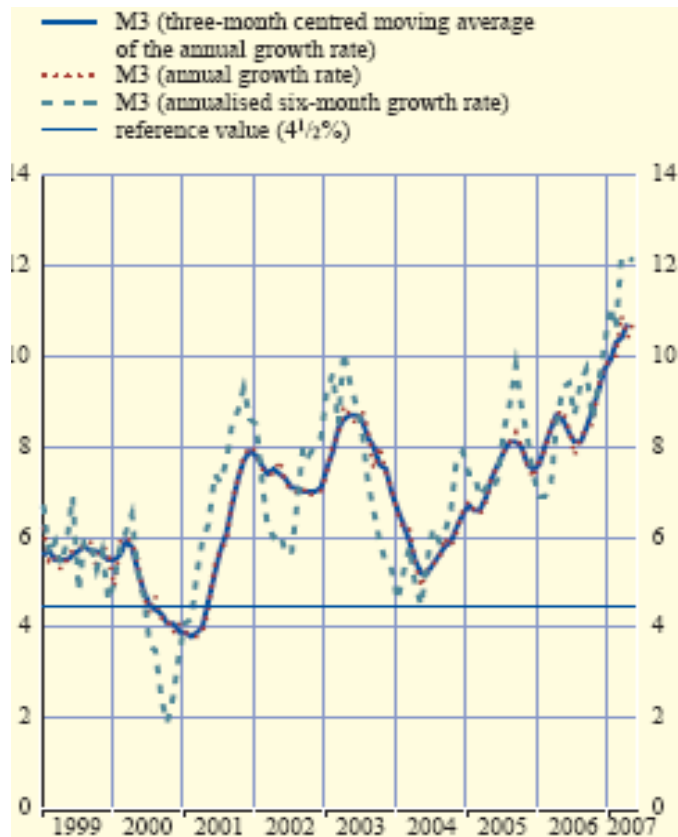
- The operational definition of price stability would be inflation in the Harmonized Index of Consumer Prices (HICP) of less than 2 percent per year, in the medium term.
- Money would be assigned a prominent role in the evaluation of financial market conditions, and this role would be signaled by the announcement of a quantitative reference value for the growth rate of a broad monetary aggregate (M3) of 4.5 percent on yearly basis.
- A broadly based assessment of the outlook for future price developments, and the risks to price stability in the euro area would play a major role.

As for the first pillar, the ECB has taken some time to hit the target (Chart 1), the second pillar (M3) has never been centered (Chart 2). Recent studies express a relationship between the “low frequency component” of monetary growth and that of inflation. In this context, the low frequency component is understood as the more persistent or trend-like movements in these time series that remain once the short-term volatility is filtered out.

**Chart 1. Inflation rates**



Sources: National data, BIS, Eurostat and ECB calculations.  
 1) Eurostat data are used for the euro area and the United Kingdom; national data are used for the United States and Japan. GDP figures have been seasonally adjusted.  
 2) HICP for the euro area and the United Kingdom; CPI for the United States and Japan.

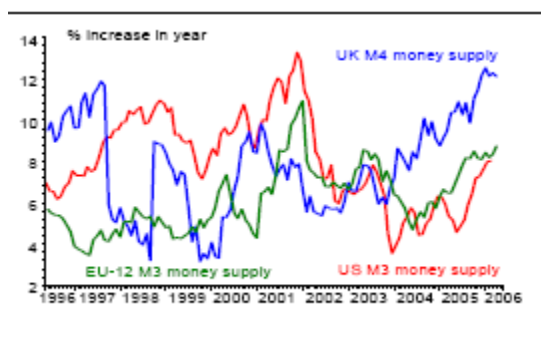


Source: ECB.

Though, fixing M3 target is not such an easy task. Problems stem from the architecture of the European System of Central Banks (ESCBs), in which the ECB is not responsible for the eurozone banks' supervision, which has been left to the responsibility of national central banks. As Eijffinger remarked: "National supervisors may have interests of their own, like keeping national banks in business. Lacking expertise and the time to acquire any, the ECB is likely to follow the advice of the national supervisor if a crisis occurs. Led astray by possibly biased advice and information, the ECB may then create excess of liquidity, thereby perhaps even compromising on its primary objective of price stability"(2001:4).

Excess of liquidity is not a special Eurozone problem, but worldwide(Chart 3).

