

7.4: Money Supply Measures

Learning Objective

1. Learn the various definitions of money supply and their approximate values in the U.S. economy.

In the United States, the **Federal Reserve Bank** (or “Federal Reserve,” and more informally, “the Fed”) reports several distinct measures of the aggregate money supply. The narrowest measure, M1, includes only the most liquid assets. Higher numbers following an “M” reflect broader measures of money that include less liquid assets. Below is a description of M1–M3. However, unless otherwise specified, all later references to the money supply will relate to the M1 definition.

Money Supply Measure “M1”

M1 consists of the most highly liquid assets. That is, M1 includes all forms of assets that are easily exchangeable as payment for goods and services. It consists of coin and currency in circulation, traveler’s checks, demand deposits, and other checkable deposits.

The first item in M1 is currency and coin in circulation. In the United States, “currency” refers to \$1, \$5, \$10, \$20, \$50, and \$100 bills. U.S. “coin,” meanwhile, refers to pennies, nickels, dimes, and quarters. “In circulation” means that it has to be outside of banks, in people’s wallets or purses and businesses’ cash registers. Once the currency or coin is deposited in a bank, it is no longer considered to be in circulation, thus it is no longer a part of the M1 money supply.

The second item of M1 is traveler’s checks. Traveler’s checks are like currency, except that they have a form of insurance tied to them. If a traveler’s check is lost or stolen, the issuer will reimburse you for the loss.

The third item in M1 is demand deposits or checking account balances in banks. These consist of money individuals and businesses have deposited into an account in which a check can be written to pay for goods and services. When a check is presented to the bank, it represents a demand for transfer of funds from the check writer to the agent receiving the check. Since the funds must be disbursed on demand, we also refer to these as demand deposits.

The final category in M1 is labeled “other checkable deposits.” This consists of two items; NOW accounts and ATS accounts. NOW stands for “negotiable orders of withdrawal.” A NOW account is exactly like a checking account except for one thing: it can earn interest. Thus checking accounts without interest are demand deposits and those with interest are NOW accounts. ATS stands for “automatic transfer service.” ATS accounts are savings accounts (also called time deposits) with one special feature. They can be drawn automatically to cover overdrafts from one’s checking account. Thus if an individual has a checking account with “overdraft protection” tied to their savings account, then the savings account is an ATS account.

Table 7.1 shows the M1 money supply for the U.S. economy as of November 2009. Notice that the largest component of M1, just over half, is the coin and currency in circulation. Traveler’s checks are an insignificant share at \$7.5 billion. Demand deposits and other checkable deposits almost equally split the remaining shares of M1 at close to 25 percent each. The total value of the M1 money supply is \$1,688 billion, which is over 10 percent of annual U.S. GDP.

	Billions (\$)	Total M1 (%)
Currency in Circulation	859.1	51
Traveler’s Checks	5.1	< 1
Demand Deposits	439.0	26
Other Checkable Deposits	385.4	23
Total M1 Money Supply	1,688.7	100

Figure 7.4.1: Table 7.1 Components of U.S. M1 Money Supply, November 2009. Source: Federal Reserve Statistical Release, Money Stock Measures, January 14, 2010. <http://www.federalreserve.gov/releases/h6/Current>.

Money Supply Measure “M2”

M2 is a broader measure of money than M1. It includes all of M1, the most liquid assets, and a collection of additional assets that are slightly less liquid. These additional assets include savings accounts, money market deposit accounts, small time deposits (less than \$100,000) and retail money market mutual funds. Excluded are IRA and Keogh deposits in money market accounts. (These are excluded since they are retirement funds and hence are unlikely to be used as payment for goods and services anytime soon.)

Money Supply Measure “M3”

M3 is an even broader definition of the money supply, including M2 and other assets even less liquid than M2. As the number gets larger (i.e., “1, 2, 3...”), the assets included become less and less liquid. The additional assets include large-denomination time deposits (amounts greater than \$100,000), balances in institutional money funds (these include pension funds deposits), responsible party (RP) liabilities issued by depository institutions (refers to repurchase agreements), and eurodollars held by U.S. residents at foreign branches of U.S. banks worldwide and all banking offices in Canada and the United Kingdom (eurodollars are any U.S. dollar deposits made in a depository institution outside the United States). M3 excludes assets held by depository institutions, the U.S. government, money funds, and foreign banks and official institutions.

The United States values of all three major money supply definitions are given in Table 7.2. Note that the M1 definition of money is just under one-tenth of the value of the annual GDP in the United States. The M2 money supply is almost six times larger, indicating substantial deposits in savings and time deposits and money market funds. M3 was last reported by the U.S. Fed in February 2006. But at that time, it was almost 90 percent of the U.S. annual GDP.

M1	1,688.7
M2	8,391.9
M3 (February 2006)	10,298.7

Figure 7.4.2: Table 7.2 U.S. Money Supply Measures (in Billions of Dollars), November 2009. Source: Federal Reserve Statistical Release, Money Stock Measures, January 14, 2010. For the most recent figures, go to <http://www.federalreserve.gov/releases/h6/Current>. (M3 was last reported for February 2006.)

Key takeaways

- M1 consists of the most highly liquid assets, including coin and currency in circulation, traveler’s checks, demand deposits, and other checkable deposits.
- M2 is a broader measure of money than M1. It includes all of M1, plus savings accounts, money market deposit accounts, small-time deposits, and retail money market mutual funds.
- M3 is an even broader definition of the money supply that includes M2 plus large-denomination time deposits, balances in institutional money funds, repurchase liabilities, and eurodollars held by U.S. residents at foreign branches of U.S. banks.
- In 2009, the U.S. M1 was at just over \$1.6 trillion, around 10 percent of the U.S. gross domestic product (GDP).

Exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - Of *M1*, *M2*, or *M3*, this measure of money is the most liquid.
 - Of *M1*, *M2*, and/or *M3*, this measure(s) of money includes checking account deposits.
 - Of *M1*, *M2*, and/or *M3*, this measure(s) of money includes savings account deposits.
 - Of *M1*, *M2*, and/or *M3*, this measure(s) of money includes coin and currency in circulation.
 - Of *M1*, *M2*, and/or *M3*, this measure(s) of money includes eurodollars held by U.S. residents at foreign branches of U.S. banks.

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