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Global liquidity glut: problem or growth driver?

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Abstract

Following the bursting of the stock market bubble, central banks in the major industrial countries massively loosened monetary policy, ratcheting key interest rates down to their lowest level in 40 years in some instances. This subsequently spawned a correspondingly steep rise in liquidity around the globe. The liquidity supply got way ahead of nominal economic output, resulting in a liquidity overhang which could have an inflationary impact or give rise to further bubbles on the asset markets (bonds and/or real estate markets). Alongside the traditional credit channel, excess liquidity was also fueled by the interventions of Asian monetary authorities in the currency markets. The pronounced tendency to prop up one's own currency against the dollar has countervailed a reduction in global imbalances – as evidenced first and foremost by the persistence of the US current account deficit.

The global trend in liquidity has contributed to a series of unusual constellations on the financial markets and in the monetary economy. Among these are the fact that, stateside, long-term interest rates have barely reacted to the Fed's tightening while the euro area has seen a sharp drop in the velocity of money in conjunction with unusually low long-term rates. To some extent at least, monetary policy of recent years is likely to have contributed to these aberrations, particularly as low key rates have paved the way for extensive carry trades.

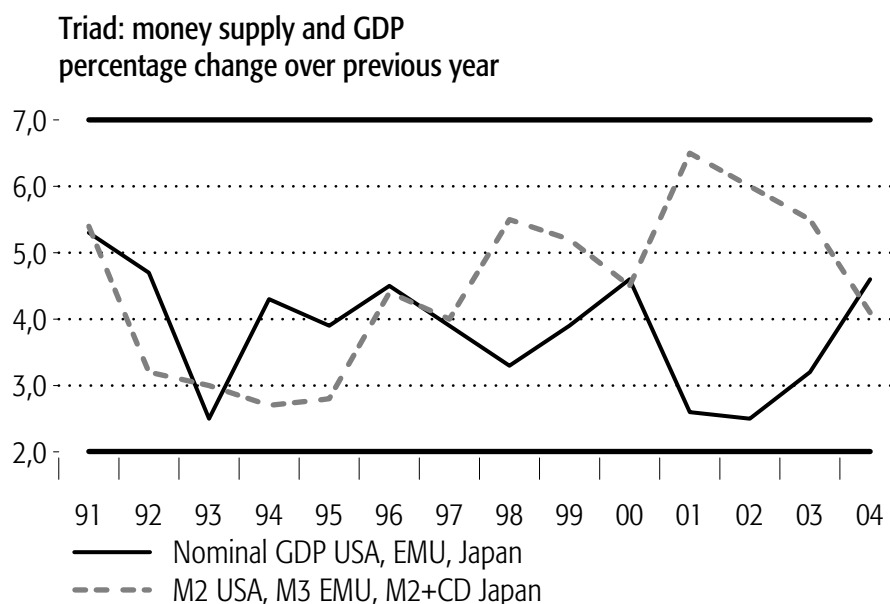
The extent to which the current liquidity overhang represents an inflation risk will hinge on whether self-reinforcing wage-price spirals emerge. However, given the ongoing impact of globalization, which severely restricts the wage scope of both suppliers of labor and of companies operating on the global stage, this risk is not pronounced compared with the 1970s. Even a surge in commodity prices is unlikely to be sufficient to trigger such an outcome.

As for the question what conclusions monetary policy should draw from liquidity growth, we ultimately have to rely on theoretical notions of how monetary policy works. There is much to suggest that the monetary impulses of recent years will feed through into the real economy, as we have already seen in the USA. For this reason, the tightening of monetary policy in America is logical and a rate cut by the European Central Bank unlikely. From a conceptional angle, the sharp price changes on asset markets, driven not least by interest rates and liquidity, argue for a longer-term orientation of monetary policy. Shifts in asset prices simply cannot be encompassed with short-term explicit inflation targets. Moreover, recent years have highlighted the importance of credit growth for monetary policy.

1. Development in liquidity

There are various ways of measuring excess liquidity. A large number of approaches exist on money and price gaps. But we can get to the heart of the matter by using, for the sake of simplicity, the quantity equation (also known as the equation of exchange) in its dynamized version. Setting aside trend changes in the velocity of money circulation, monetary expansion should roughly equal

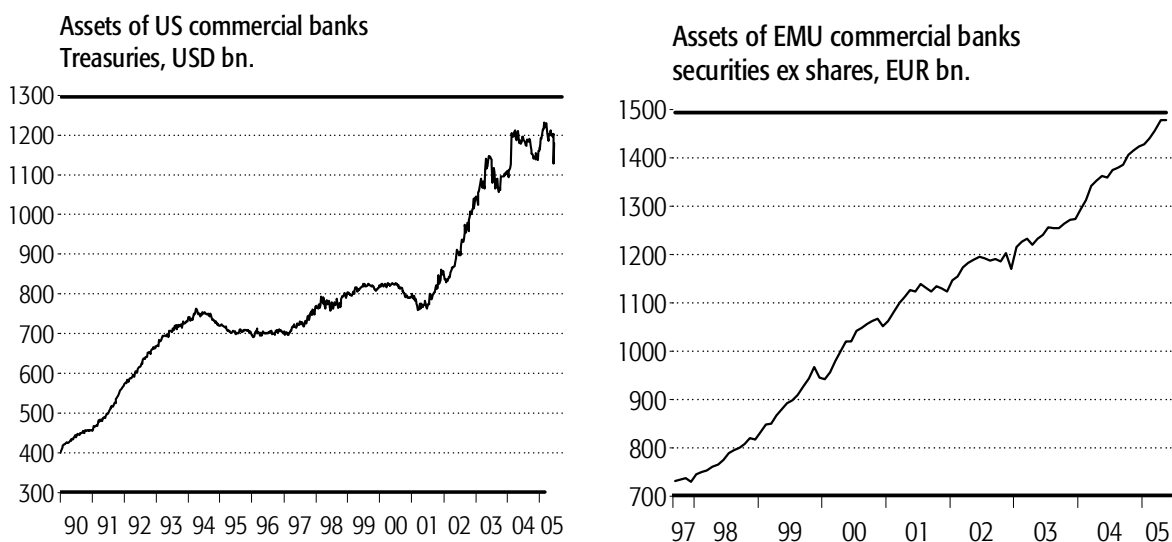
real potential macroeconomic growth plus price increases. If this is not the case a liquidity surplus arises – when money supply expands faster than nominal aggregate output – or a liquidity deficit when the opposite occurs. The adjoining chart shows that after 2000 monetary expansion and the increase in nominal gross domestic product drifted apart globally. Although the gap closed again last year, i.e. there was no further increase in excess global liquidity, for liquidity to be run down monetary growth would need to be less than the rise in nominal GDP for some time. Before discussing in the following how liquidity can be reduced, we must first clearly understand how it actually arises in the first place.