**Chart 3. Global excess of liquidity**



Source: *Economics Weekly*, November 27 2007

Recently, several observers have hinted to central banks as liable for the current excess of liquidity in the global economy. The Greenspan's policy has been submitted to a rather severe scrutiny, as the Fed -some argue- despite the rise of short-term interest rates, has left monetary policy on an unusually expansionary mode. Between 2001-2005, average short-term rates in America, Europe and Japan have remained below nominal GDP growth for the longest period since the 1970s. In addition, the US loose budget policy in this period has been amplified by the build-up of foreign-exchange reserves and domestic liquidity in countries that have tied their currencies to the dollar, notably China and the rest of Asia. As a result, over the past couple of years, global liquidity has expanded at its fastest pace for three decades. As the "Economist" argues "If you flood the world with money, it has to go somewhere, and some of it has gone into bonds, resulting in lower yields. Or, more strictly, bond prices have been bid up until yields are so low that people are happy to hold the increased supply of money" (quotation from Delong 2005).

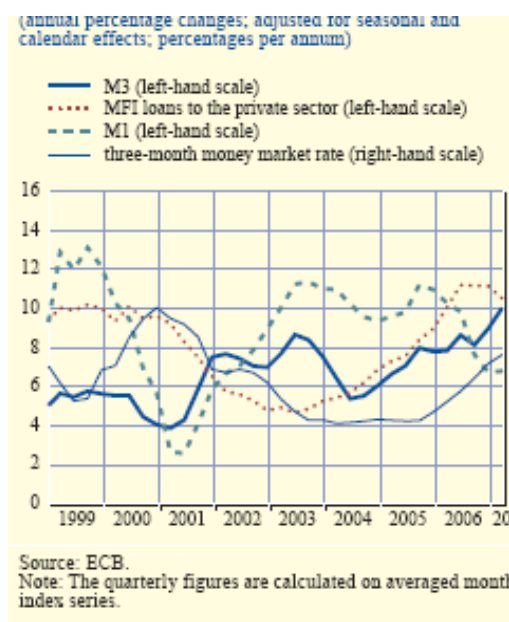
Rupper and Stracca (2006) counter this argument underlining that in a world of developed financial markets, the definition of liquidity cannot be related to central bank-driven injections of high-powered money<sup>4</sup>, but rather reflects the endogenous choice of households and firms ("endogenous" money)" (Rupper and Stracca 2006). As they conclude, central banks cannot be charged exclusively for excess of liquidity, financial institutions have to share the responsibility.

<sup>4</sup> "High-powered money is a macroeconomic term referring to the monetary base that is, to highly liquid money such as currency and deposits held in demand accounts such as checking accounts. (...)The monetary base is called high-powered because the magnitude of changes in monetary base can be greatly magnified by the monetary multiplier. That is, a small change in the monetary base can result in a large change in the overall money supply. As an example, a \$1 billion increase in monetary base may lead to a \$10 billion increase in the money supply because of money multiplier effects" (Wikipedia)

### M3 overshooting in Eurozone: 2001-2003, 2004 –2006

Focusing on eurozone's recent history, Arnold (1999), Wyplosz (2005) Goodhart (2005) distinguish two excesses of liquidity, which have shown in two distinct episodes 2001-2003, and 2004-2007. The first, a risk-free episode, was justified by expansionary monetary policy as a by-product of current inflation and growth prospects. In this episode, the abundance of liquidity reveals weak bank lending given historically low interest rates. The reason is that growth prospects were not very bright. Monetary policy was very expansionary but hardly effective. In the second episode (2004-2007), excess of liquidity turned risk-led in the event of solid improvements in growth prospects, and liquidity became quickly excessive. Focusing on M3 changes (Chart 4), there is clear-cut evidence for M3 misbehaving relative to the reference value of a growth of 4.5% since 2001, and, apart from a brief spell in 2004 when its growth fell back to the reference value, it has continued to grow much faster than consistent with the bank's reference value (Goodhart 2005:6). Yet a detailed analysis of the composition of loans to the private sector confirms and strengthens the view that M3 trends include two periods, which are different in nature (Chart 4).

