Economic Newsletter for the New Millennium
< BLOG>
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The Money Supply and those (supposedly) Overworked Printing Presses

Christopher's question…

What is the linkage between the money supply and the monetary base? I have heard repeatedly that the money supply is expanding and the printing presses are running overtime. If this is the case, how can that *NOT* be inflationary moving forward?

M1 Money…

1. M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (4) other checkable deposits (OCDs),

consisting of negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. Seasonally adjusted M1 is constructed by summing currency, traveler's checks, demand deposits, and OCDs, each seasonally adjusted separately.

Currency takes care of the underground and the rest of the world's needs.

The overwhelming majority of transactions in the aboveground (legitimate) economy (not evading taxes, not trying to escape indictments, etc.) takes place in the checkable deposit of M1

Note:

From the NY Fed
http://www.newyorkfed.org/aboutthefed/fedpoint/fed01.html

As of December 2006, currency in circulation—that is, U.S. coins and paper currency in the hands of the public—totaled about $820 billion dollars. The amount of cash in circulation has risen rapidly in recent decades and much of the increase has been caused by demand from abroad. The Federal Reserve estimates that the majority of the cash in circulation today is outside the United States.

By some estimates, up to two-thirds of the currency in circulation is outside of the U.S.

FYI – While currency in circulation is certainly higher than it was a year ago, it has not grown all that much (M1 has increased a bit more)

http://federalreserve.gov/releases/h6/current/h6.htm

Table 3
Seaonally Adjusted Components of M1
Billions of dollars

Date	Currency1	Traveler's checks2	Demand deposits3	Other checkable deposits			Total M1
				At commercial banks4	At thrift institutions5	Total	
Mar 2008	760.7	6.2	294.6	176.6	134.9	311.5	1,373
Feb 2009	834.6	5.5	397.3	180.8	140.2	321	1,558
	9.7%	-11.3%	34.9%	2.4%	3.9%	3.0%	13.5%

Update…

http://federalreserve.gov/releases/h6/current/h6.htm

Table 3
Seaonally Adjusted Components of M1
Billions of dollars

Date	Currency	Traveler's checks2	Demand deposits	Other checkable deposits			Total M-1
				At commercial banks	At thrift institutions	Total	
Jul-09	862.2	5.1	443.7	234.1	151.4	385.6	1,696.6
Nov-10	915.0	4.7	507.1	242.4	162.9	405.2	1,832.0
	6.1%	-7.8%	14.3%	3.5%	7.6%	5.1%	8.0%

If we are not running the printing presses, then what is going on?

Let's take a walk through the credit creation process…

Checkable deposits

1 – Borrow request a loan from a depository institution (e.g. commercial bank)

2 – If the loan is approved, the borrower is asked to sign a note payable, which details how the principal and interest is to be repaid to the bank.

This is a liability or a note payable to the borrower

Asset or a note receivable to the bank

What does the borrower get in return?

3 – Bank issues a deposit slip to the borrower.

This increases the borrower's checkable deposit equal to the amount of the loan.

This checkable deposit is an asset to the borrower, but a liability to the bank.

4 – Credit is thus created by the bank in favor of the borrower – the M1 increases because checkable deposits are part of the M1 Monetary Aggregate (Money Stock).

Fractional Reserve Example - Money (M-1) Creation by Depositories

1 Fed buys **$100** on Open Market

2 **Seller deposits $100**

			Deposit (Banks Liability)	Held in **Reserve**	Checkable Deposits Created	Loans Receivable
Bank	A	Added to Total Reserves of Bank	**$100.00**		**$100.00**	
		Required Reserves		**10.00**		
		Excess Reserves	90.00			
		Creates Checkable Deposits			90.00	
		Loan Receivable				90.00
		Borrower spends	(90.00)			
Bank	B	Added to Total Reserves of Bank	90.00			
		Required Reserves		9.00		
		Excess Reserves	81.00			
		Checkable Deposits			81.00	
		Loan Receivable				81.00
		Borrower spends	(81.00)			
Bank	C	Added to Total Reserves of Bank	81.00			
		Required Reserves		8.10		
		Excess Reserves	72.90			
		Checkable Deposits			72.90	
		Loan Receivable				72.90
		Borrower spends	(72.90)			
				$100	**$1,000**	**$900**

