

ACTIVITY 35**What's All This About the M's?**

The Federal Reserve and its monetary policies have been in the news to an unprecedented degree. A great deal of attention has focused on the rate at which the money supply grows because of the increased awareness that money growth influences inflation, unemployment, and output. By law the Fed is charged with targeting rates of money growth that promote price stability, full employment, and economic growth. The Fed's choice of target rates of growth for the money supply and its ability to achieve them are constantly analyzed and commented on by economists, elected officials, and the media, among others.

The Fed reports to Congress twice a year on its target rates for growth of money. In addition, representatives of the Federal Reserve System often testify before congressional committees on the difficulty of achieving monetary targets when the financial system is rapidly changing and on the ongoing problem of simultaneously reaching full employment and price stability. These occasions provide a regular public forum in which members of Congress examine policies pursued by the Fed.

While monetary policy is the subject of debates that occur in the limelight, the first steps in the formulation of policy may appear relatively mundane: the money supply must be defined and measured. Defining and measuring money is difficult because people hold money in a variety of forms.

A Perennial Political Problem

Throughout our history the public has linked the money supply to the economic well-being of our country. Questions concerning the money supply and the proper role of government in the financial system have from time to time dominated the political scene.

Before the Revolutionary War, many of the 13 colonies issued their own paper money despite intense political opposition both from domestic adversaries and the king of England. After the adoption of the Constitution, one of the first major political controversies faced by

Congress concerned the proper role of the federal government in the banking system. The debate focused on chartering the First Bank of the United States and its successor, the Second Bank of the United States, both of which exercised some of the functions of a central bank. The debate continued until the charter of the Second Bank expired in 1836.

In the 1870s the principal plank of the Greenback party platform called for an expansion of the money supply through an increase in the outstanding level of "greenbacks," that is, paper money. In the 1890s the money supply was again at the center of the political stage. The Populist party called for increasing the money supply through the "free and unlimited coinage of silver." The passage of the Federal Reserve Act in 1913, which created this nation's central bank, was preceded by a six-year debate. The controversy focused on preventing the kinds of financial "panics" that had severely tested the stability of banks and the monetary system from the Civil War through the panic of 1907.

Money Defined...

There is widespread agreement on a simple conceptual *definition* of money. However, the complexity of the real world prevents agreement on a single *measure* of money, and that causes some confusion. Conceptually, money is any item that is (1) widely accepted as a means of payment (a medium of exchange), and (2) used to transfer purchasing power from one period of time to the next (a store of value). Money performs other functions, but these are not crucial to the working definition of the M's. Problems arise in defining the measures of money because a variety of financial assets, from currency (and coin) to large certificates of deposit of \$100,000 or more, serve as both a medium of exchange and a store of value.

The Fed sets targets for the monetary aggregates, or M's, by grouping assets that the public uses in roughly similar ways. In defining these measures of money, the Fed draws somewhat arbitrary lines between groups of assets that

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can perform both the medium of exchange and store of value functions of money.

...And Measured

M1 is the narrowest definition and measure of the money supply. It contains only those assets that are used primarily for transactions, that is, as a medium of exchange—currency in the hands of the public and deposits in checking accounts. The payment of interest on some checking accounts is a fairly recent phenomenon and has changed the reasons people use and hold these accounts. With the payment of interest on some checking accounts, people have increased their use as a store of value. There are other assets that serve primarily as stores of value, but that can be converted into a medium of exchange with a minimum of inconvenience. These assets are included in broader measures of money.

M2 is one of the broader measures. In addition to the items in M1, M2 includes the amount in savings and small time deposits, including money market deposit accounts (MMDA's), noninstitutional money market mutual funds shares (MMMF's), and certain other short-term money market assets.

M3 is an even broader definition of the money supply. It includes all the components of M2 plus a number of financial assets and instruments generally employed by large businesses and financial institutions.

The Fed considers a number of factors when it defines the monetary aggregates, but ultimately what matters is how the public uses the different forms of money available to it. For example, depositors can write checks on their MMDA's or their MMMF's. The public, however, uses them primarily for savings and only secondarily for transactions. Consequently, the Fed places MMDA's and MMMF's in M2 with savings accounts and time deposits, which are also primarily held as stores of value. On the other hand, deposits in NOW (negotiable order of withdrawal) accounts and ATS (automatic transfer service) accounts are included in M1 because they are mainly used for transactions even though they pay interest and depositors

use them for savings.

The M's will continue to be examined and revised as necessary by the central bank whenever financial innovations lead people to alter the forms in which they hold money. These innovations have also caused changes in the relationship between money and economic activity.

Our Current M's

The technical definitions of the M's can be found in the *Federal Reserve Bulletin*:

M1:

1. Currency (including coin) in the hands of the public
2. Traveler's checks
3. Balances in demand deposit accounts
4. Balances in NOW accounts
5. Balances in ATS accounts
6. Balances in credit union share draft accounts

M2: M1 plus

1. Savings and small time deposits (less than \$100,000) at depository institutions (including MMDA's)
2. Overnight repurchase agreements (RP's) at commercial banks
3. Overnight Eurodollar deposits
4. Shares in MMMF's held primarily by households and small businesses

M3: M2 plus

1. Large time deposits (\$100,000 or more) at depository institutions
2. Repurchase agreements with maturities longer than one day at commercial banks and savings and loan associations
3. Eurodollars with maturities longer than one day
4. Shares in MMMF's that are used by large financial institutions and corporations

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1. Why is it important for the Fed to know the size of the money supply?
2. What are three basic functions of money?
3. Name a type of money that serves primarily as a medium of exchange.
4. Name a type of money that serves primarily as a store of value.
5. Why are financial assets such as savings accounts included in the broader definition of money?
6. Why does the Federal Reserve watch the growth of the money supply?
7. What goals are sought by the Federal Reserve when it controls the supply of money?
8. Why do you think credit cards are not counted in M1?
9. Why is it difficult for the Fed to get an accurate measure of the money supply?
10. Use the data on the table, *Calculating the M's*, to calculate M1, M2, and M3. Assume that all items not mentioned are zero.

Calculating the M's

Checkable deposits (demand deposits, NOW, ATS, and credit union share draft accounts)	\$444
Currency	168
Large time deposits	635
Noncheckable savings deposits	302
Small time deposits	1,614

- a. $M1 = \underline{\hspace{1cm}} + \underline{\hspace{1cm}} = \underline{\hspace{1cm}}$
- b. $M2 = \underline{\hspace{1cm}} + \underline{\hspace{1cm}} + \underline{\hspace{1cm}} = \underline{\hspace{1cm}}$
- c. $M3 = \underline{\hspace{1cm}} + \underline{\hspace{1cm}} = \underline{\hspace{1cm}}$