2. Sources of liquidity

Liquidity can be taken as synonymous with the customary monetary aggregates, which in turn are broadly defined as corresponding to certain deposits by the domestic non-bank sector with commercial banks. Money supply thus arises chiefly as a result of monetary transactions between the domestic non-bank sector and other sectors. The traditional source of monetary creation is the credit channel. Banks extend loans to domestic companies and households, which use it to make transactions that ultimately flow back into the banking sector as deposits. The banking sector itself refinances its operations at the central bank. Another way of creating liquidity is the “bond channel”, through which the domestic banking sector purchases securities from the non-bank sector. Again, the corresponding counterpart is a deposit with the banking sector itself. Even if foreign investors are net purchasers of securities from the domestic non-bank sector, the result is the same. A good illustration of this is the interventions on the foreign exchange markets by Asian economies in recent years. In the course of these transactions, too, securities are purchased from the national non-bank sector, pushing up deposits by this sector with the local banking sector.

And indeed, analysis of the counterparts to the development in money supply shows that transactions outside the credit channel have also played a significant part in the generation of liquidity in the United States and the euro area.



The commercial banking sector in the US ratcheted up the volumes of government securities held between 2000 and 2004 by around USD 400bn to USD 1,200bn; in the euro area debt securities (excluding shares) were increased by almost EUR 480bn to upwards of EUR 1,400bn. The main reason why this way of creating money, dubbed the “bond channel”, has become so important in the past few years lies in the coincidence of rather sluggish economic development with low central bank interest rates. While demand for credit is comparatively slack, the banking sector’s refinancing possibilities are good. This makes “carry trades” (in which loans are raised with the central bank on favorable terms and used to purchase higher-yielding bonds) an attractive way for banks to make a profit on maturity spreads.

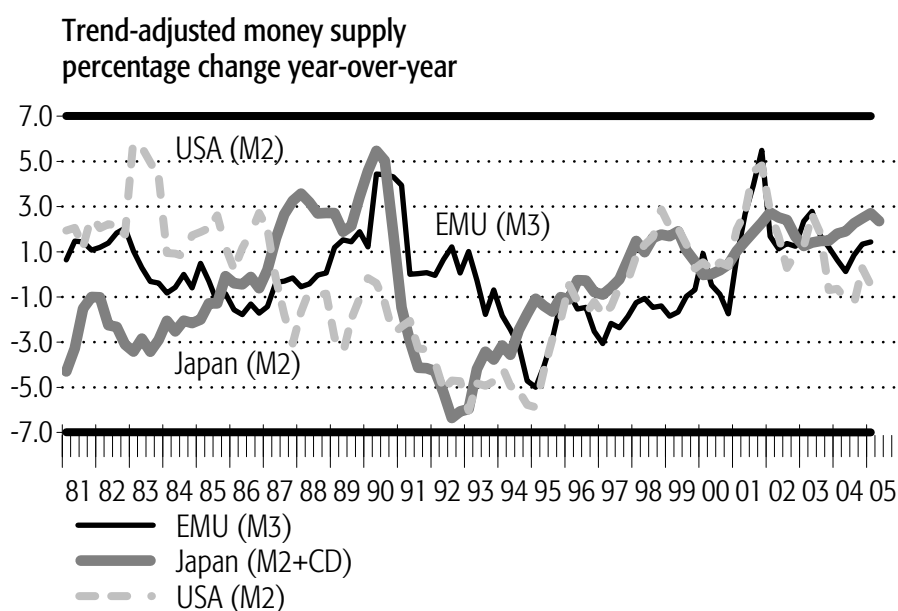
Foreign investors also fueled the supply of liquidity to the domestic non-bank sector. The value of US Treasuries held by other countries during the same period doubled to almost USD 1,200bn (by an annual average of around USD 120bn). Whereas net external assets in the euro area dropped in 2000 and 2001, they subsequently registered a sharp jump by an average of more than EUR 100bn per year.

This notwithstanding, commercial bank lending still represents the most important liquidity creation channel in quantitative terms. Lendings by US commercial banks in the period 2000 to 2004 soared by altogether USD 1,500bn to USD 6,750bn. In the European Monetary Union lending to the private sector by monetary financial institutions (MFI) climbed from roughly EUR 6,200bn end-1999 to not quite EUR 8,700bn at the end of last year.