It is clear that the bank has created both credit (the loan) and money (M1 – checkable deposit). We could also say that the bank has also created M1 money in checkable deposit form and lent it to the borrower. We could also say that the bank has monetized the borrower's debt. The borrower's debt, or note payable, is not M1 money. The bank's liability – the checkable deposit, is M1 money. Therefore in this process of creating credit for the borrower, it has also created NEW M1 money. Yet another way of looking at this, is that the borrower and the bank swap debt or liabilities with each other and new money and credit are created. Note that the bank need not have the M1 money to lend it out: it simply creates a liability on itself.

Rarely does the bank lend currency money out. In almost all cases, the bank simply creates a checkable deposit liability on itself and gives title to that to the borrower. The borrower can 'spend' that money by means of check, debit card, or wire transfer. Spending this money really means conveying title of this checkable deposit to someone else.

Confusion often arises in the minds of most people because most of the time they go to a bank (depository in general…bank, credit union, etc.) and deposit currency or checks in their account. Obviously, that currency or check already existed – and we can think of it as 'old money'. This type of deposit has been called 'primary deposit' in the past. When banks create new deposits (as explained in the loan transaction above), these newly created deposits are referred to as secondary deposits. These secondary deposits are the result of the borrower signing a note payable in favor of the bank. Since the vast majority of 'new money' is created by depositories, in the process of creating credit, NO PRINTING PRESSES ARE REQUIRED!

Where does the expression, RUNNING THE PRINTING PRESSES, come from?

In the 1860s, in order to partially finance the Civil War, the US government (the North – Union), actually printed United States Notes, often called 'greenbacks' and spent them. Up until the

Civil War, state chartered banks also had paper money (currency) printed and would lend that paper money out when making a loan. By placing a heavy tax on this bank note (or paper money) issue, the Federal government ended this practice by state chartered banks.

In order to maintain their ability to maintain loans or credit, state-chartered banks aggressively promoted checking accounts. Federally-chartered national banks were given the power in the 1860s to issue bank notes or paper money. This power was eliminated in the 1930s. This left only the federal government with the legal ability to print paper money. At various times in the past, the US government would purchases silver and gold and on the basis of those purchases, would print silver and gold certificates. Such purchases were eventually eliminated and the silver and gold certificates were withdrawn from circulation.

With the passage of the Federal Reserve Act, the Federal Reserve System was empowered to issue paper money, called Federal Reserve Notes. At the present time, with very minor exceptions, the only paper money in circulation in the US are Federal Reserve Notes. All other forms of paper money no longer legally circulate with the exception of the United States Notes. They are so scarce that those remaining are in the hands of collectors.

The Fed does not issue paper money in the form of Federal Reserve Notes as part of the credit creation process. Rather, it stands ready to supply paper money in the form of Federal Reserve Notes to the public when they demand it. This issuance of Federal Reserve Notes to the public is channeled through the depository institutions. It is part of the depository institutions 'cash in the vault'. As a practical matter, nearly 90% of all legitimate transactions in the US economy are facilitated by means of checkable deposits – NOT CURRENCY. In the illegitimate, or underground economy (estimated to be in the 10-20% range of the total economy), currency – or paper money, does virtually the facilitation of transactions. Much of that paper money stock (Federal Reserve Notes) serves as the currency of other nations whose citizens do not trust the currency of their respective countries.

It is, therefore a bad characterization to say that inflation is caused by RUNNING THE PRINTING PRESSES! On occasion, it could be said that hyperactivity by loan officers at depository institutions might cause acceleration in inflation.

How does the Fed controls this activity? http://byrned.faculty.udmercy.edu/2003%20Volume,%20Issue%205/newsletter%20fiveA.htm

Again, more to follow…