*Our Money Supply*

What does our money supply consist of?

What does our [**money supply**](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-kt6) (M1) consist of? Gold? No! U.S. government bonds? No! Diamonds? No! Money consists of just a few things: coins, paper money, demand or checkable (previously called checking) deposits, and checklike deposits (sometimes called NOW—or negotiable order of withdrawal—accounts) held by the nonbank public. Coins (pennies, nickels, dimes, quarters, half-dollars, silver dollars, and other dollar coins) and paper money (dollar bills, fives, tens, twenties, fifties, and hundreds) together are considered currency.[1](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-fn1) (By the way, where did the *dollar* come from? See the box on this topic.)

The **money supply** (M1) includes currency, checkable deposits, and checklike deposits.

Nearly 5 out of every 10 dollars in our money supply are demand deposits and other checkable deposits. Virtually all the rest is currency. We have to be careful, however, to distinguish between checks and demand (or checkable) deposits. Jackie Gleason used to tell a story about two guys who get into an argument in a bar about who is more miserly (or cheaper). Suddenly one of them pulls out a dollar bill and a book of matches, lights the bill on fire, and lets it burn to a crisp. Not to be outdone, the other guy pulls out a five, lights it, and watches it burn to a crisp. So then the first guy does the same thing with a $10 bill. Well, the other guy doesn’t want to look bad, so he reaches into his pocket, pulls out his checkbook, writes out a check for $1,000, lights it, and watches it burn to a crisp.

Checks are *not* money. Checkable deposits *are*. Checkable deposits are essentially demand deposits.

Incidentally, demand deposits are so named because they are payable “on demand.” When you write a check, your bank must honor it, provided, of course, that you have enough money in your account to cover the check. Banks also insist that a certain number of business days go by before they will cash a specific check. It is usually 5 days for a local check and 7 to 10 days for an out-of-town check. Banks call this waiting period the time it takes for a check to clear. But any money in your checking account that has been cleared is available to depositors on demand.

Our currency is legal tender for all debts, public and private. But don’t take *my* word for it. You’ll find those words written just to the left of George Washington’s portrait on the one-dollar bill, or to the left of Abraham Lincoln’s on the five. So the government says that your money must be accepted for payment of all debts. Does the government say that about checks and credit cards? No! (See the accompanying box.) Now what does it say on the back of each dollar just below “THE UNITED STATES OF AMERICA”? It says, “IN GOD WE TRUST.” And as many people say: “In God we trust—all others pay cash.”

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on the web

If you’d like to learn more about our supply of currency, the Federal Reserve Bank of Atlanta has a very interesting website:[www.frbatlanta.org/pubs/dollarscents](http://www.frbatlanta.org/pubs/dollarscents) and click on any of the topics listed in the top right corner of the “Dollars and Cents brochure.”

*How Do We Pay Our Bills?*

There are many ways to pay for things—cash, check, credit card, debit card, prepaid or stored-value cards, and electronic fund transfers. Checks had been most important before the new millennium, but we have been moving rapidly toward a relatively checkless economy.

Credit cards, and especially debit cards (see the box [“Are Credit and Debit Cards Money?”](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-box3)), increasingly are used to pay for goods and services. And prepaid cards, which have long been issued by phone companies, are now issued by nearly all major retailers as well as by credit card companies.

More and more people are paying their bills with electronic fund transfers— movements of funds directly from one bank account to another. Many people have arrangements with the phone and electric companies to have their bills automatically deducted from their bank accounts. Similarly, some employers deposit paychecks electronically. And every month, the Social Security Administration sends out tens of millions of benefit payments electronically. Today three-quarters of all financial transactions are electronic.

*M1 and M2*

[**M1**](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-kt7) = currency, demand deposits, traveler’s checks, and other checkable deposits

*Our money supply* **(M1)** *includes* **currency**, *demand deposits, traveler’s checks, and what the Federal Reserve terms “other checkable deposits,” which include the NOW accounts and “share draft accounts,” or checking accounts issued by credit unions.*

[**Currency**](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-kt8) includes coins and paper money that serve as a medium of exchange.

According to the Federal Reserve there is over 1.2 trillion in currency in the hands of the public (see [Figure 1](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-fig1)). But the U.S. Treasury estimates that between two-thirds and three-quarters of U.S. currency is held outside the United States. Foreigners, especially Russians, consider American dollars—particularly one-hundred-dollar bills—as a much better medium of exchange and standard of value than their own currencies. So the bottom line is that our money supply, M1, may be as much as $500 billion lower than the official figure shown in [Figure 1](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-fig1).