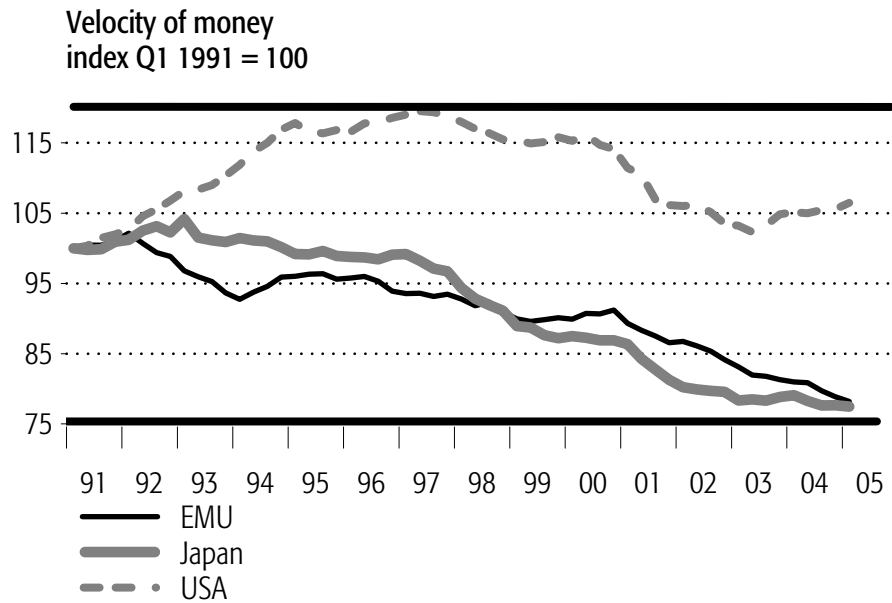
3. In what respect are latter-year developments unusual?

The first striking fact is, of course, that in terms of the definitions deemed central by the respective national authorities, monetary growth in the past four years was stronger than the customary trend. This contrasts particularly starkly with experience during and after the downswing in the early 1990s (1990/91 in the US, 1992/93 in Europe), when the increase in liquidity fell well short of trend growth.

Unlike the past, in the 2000/2001 downswing and the initial stages of the subsequent recovery no cap was put on the supply of liquidity, and hence also on the potential for future inflation. On the contrary, it was precisely the Federal Reserve in 2003 that conducted quite an intensive debate on the danger of deflation and possible liquidity-boosting measures to counteract this.



At the same time, however, nominal economic growth lagged liquidity supply, which was reflected in purely arithmetical terms in what was in some cases a marked deceleration in the velocity of money (expressed as nominal GDP divided by the quantity of money). Now for the euro area at least, deceleration in the velocity of money is the rule rather than the exception. The ECB, for example, calculates on trend deceleration of 0.5 to 1 % a year in the velocity of money. In point of fact, though, money circulation velocity has fallen since 2001 by well over 1 % per annum.



This pronounced slowing phenomenon (determined by analogy with the quantity equation as a non-observable residual amount) is currently being examined for the euro area with reference to the following aspects in particular: How come monetary growth has been strong since 2001 without the emergence so far of corresponding upward price pressures? Can a distinction be made between monetary movements of relevance to inflation and movements that do not jeopardize price stability?

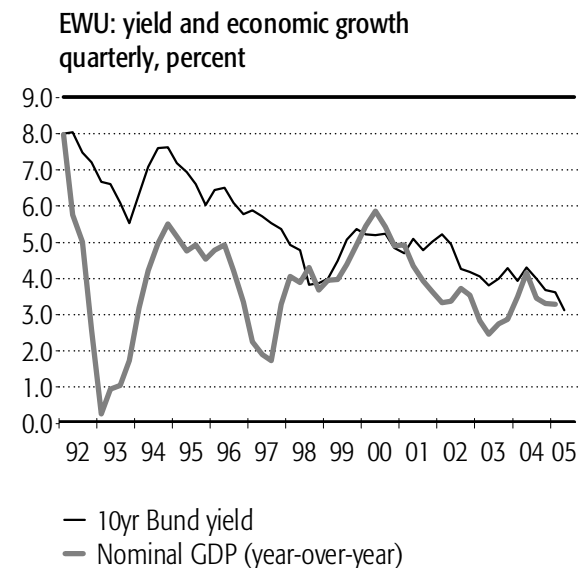
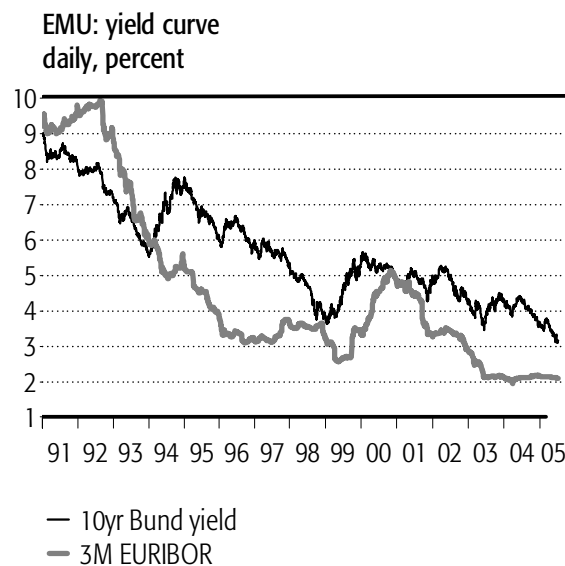
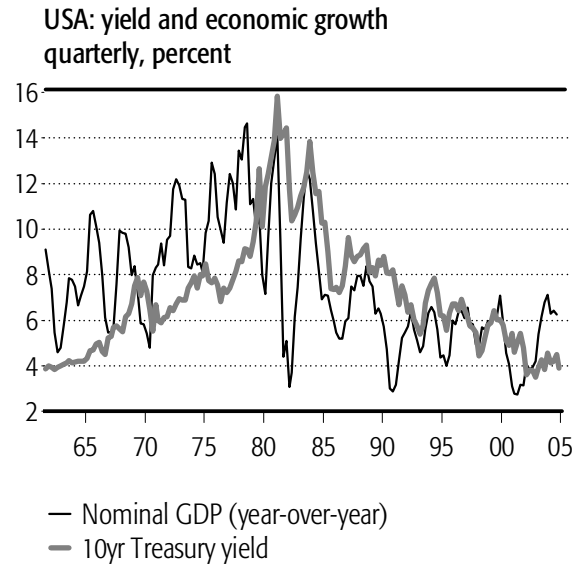
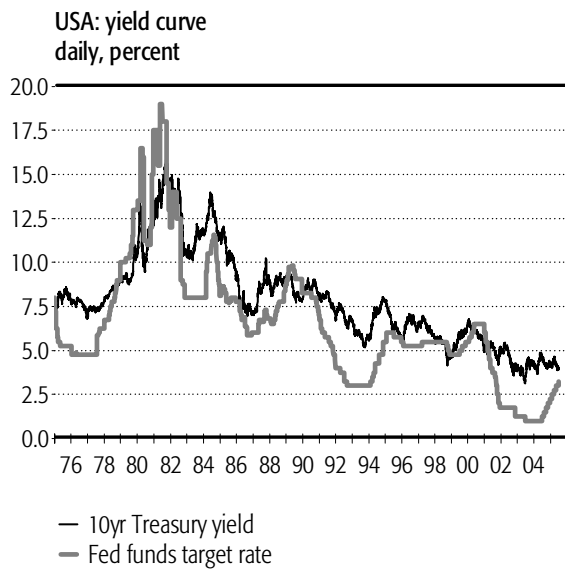
Some studies use empirical filter methods to fade out short-term fluctuations or disturbances in monetary development. Neumann and Greiber (2004), for instance, calculate the core component of monetary growth, or “core money”, i.e. the share of the trend component of nominal monetary growth that exceeds the trend component of real development in money demand. As the Bundesbank also writes in its January 2005 monthly report, the core money time series replicates the trend inflation rate in the euro area very well over most of the observation period. This empirical co-movement has no longer been given in recent years, however, possibly partly because filters run into data problems at the current margin. A key finding of Neumann and Greiber’s work, though, is that short to medium-range fluctuations in monetary growth with a cycle of up to about eight years are not significant to the development in inflation. Certainly, in their latest joint diagnosis the economic research institutes do arrive at a result suggesting that slightly shorter monetary growth cycles of four to five years may also have consequences for price increases, but basically the core money concept is underpinned. So if the strong monetary expansion that has taken place since 2001 self-corrects in the near future with a counter-movement, latter-year core money rates may in retrospect prove lower than currently stated. That would make the present exceptional deviation from the rates of inflation turn out to be less, or indeed disappear entirely.