**Chart 4. Monetary aggregates, MFI loans to private sector and short-term interest rate**



Source: *ECB, MB July 2007*

The constellation and explanation of monetary and credit dynamics between mid-2004 and late 2005 differ from those of the previous period of strong M3 growth in the euro area between mid-2001 and 2003 (ECB, MB July 2007:54-55). In particular, the relationship between M3 growth and the evolution of MFIs<sup>5</sup> loans to the private sector is quite different. In the earlier period, strong M3 growth was associated with weak private sector borrowing. Fragile business and household confidence in the aftermath of a sharp fall in equity prices and the terrorist attacks

<sup>5</sup> Euro area MFIs are “monetary financial institutions”, the money-creating sector in the Eurosystem's statistical framework. This sector consists of the ECB, national central banks, credit institutions and money market funds. For more, Rupper and Stracca (2006).



of 2001 led to caution in taking loans, but a greater desire for safe and liquid monetary assets. It coincided with a slow-down in world growth, following the Nasdaq/Tech bubble burst, in which both Eurozone and US growth were temporarily brought down much lower than average. Indeed the reverse was occurring. Bank lending growth was declining fast during these years. Goodhart (2006) sees several reasons why broad money growth which is not accompanied by similar rapid expansion in bank lending may seem less threatening, than when they are both expanding fast together. "First, if there is no accompanying bank lending expansion, it would seem less likely that the broad monetary growth would be associated with asset bubbles, and/or over-confidence and high risk appetite by banks and private agents (...). Second, there is the strand in the recent literature that associates the effect of bank expansion on the economy, over and above that directly associated with a concurrent reduction of real interest rates, with the relaxation of credit rationing constraints, especially on SMEs."(2005:2-4). On the whole, Goodhart argues that in this first episode "the ECB (rightly) continued to cut interest rates over this first period (2001-3), ignoring the excess of M3 growth over its reference value" (Goodhart 2005: 5).

The monetary context is different in the second, latest and most recent episode of fast monetary growth. Since 2004 financial markets have recovered, and seem relatively stable. The growth in M3 is being accompanied by equally rapid growth in bank lending to the private sector. During the period, world economy continues to grow reasonably rapidly (despite oil prices) and in the eurozone real output growth appears to start recovering, if only irregularly. On this occasion, Goodhart remarks that it is difficult "to dismiss M3 growth as a temporary anomaly. Assuming that the medium (and longer) term association between monetary growth and inflation persists, then this latest occasion of rapid monetary growth must, surely, be a serious warning (an amber light at least) of future inflationary pressures" (Goodhart 2005 *ibid.*).

Indeed, the combination of easy money, low real interest rates, and rapid credit expansion on the one hand and the lack of signs of cost inflation on the other hand is not peculiar to eurozone. This conundrum, as Greenspan dubbed it, has puzzled central bankers in most developed OECD countries. The difference, however, is that in the USA it has been easier for the monetary authorities to return from a stance of monetary ease to a more neutral level of interest rates without significant criticism from outside, while in Europe, the recovery "in real output, from the trough in 2001-3, has been much more fitful and unsatisfactory"(Goodhart 2005:6-7). With fiscal policy somewhat constrained by the Stability and Growth Pact, Ministers of Finance concerned that a "withdrawal of monetary ease could prevent a firm recovery taking place. Hence there has been considerable tension and a counter-flow of criticism and accusation between (some of) the national fiscal authorities and the federal Governing Council of the ECB"(Goodhart 2005:7).

As the ECB Monthly Bulletin (July 2007) admits the excess of liquidity in the eurozone started to build-up in 2004:"The exceptionally low level of interest rates and latterly the strengthening of economic activity has led both to a renewed demand for money for transactions purposes and to an increased appetite to borrow to finance spending and investment. Therefore (...) monetary growth and credit expansion have increased in parallel"(ECB MB July 2007: 57) (Chart 4.). Similarly to Goodhart (2005) and others, the ECB confirms that the increases in money holdings between 2001 and 2003 took place in a context of declining growth in loans to households and non-financial corporations, and that, in contrast, increases in M3 growth since mid- 2004 reflected in increases in loan growth for all purposes and across all maturities. The breakdown of MFI loans to households shows that the growth of consumer loans declined between 2001 and 2003, reflecting declining consumer confidence, rising unemployment and weaker income growth (Chart 4). A completely different picture develops between 2004 and mid-2006: the annual growth rate of consumer credit quadrupled, mirroring increases in confidence and spending. Loans for house purchase also increased steadily, reaching very high levels in 2006. Following the increases in interest rates from December 2005, loan demand for households

slowed somewhat, while nonetheless remaining at vigorous rates through early 2007 (MB July 2007:55-57).

