

Mini-Lesson: Money Supply

Frequently in the CJ newsletter, references are made to money supply. There are several measures of money supply and all measure different levels of the “money multiplier effect.” Let’s try to define these measures in common sense terms, provided you understand that such definitions are not as exact as the technical definitions.

First, let’s discuss/define the “money multiplier effect.” Money “multiplies” through using a banking system. For example, a carpenter has \$100. He deposits it in the bank, and now the bank *also* has \$100 – although there is also a liability to the carpenter for \$100. Now, in certain measures, there is \$200 in the economy, instead of \$100. Finally, the bank loans the \$100 to a baker. Now the carpenter, bank and baker *all* have \$100, making the money in the economy equal to \$300, even though the bank and the baker have equivalent liabilities. That is how money “multiplies” through an economy.

Please note that the economic *wealth* has not increased, only the money measured. This is another reason why measuring the money supply is not the same as measuring the *size* of an economy. However, these measures can be useful in understanding some underlying economic activities and can help predict future economic activity.

Major Money Measures:

- **Currency** – The total of paper and coined money in circulation.
- **M1** – Also called “high powered money.” This is all currency in circulation plus any immediately available money to be used for purchasing goods, investing or retiring debt.
- **M2** – M1 plus savings deposits, small denomination CD’s and retail money market (MM) accounts. This is money available immediately or quickly for uses as described in M1.
- **MZM** – (Money of Zero Maturity) Remove the CD’s from M2 and add institutional MM accounts. Essentially, this is *all* money in the economy immediately available to buy, invest or retire debt.
- **M3** – The largest measure. Includes M2 plus all large time deposits (CD’s, loans, *etc.*) and any and all dollar denominated deposits worldwide. Basically, this is ALL dollars worldwide anyone has claim to now or in the future.

Key points:

- There is no *one* measure of money that describes the size of the money supply.
- Money supply does NOT equal either wealth or economic size.