But it is also quite conceivable that longer-lasting structural changes have taken place which the core money concept is unable to accommodate or which are having the effect of distorting core money upwards. The European Central Bank has, indeed, identified extraordinary portfolio shifts,

caused by heightened economic, financial and geopolitical uncertainty after the stock market crash in 2001 and the September 11 terrorist attacks. Up to 2003 the domestic non-bank sector switched funds previously invested in longer-term securities into safe, liquid investments, which inflated the M3 measure of money supply. On the counterparty side, the ECB concludes that it was less the domestic banking sector which bought these securities, but that ultimately most of the transactions were with non-euro area residents (foreign investors). Referring back to the sources of liquidity discussed, this means that of the M3 counterparts neither loans nor the banking sector's longer-term liabilities were instrumental, but that net external assets were most significantly at play. In addition to the official monetary data, in its October 2004 monthly bulletin the ECB presented an M3 time series adjusted by the estimated effect of portfolio shifts. This was prompted by the consideration that the part of money holdings extracted will presumably have no effect on demand anyway, and consequently no inflationary implications.

The conclusion from the above comments on core money and on the money stock stripped of uncertainty-related portfolio shifts is that there are good reasons why the marked rise in money holdings in recent years and the deceleration in the velocity of money may not entail such great risks to price stability as suggested by the official M3 data and the measures of excess liquidity deduced from them. For one thing, the correlation between monetary growth and price developments is longer-term in nature: Judging by the quoted cycle lengths of four, five or even eight years as from which the correlation is statistically underpinned, the expansion in M3 observed since 2001 need not necessarily culminate in a corresponding price surge. For another, the special effect of portfolio shifts does not compellingly point to added inflationary potential. Consequently, it may well be better to calculate core money with the adjusted rather than the official M3 time series. Whilst all this may offer a measure of reassurance, the unusual constellation in the euro area nonetheless still leaves a certain sense of unease, because ultimately there is no saying for certain in "real time" whether the monetary development with which we are faced at present is not really a harbinger of inflationary tendencies. Only if it were to raise the multi-year monetary growth trend would cause for concern indeed exist.

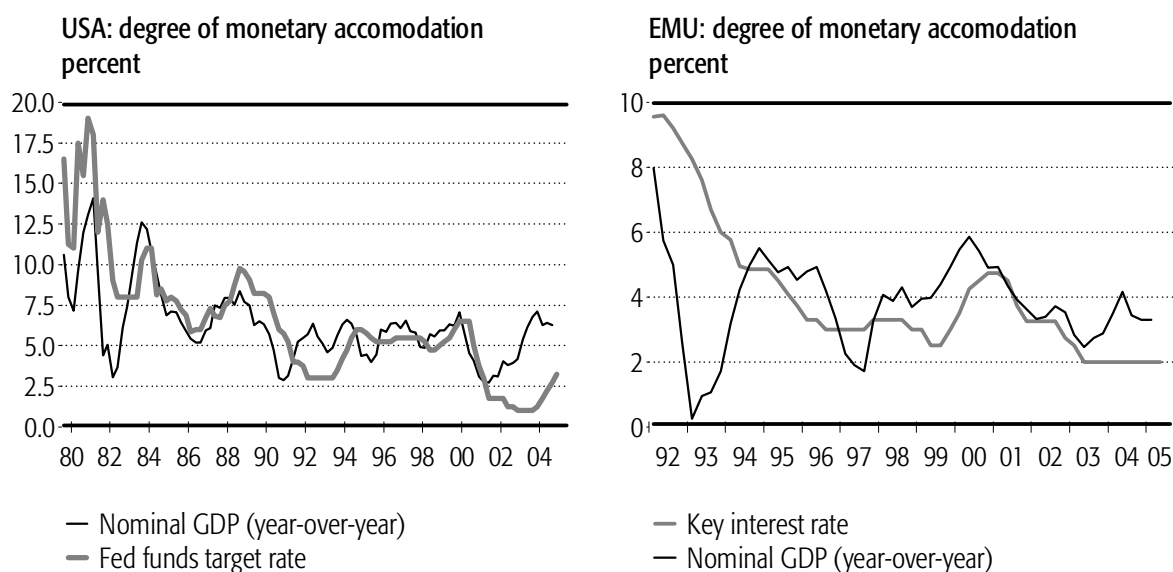
Turning to the US in contrast, at first sight it is less the increase in liquidity that appears really exceptional than the shape of the yield curve. On the one hand the term structure of interest rates, measured as the difference between ten-year government bonds and the Fed Funds Target Rate, has been particularly steep in the past few years. Yet on the other hand, since the beginning of 2002 long-term interest rates have been persistently below the rate of growth in nominal GDP – a situation last seen in the late 1970s (although before that this had tended to be the rule and not the exception).