In line with the conclusions drawn from the previous analysis, the ECB suggests that “quite different forces underlay strong monetary growth between 2001 and 2003, and have done so since 2004. In particular, the former episode was associated with increases in the liquidity preference of money holders, whereas the latter episode has been driven, inter alia, by the low level of short-term interest rates (reflecting the accommodative stance of monetary policy)” (ECB, MB July 2007: 59). By insisting that the excess of liquidity does not depend “entirely upon central bank’s interest rate policy, the so called high-powered money, as it often represents only a tiny fraction of monetary and credit aggregate” (MB July 2007:58), the ECB seems clearly set to rebuff criticism of “systematic leniency” (Goodhart 2005:8).

Yet, the rationale for the ECB to control liquidity growth is stronger than the bank would admit. As Wyplosz makes clear there are at least two reasons for it.

1. With very large amount of available cash, banks can promptly expand lending if demand materializes, with the result of inflationary pressure (Wyplosz 2005). At this time, as liquidity expands the ECB “must stand ready to rapidly re-absorb much liquidity, which means ratcheting up interest rates. This would be entirely appropriate in the event of a resumption of solid growth, but the abundance liquidity over the last three years has created a situation that could soon appear as very risky”(2005:1-4).
2. With significant spill-over of global liquidity on the euro area economy and (albeit to somewhat more limited extent) in Japan, as stated by the existing empirical literature, global monetary shocks are more significant for eurozone than for the US economy. As Rupper and Stracca admit “It appears that global liquidity plays a different and more limited role for the ‘leader’ currency [the US dollar] in the international monetary system” (2006: 8-12).

On balance, the different composition of M3 and the distinct roots of its behavior in the two episodes allow to conclude that M3 growth pattern in the eurozone is sensitive to the ECB policy as well as to global excess of liquidity. Then, given the relationship between the “low frequency component” of monetary growth and inflation, is reasonable to raise questions over the resolve of the ECB to rein in the M3 overshooting.

### **Concluding remarks**

A wide-shared consensus on the causes of summer 2007 financial turbulence is that three factors have played a major role: the complexity of some of the instruments put in place by the financial system, errors in mathematical models, and the role of rating agencies.

At a closer scrutiny, however, Walter Munchau suggests that central banks’ accommodative policy must be questioned as “the explosive growth in credit derivatives and collateralised debt obligations between 2004 and 2006 was caused by global monetary policy between 2002 and 2004” ( 2007:9).

This paper goes in a similar direction. By drawing attention on M3 overshooting, the paper finds that the ECB accommodative monetary policy has some responsibility in the build-up of excess of liquidity. In Europe, though justified by a fitful economic growth, euro policymakers have been too slow in interest rate increase, and have shown uncertainty over mopping up the excess of liquidity they have contributed to generate. In the present circumstances of credit restraint euro policymakers are facing three alternatives, each conveying risks for eurozone monetary condition.

### Box 1. ECB's in alternatives

- If the bank eases monetary policy and cuts rate, as did the US Fed on September 18, the move would be inconsistent with ECB assessment of monetary analysis (ECB MB July, October 2007). It will make the ECB accountable for dumping M3, while adding to risks of inflation beyond 2 percent target, and likely furthering credit bubble.
- If the bank keeps on a “wait and see” posture, as it did in the last three monetary sessions on the ground of pending credit crunch, the bank will face further delay on mopping up excess liquidity, rising risk of higher inflation rates in the near future.
- If the bank abides by its monetary path initiated on December 2005, and rises interest rate, it will act appropriately slowing M3 and countering inflation. The move could add to risks of economic slowdown as projected by the European Commission and others International Institutions.

Though the latter case is mostly expected for the bank's pledge to crack down on creeping inflationary pressure and M3 excessive growth, this could hardly be the real case. By keeping interest rate to go up would add to an appreciation of the euro against the dollar, so exposing the bank to politicians bullying intervention in exchange rate markets. All things considered, policymakers in Frankfurt could continue to prefer neglecting M3 overshooting leaving on hold or even cutting rates, than facing politicians intrusion on exchange rate policy. The move could gain the bank retaining independence over euro exchange rate policy countering euro politicians pressures, though at an inflated price. Leaving money supply to grow over target could add to a jump in inflation, which will end to damage the bank's anti-inflationary credibility. If a battle of dominance between the bank and eurozone politicians were to kick off, the bank is likely to swerve first from its path, ending to play chicken in the game.

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