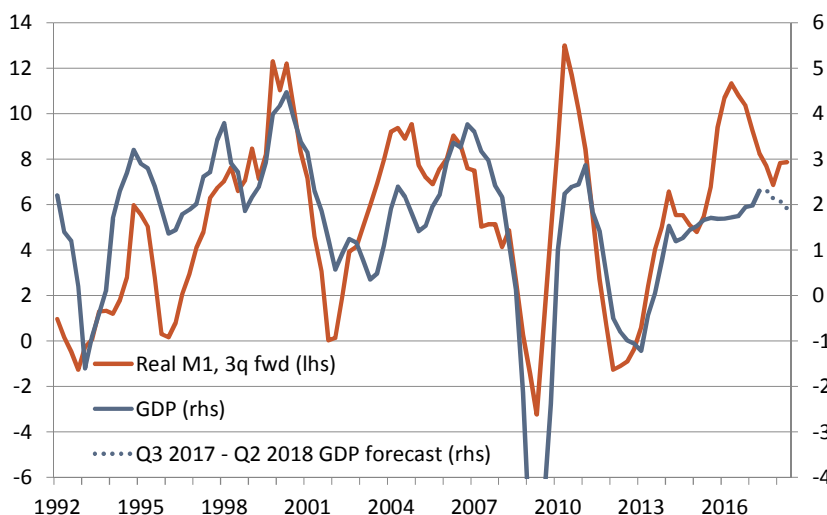


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13 October 2017

## The power of money: stable upswing ahead

Eurozone real M1 money supply and economic growth



Eurozone real M1, deflated by CPI, advanced by three quarters, Q3 2017: average of July and August; real GDP adjusted for 2015 spike in Irish GDP; yoy changes in %. Source: ECB, Berenberg calculations

- **Money matters:** Real M1 money supply has been our favourite leading indicator for the Eurozone business cycle for a long time. Major turning points in real M1 growth usually herald changes in GDP dynamics some three quarters in advance (see chart). For example, the rebound in real M1 growth after mid-2012 proclaimed the return to economic growth in spring 2013. The pace of real M1 gains increased sharply after the ECB eased monetary policy further in mid-2014 (negative deposit rate, long-term tenders followed by QE), and pointed to a firmer upswing from mid-2015.
- **Have money, will spend:** The link between money and economic activity works for a simple reason. M1 adds up cash and overnight bank deposits, that is the money which companies and households can use freely at any time they want to. If they have ample liquid reserves, they will eventually spend some of it.
- **Monetary dynamics in the age of caution:** Of course, the fit between money supply and GDP growth is not perfect. Real GDP fell by more in the Lehman crisis and recovered by less right afterwards than real M1 would have indicated. Grippled by fear, households and companies built up unusually high liquidity balances, hoarding more cash and spending less than usual. It thus took a much stronger monetary stimulus to elicit a significant demand response. While the monetary transmission mechanism still worked, it did so less effectively than in the past.
- **A more moderate expansion:** In a similar vein, the major acceleration of real M1 growth from mid-2014 onwards has so far shown up only partly in real GDP dynamics. Some of the liquidity which the European Central Bank (ECB) is injecting into the banking system via its asset purchases is finding its way into the liquid balances of households and companies. While households and companies have stepped up their spending, they have done so only modestly. At a low opportunity cost of holding liquid balances, they are hoarding some of the additional cash. Conversely, the slowdown in real M1 growth from a peak of 11.3% in Q3 2015 to a still strong 7.9% on average in July and August 2017 has not – or not yet – caused any loss of momentum in domestic demand.
- **Enough money to finance solid growth:** The monetary dynamics tell us three things about the future. First, after the strong gains in real M1 since early 2009, households and companies have ample liquidity to finance more spending. Second, as memories of the post-Lehman and the subsequent euro crises fade, households and companies may slowly become less cautious and use some of the additional liquid balances they have accumulated to consume or invest more. Third, the phasing out of ECB asset purchases over 9-12 months from January 2018 onwards is unlikely to dampen economic growth in any meaningful way – the liquidity cushions held by banks, households and companies are very ample.
- **We cannot rule out a positive surprise:** The small uptick in real M1 growth since early 2017 is particularly encouraging. Although it is too early to tell whether this marks a change in trend, it does project some upside risk to our forecast of a small loss in GDP growth momentum from an annualised rate of roughly 2.4% in the last three quarters to 1.9% in late 2017 and 2018.

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# Economics

## Chart of the week



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