Fed Chairman Alan Greenspan described this situation on the fixed-income market at the beginning of the year as a conundrum. He said that spreads, read from the maturity and risk premiums on corporate bonds, for example, were currently understated. This is particularly surprising in that the Federal Reserve itself argued very strongly with the expectations theory of interest rates in the context of the deflation debate in 2002 and 2003. According to this hypothesis, the long-term interest rate is formed as the expectation value of future key interest rates plus a risk premium. Following this approach, a pronounced period of low key rates should therefore also depress yield levels perceptibly in the medium term. With regard to the steepness of the term structure of interest rates in recent years, the picture for the euro area was similar to that in the United States; but the yield curve at the current margin on this side of the Atlantic does not exhibit the marked flattening found stateside owing to the Fed's rate hikes. Although the EMU yield level is not significantly below the rate of nominal GDP growth, relative to the explanatory patterns valid in the past 30 years it is at least equally as exceptionally low as in the US.

4. Is monetary policy responsible for the unusual constellation?

Key interest rates have an anchor function for the financial markets that should not be underestimated. De facto they form the price floor for the profitability of any financial and capital investment. As already mentioned, the expectations theory of interest rates assumes that the yield on a fixed-income security equals the total of expected key rates to maturity plus a risk premium. In turn, the yield on longer-term government bonds is frequently used in simple valuation approaches, like Gordon valuation, as a benchmark for other types of investment such as shares.



When setting the central interest rate there is no really objective benchmark that can be calculated in “real time”. Central banks are always obliged to act in relative ignorance of the economic fundamentals. As a rule of thumb, however, we can deduce from neoclassical or neo-Austrian growth theory that a “neutral” interest rate, as the politically set, risk-free price of capital, is roughly equivalent to the rate of growth in nominal gross domestic product. In the neoclassical model this follows from the golden rule of capital accumulation, according to which an economy whose potential growth rate is restricted by the increase in the real capital stock achieves its optimum (equilibrium) growth path when the marginal product of capital and interest rate coincide. In neo-Austrian growth theory, on the other hand, an economy is on the optimum (= intertemporally welfare-maximizing) growth path when the returns from “roundabout” production, i.e. building up the capital stock by abstaining from consumption, are consistent with society’s time preference rate.

Both approaches must, of course, be viewed critically for valuation in that they operate without a monetary policy authority that has a de facto monopoly on interest rate setting and do not therefore determine a neutral key interest rate. But we can deduce quite clearly from the previous two charts and from theory that key interest rate levels since 2002 (USA) and 2003 (euro area) have been extremely low, both historically and relative to the macroeconomic environment. For the euro area

this is true on an aggregated basis at least, although certainly not to the same extent in all member states. By making “cheap” liquidity available, monetary policy has thus undoubtedly encouraged its expansion. Whereas the US central bank last year began reining in its stimuli, the ECB will probably not alter its monetary stance before the end of this year at least. As we saw earlier, no further liquidity was built up in the triad last year, but the question remains as to the effects of the excess liquidity still available.

5. How can liquidity be worked off?

In principle, various channels are conceivable through which liquidity can “disappear”, whereby this is then reflected in different ways (see ECB Monthly Bulletin October 2003; ECB Annual Report 2004):

1. A structural break in money demand cannot be ruled out so far. This would mean that the increased preference for liquid investments was permanent rather than temporary (structurally higher risk aversion following the stock market collapse). In this case the precautionary positions built up would not be converted into transaction balances. In other words, the excess liquidity would be manifested in permanently higher money holdings of no relevance to inflation.
2. The ideal situation would be for real economic growth to absorb the excess liquidity inflation-free. The prospects of this happening are good as long as existing capacities are under-utilized. Where this is no longer the case, it depends how the liquidity affects demand. If channeled mainly into consumption, it is more likely to unfold inflationary effects than if used for investment, given that the latter can increase capacities and inflation-free economic growth.
3. Another possibility would be higher nominal GDP growth as the result of a sharp pick-up in the rate of price rises. Section 6 below discusses how probable such an inflation scenario looks from the present position and the extent to which globalization, as a fairly recent development, overrides or masks earlier mechanisms.
4. Finally, the excess liquidity may not be reflected primarily in prices for goods and services at all; instead, slowing monetary growth may be associated with massive share or bond price surges. A bull run on the real estate market would also be possible, although this would probably not have the effect of reducing the excess liquidity, since transactions there take place mainly within the domestic non-bank sector, which does not influence the money stock.