***Are Credit and Debit Cards Money?***

No—neither credit cards nor debit cards are a form of money. But both *do* enable us to buy a huge range of goods and services without needing cash. Because they look alike and are issued mainly by VISA and Master-Card, when you present your card, you will be asked, “Credit or debit?”

Credit cards enable you to borrow thousands of dollars, depending on the size of your credit line. What the issuing banks would really like you to do is run up a large balance and make just the minimum payment each month, year-after-year. That way they can keep charging you 18 or 20 percent interest (or possibly even higher rates) on your outstanding balance. Today American households, on average, possess 14 credit cards, some of which were issued by banks, and others by stores, oil companies, and other retailers.

Both credit and debit cards are very important forms of ID. Not only can you travel and make major purchases without having to carry hundreds or thousands of dollars in cash, but you won’t be able to rent a car, stay in some hotels, or transact certain types of business without such a card. But remember, they’re only pieces of plastic—not money.

Debit cards look like credit cards. They’re not money either. When you buy something, the sales clerk asks you, “Credit or debit?” If you have a debit card, the money comes right out of your checking account. Suppose you’ve got $1,000 in your checking account and use your debit card to pay for a $200 purchase. Before you’ve left the cash register, your checking account balance has already gone down to $800.

Credit cards first became widely used in the 1960s, while debit cards came into their own in the late 1990s. Today, debit cards account for over 35 billion purchase transactions a year; credit cards account for 25 billion. But the total dollar amount of credit card purchases, $2.2 trillion, is still much greater than the $1.4 trillion in purchases made by debit cardholders.

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**F*igure* 1**

M1 and M2, March 7, 2013

By adding savings deposits, small-denomination time deposits, and money market mutual funds held by individuals to M1, we get M2. Percentages may not add to 100.0 percent due to rounding.

*Source: Federal Reserve Statistical Release,* March 7, 2013.

M1 is shown along with M2 in [Figure 1](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-fig1). As of February 2013, our money supply totaled $2,461 billion. Nearly everyone considers M1 our money supply, but we’re also going to consider a broader measure of money, M2.

M1 + savings, small-denomination time deposits, and money market funds = **M2**

M2 + large-denomination time deposits = **M3**

*By adding savings deposits, small-denomination time deposits, and money market mutual funds held by individuals to M1, we get* [**M2**](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-kt9)*.* You know what savings deposits are. Time deposits hold funds that must be left in the bank for a specified period of time—a week, a month, three months, a year, five years, or even longer.

Remember the bank ads that warn, “There is a substantial penalty for early withdrawal”? These warnings are another way of saying that under the conditions of a time deposit, you are legally required to leave your money in the bank for a specified period of time. And so, unlike a demand deposit, time deposits are not payable until a certain date.

Technically, the money held in time and savings deposits does not have to be paid to the depositors “on demand.” When you fill out a withdrawal slip to take money out of your savings account, you are completely confident that you will walk out of the bank with your money. Legally, however, your bank can require up to 30 days’ written notice before giving you these funds. In practice, of course, no bank ever does this. Although nearly every bank in the country is insured by the Federal Deposit Insurance Corporation, it is quite possible that, if a 30-day waiting period were enforced, many nervous depositors would rush into their banks to get their money while they could. Money market mutual funds are issued by stockbrokers and other institutions, usually pay slightly higher interest rates than banks, and offer check-writing privileges.

As you’ll notice in [Figure 1](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-fig1), M2 is five times as large as M1. That’s because M2 includes not just M1 but also savings deposits, small-denomination time deposits, and money market mutual funds held by individuals. By adding large-denomination time deposits to M2, we get [**M3**](https://jigsaw.vitalsource.com/books/1259691659/epub/OEBPS/Chapter13.html?create=true#ch13-kt10).

A strong case can be made to designate M2 as our basic money supply rather than M1. First, it is the monetary measure most closely watched by the Federal Reserve, the agency that controls the growth of our money supply. Second, with the enormous growth of money market deposit accounts, time deposits, and money market mutual funds, which people can quickly convert into cash, attention has shifted to M2. But I’m enough of a traditionalist to keep calling M1 our basic money supply—at least until the next edition of this text.