With regard to this fourth point, attention is currently focusing on the bond market, as already elucidated in Section 3. Why have long-term interest rates apparently not reacted at all to the roll-out of a tighter monetary stance in the US – more or less contradicting the expectations theory of interest rates – and why are they continuing to fall in the euro area? Partly, but not exclusively responsible for this, in our opinion, is that the liquidity has “spilled over” into another market. That overly expansive monetary policy, through the expectations channel, and the possibility of carry trades (with market participants borrowing short-term funds on favorable terms and using them to buy government bonds, real estate, commodities etc.) have freed up large amounts of speculative

capital, sharply driving up prices on extremely illiquid markets in some cases, is just one aspect. There is a raft of other relatively logical interpretation patterns:

1. Foreign investors – and in particular the accumulation of currency reserves by Asian central banks in past years – are keeping yield levels down. The Fed estimates that in the recent past this effect has depressed US yields by around 50 basis points. Since we know relatively little about the reserve and accumulation structure, theoretically it would be conceivable both that part of the build-up was made directly in euros or that the pressure on yields has spilt over onto the European markets through the international transmission mechanism. For the United States, this effect would persist only as long as the greenback stays under devaluation pressure. But for the European markets it could prove a relatively permanent phenomenon if the euro establishes itself as a secure investment alternative to the US dollar. So far the euro has gained importance chiefly in its function as an issuing currency for non-EU countries; indeed, in this segment it has already overtaken the greenback. But it is quite a likely scenario that it will grow all the more attractive as an investment currency, the deeper and more liquid the relevant market becomes.

2. Currently there is a global savings glut. The theory propagated in particular by Ben Bernanke, the new chairman of the US Council of Economic Advisers, is based on two main elements. First, some industrial countries do not have sufficient domestic investment possibilities, and this is driving up the amount of surplus cash in the private sector. The euro area and Japan in particular are registering a substantial surplus of private-sector income over expenditure. Second, the emerging markets have moved from being a net absorber to a net supplier on the international capital markets. Excessive savings and the accumulation of currency reserves are a reaction by the emerging markets to the crisis on their financial markets at the end of the 1990s, but their current account surplus stems from an export-based strategy employing low exchange rates.

So if, for a variety of reasons, there is more desired saving than desired investment worldwide, it is plausible for yields on the global capital markets to move steadily downwards. Even high public-sector deficits and America's huge current account deficit can be financed without any interest rate increases of note.

3. Altered framework conditions for institutional investors – notably greater asset-liability matching in retirement pension products – are generating particularly strong demand for long-range investments with yield levels that are perceived as secure. While asset holdings are being restructured, the pressure on the long end of the yield curve is especially high. Some of this could even become a permanent fixture if not compensated entirely over time by altered issuer behavior. However, since demand can presumably react more quickly than supply in respect of maturity patterns, many signs point to a phase shift over several years at least, in which yields may remain low.
4. The yields reflect low growth and rate expectations in the long run. The latter-year cyclical rebound is not considered durable, which in turn would justify low levels on a long-term time horizon.

5. The low long-term interest rate levels (particularly relative to nominal GDP growth) constitute a very pronounced deviation primarily from the past three decades. But they are not so exceptional in the bigger historical picture. Current developments could therefore mark a return to normality and hence become a permanent feature, particularly since monetary policy no longer has combating inflation as its sole bias, with deviations from an explicitly formulated or implicitly given inflation target being weighted more symmetrically.

So there are a number of consistent lines of argument to explain the low yields. But whether they hold the key to unraveling the yield conundrum is still an open question. At any rate, these hypotheses would collapse if inflationary tendencies were to resurface. In the following we therefore consider whether globalization can offer protection from monetary inflation.

6. Does globalization offer protection from monetary inflation?

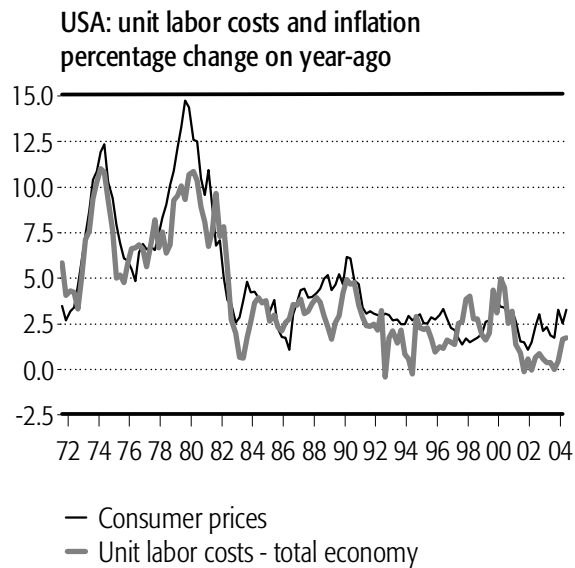
It is old economic hat that the transmission of monetary stimuli to the real economy and price levels is extremely complex. Economic schools of thought have therefore deliberately treated transmission as a “black box”. But how do sea-changes in the world economy such as globalization impact these causal linkages? It is hardly speculative to presume earlier patterns of experience might be suspended or at least masked. In the following we discuss the theory that globalization, through its impact on labor markets in the industrial countries, affords sustained protection against inflation on goods markets in the event of over-abundant money supply (see, for example, Alan Greenspan: Globalization and innovation, conference on bank structure and competition Chicago, May 6, 2004).

Nowadays companies take great advantage of the possibility of outsourcing their production to the lowest-cost locations. Higher wage demands at home can therefore be met with the threat of further relocation of production facilities. Added to which, labor – and not just capital – is becoming increasingly mobile, as highlighted all too clearly by the heated debate on the EU services directive and minimum wages.

All in all, in the course of this process securing jobs in company-level and industry-level collective agreements between employers and employees has moved much more strongly to the forefront of attention in recent years. Even at times of economic pick-up or rising raw material prices, the upward pressure on wages in the big industrial nations America, the EU and Japan has not accelerated significantly. In Japan wage trends have lagged way behind productivity gains for years, and Germany is now starting to see a similar tendency. In practically all the bigger industrial countries the rate of increase in the wage bill has tended to fall short of GDP growth.

Of course we cannot make direct assumptions on the medium-range wage trend from present developments. In economies with a comfortable employment situation the upward drift in wages could by all means start to gather pace. But matters look different in Europe. Eastward enlargement of the EU and the comparatively unfavorable labor market situation, particularly in

Germany, flag little more than a stagnating trend in unit labor costs for the coming three to five years.



From a macroeconomic point of view wages represent the major cost component. Just how strongly can sales prices climb if labor costs per unit of production do not change? Assuming that all non-financial corporations in Germany succeeded in substantially widening their domestic profit margins by selling their domestic output at 3 % higher prices each year over a five-year period, even though no change took place in labor costs or the volume of production, after five years these companies would have 56 % higher net operating income. However, in a stagnating economy with steady costs a profit leap of this magnitude seems extremely improbable, particularly given the intense competition on goods markets. Realistically, the pace of price increases, if any, would likely be extremely low. We can therefore conclude that in the absence of hefty pay increases there need be no fear of persistent inflationary processes on the goods markets.

Given the impact of globalization, is it difficult to find reasons for a sustained acceleration in the upward drift in wages? By our reckoning it would take extreme stimuli to override or, indeed, overcompensate the damping effect on wage trends of the global abundance of labor:

- A surge in raw material prices, pushing up import prices in its wake, could be one such stimulus prompting insistent demands for a cost-of-living adjustment in collective wage bargaining. In our opinion, though, import price increases would have to be in the double digits for this to happen. Given the strength of the euro, the recent leap in energy prices has driven up the level of German import prices by only about 3 to 4 % year-on-year, which in turn has fed through to consumer price rises by an estimated ½ percentage point. That has not been enough to trigger secondary effects in wage formation.

But a different situation could arise if a continued boom in the emerging markets were, first, to unleash further powerful price hikes in raw materials and, second, give rise to a generally inflationary environment in the emerging markets. Many Asian and oil-producing countries'

peg to the dollar considerably narrows their margin of maneuver on economic policy. High inflows of liquidity make measures to douse economic activity very difficult to enforce. Whereas only a few years ago debate raged over Chinese “exports of deflation”, the most important emerging markets economy in the world is now registering moderate upward price pressures. Meanwhile, in the oil-exporting Gulf states there is talk of the economic challenge posed by inflationary tendencies. Assuming the emerging markets failed to get a grip on the problem of over-abundant liquidity, and the prices of the goods they produce for both the domestic and export markets were to soar, this, in conjunction with climbing commodity prices, would seriously lift import prices for the industrial nations. That might trigger moves to secure cost-of-living adjustments in pay settlements, setting a wage-price spiral in motion.

But that is not a particularly likely scenario. Improved public finances in the emerging markets argue against a sustained acceleration in inflation there. Big emerging markets such as Russia and Brazil may not have their finances cut and dried, but neither are they still teetering on the brink. Whereas high budget deficits in the 1980s and 90s were often financed simply by printing money, that is now the exception. At present the emerging markets do not constitute a destabilizing factor in the world economy. On the whole, it can be said that external stimuli are hardly likely to provoke a marked quickening of the upward drift in wages in the industrial countries.

- A sudden demand push could create powerful impetus to wage formation. Given the caution with which European consumers and investors are behaving, however, this does not look very likely at present, although a fundamental mood swing cannot be ruled out. The powerful surplus liquidity that has accumulated in the past four years would give consumers and investors alike the possibility of substantially ratcheting up their demand. But even then, in view of the jobs situation and ever more flexible labor supply, wages would be very unlikely to gather pace significantly in the short term; dangers would exist only in the medium run.

The assessment deduced here from the wage and cost side that an inflationary process will not necessarily follow in the train of excess liquidity certainly dovetails with monetary analyses of the role of growth in the money stock as an indicator of the development in euro-area inflation. In the empirical study already mentioned, M.J.M. Neumann and C. Greiber (2004) concluded that short and medium-range fluctuations in monetary growth with a cycle of up to around eight years were not significant in terms of the development in inflation. A stable correlation between inflation and money supply exists only for long-range cycles of monetary growth. These findings on the absence of inflationary implications from short- and medium-term periods of excess liquidity can certainly be explained by the enormous damper that globalization puts on wages.

7. Deflation risks higher than inflation risks?

Excess liquidity in an economy does not therefore necessarily lead to higher goods price inflation in the short and medium term. This phenomenon, which we are seeing in the euro area, does not, of course, tell us anything about other channels through which over-abundant liquidity works. Brimming money supply may seek asset markets as a means of letting off steam. Shares, bonds or real estate become overvalued as a result. In itself this would not be a problem, were it not for the fact that such bubbles can burst, leaving massive skid marks in the real economy in the process. The fallout from aberrations of this kind is particularly serious where general euphoria over the assets has caused excess sectoral capacities to be built up that subsequently have to be run down in a drawn-out structural shakeout. The collapse in prices on the international stock markets at the beginning of this decade is the most striking example of the bursting of an asset price bubble. In its wake the possibility was even mooted of deflationary risks building up. Does too much money therefore lead to deflation? Fortunately the fears at that time proved unfounded and the global economy fell into step again.

Nonetheless, recently debate on the economic risks of asset bubbles has flared up again – this time in the context of real estate markets. The European Central Bank is evidently observing the massive escalation in prices on some European property markets with mounting concern, as increasingly expensive properties are being financed largely through additional borrowing. There could be trouble in store here. In a worst-case scenario an abrupt collapse in inflated property prices could impair investors' financial situations, drive up loan defaults and dent macroeconomic development. The example of the over-priced Japanese real estate market in the early 1990s demonstrates that events of this kind can trigger deflationary tendencies. Crucial at that time was the additional deep crisis on the financial markets, necessitating years of consolidation for banks and companies.

However, the euro area is definitely not facing dangers like this on a Japanese scale at present. Although our estimate approaches do reveal overpricing on the property markets in Spain and France, for example, the limited extent of overvaluation is hardly likely to culminate in a protracted period of economic weakness, even in the event of an abrupt correction. Most importantly, even though construction activity is at its highest level for the past 20 years, it is not yet evident at the moment that such substantial excess construction capacities have been built up as to plunge the industry into a structural crisis.

We therefore consider the economic risk very low of deflationary tendencies arising in the euro area from any bubbles on the asset markets. This does not mean that, conversely, there are no deflationary risks in the euro area. Deflationary tendencies can also surface in economies that slip into a crisis of confidence without there being any form of mispricing on the asset markets. Among the nations of Europe, the German economy is closer to deflationary trends than others. Faced with persistent consumer and investor restraint, it does at least run a risk of sustained economic stagnation. But even in Germany, macroeconomic framework conditions such as the corporate

financial situation are on the mend, as a result of which a downward spiral in domestic demand ultimately descending into deflation is not in sight.

8. Monetary policy and international imbalances

A key question when analyzing international monetary policy is its contribution to the high balances in trade and on capital account in recent years. That these “global imbalances” pose a risk to the global financial markets and to the US dollar, as the world currency, will hardly be disputed. They are reflected in the relentless rise in America’s current account deficit which has reached alarming proportions.

The current account is expected to close in 2005 with a shortfall of around USD 760bn, i.e. the American economy is consuming and investing some 6.2 % more in goods than are produced in the United States. To finance this deficit, America has to import capital of more than USD 2bn a day. In the past few months slightly more of its borrowing requirements have been satisfied by private investors, but over the past one to two years most of the necessary funds have been provided by foreign central banks.



Even if the responsibility for its high current account deficit does not rest with America alone, the monetary and financial policy it has pursued in recent years is one of the main explanatory factors. The swingeing interest rate cuts that began in 2000 and the reversal in fiscal policy to higher deficits have considerably pushed up domestic absorption stateside. From a technical market perspective the swelling current account deficit and the inflows of capital needed to finance this should, if anything, have tended to weaken the dollar; however high interventions by Asian central banks have checked the decline in the greenback.

Objectively, there is no gainsaying American politicians and central bank officials when they hasten to point out that a total reversal has come about in capital transactions with the emerging markets

in particular and that the US is mopping up this surplus supply of capital. The change of direction in the emerging markets' capital flows was caused by a change of policies in many countries. After the crises of the 1990s debt retrenchment and the buildup of currency reserves were given high priority. Viewed in isolation such policies are by all means desirable and help stabilize global financial markets. Export surpluses only turn into a problem when they are generated by keeping the currency artificially low and thus also bloat the global supply of money. This judgment arguably applies to many Asian countries that have piled up massive currency holdings in the past few years. They should be called on to play their part in removing the imbalances by correcting their interest rate policies and permitting their currencies to appreciate somewhat.

The European monetary authorities, however, did not set their face against appreciation of the euro versus the US dollar by intervening on the foreign exchange markets. With hindsight, this policy must be acknowledged as sensible. By and large, Europe's current account is balanced with other regions, i.e. a similar amount of capital is exported as is imported, and the euro has eased back against the dollar without intervention.

So what can monetary and fiscal policy do to help shrink the US current account deficit? Apart from greater flexibility in Asian countries' exchange rate policies, responsibility presumably lies chiefly with America itself. The Europeans have largely exhausted their scope for monetary and fiscal expansiveness. Supply-side measures to stimulate growth are needed, but they take time to produce results. In the United States itself the central bank has reversed its policy in recent months, but fiscal policy continues to steer an expansive course. In terms of an optimum policy mix, slightly tighter fiscal policy with a rather more moderate – neutral – monetary bias would be preferable. The more the burden of adjustment is assigned to monetary policy alone, the greater the risk of the US dollar's gaining in value vis-à-vis other currencies as a result of interest rate hikes, thereby slowing external adjustment. Budget consolidation, on the other hand, would keep interest rates low, and with them the dollar, with the effect of more rapid adjustment in the current account.

9. Conclusion / Implications for monetary policy

In such a highly stratified environment, monetary policy is without doubt facing a tightrope walk. Arguments for a more restrictive monetary policy must be weighed against those for a more expansive line. Having weighed the differing trends, the ECB considers its present key rates appropriate. On the one hand, strong monetary and credit expansion in the euro area signals inflation risks in the medium term. Added to which, the escalation in real estate prices in some euro-area countries is a cause of concern and inflation is already running at 2 %. But plausible arguments also exist for a somewhat more expansive monetary approach with low interest rates: for example, the rather weak economic data in recent weeks, which are clouding sentiment among many EMU members. This year, euro-area growth is expected to be less than 1.5 %, and in the light of oil prices the risk of an economic downturn is greater than the chances of an upturn.

Weighing these pros and cons ultimately depends on the conception of the way monetary policy works. There is much to suggest that the monetary policy stimulus of recent years will gradually spread from the financial markets to the real economy, the crucial factor being that the abundant liquidity is meanwhile generating high demand and low returns on practically all financial markets. With yields on financial investments low, investors are increasingly turning to real estate markets. Once prices there are high and returns correspondingly meager, the stimulus will extend to real consumer and capital investment demand. In some European countries this chain reaction is already apparent, in others it will soon be the case. The way the US economy has developed over the past few years should also have dispelled doubts over the effectiveness of monetary policy. We should learn from the experience. EMU interest rates are already low, and there is no need for further easing.

But what fundamental conclusions should central banks draw from the links between liquidity and asset markets? For one thing, they should highlight possible asset bubbles clearly and at an early stage in their communications. This would allow them freedom to act at a later juncture. They could also achieve greater leeway by not committing themselves too stringently to an explicit numerical inflation target for a short time horizon. In general terms, the development of global asset markets has lengthened the relevant horizon for monetary policy measures. Finally, central banks should not only deploy monetary concepts to interpret asset prices, but should also keep an eye on credit growth as an additional source of information.