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What's behind the recent surge in the M1 money supply?



Posted on January 11, 2021



CPI +3.2 % Chg. from Yr.
Ago on Feb 2024

Civ. Unemploy. Rate 3.9 % on Feb 2024

10-Yr. Treas. Rate 4.22 % on 2024-03-22

Real GDP +3.2 %, Comp.
Annual Rate of Chg.
on Q4 2023

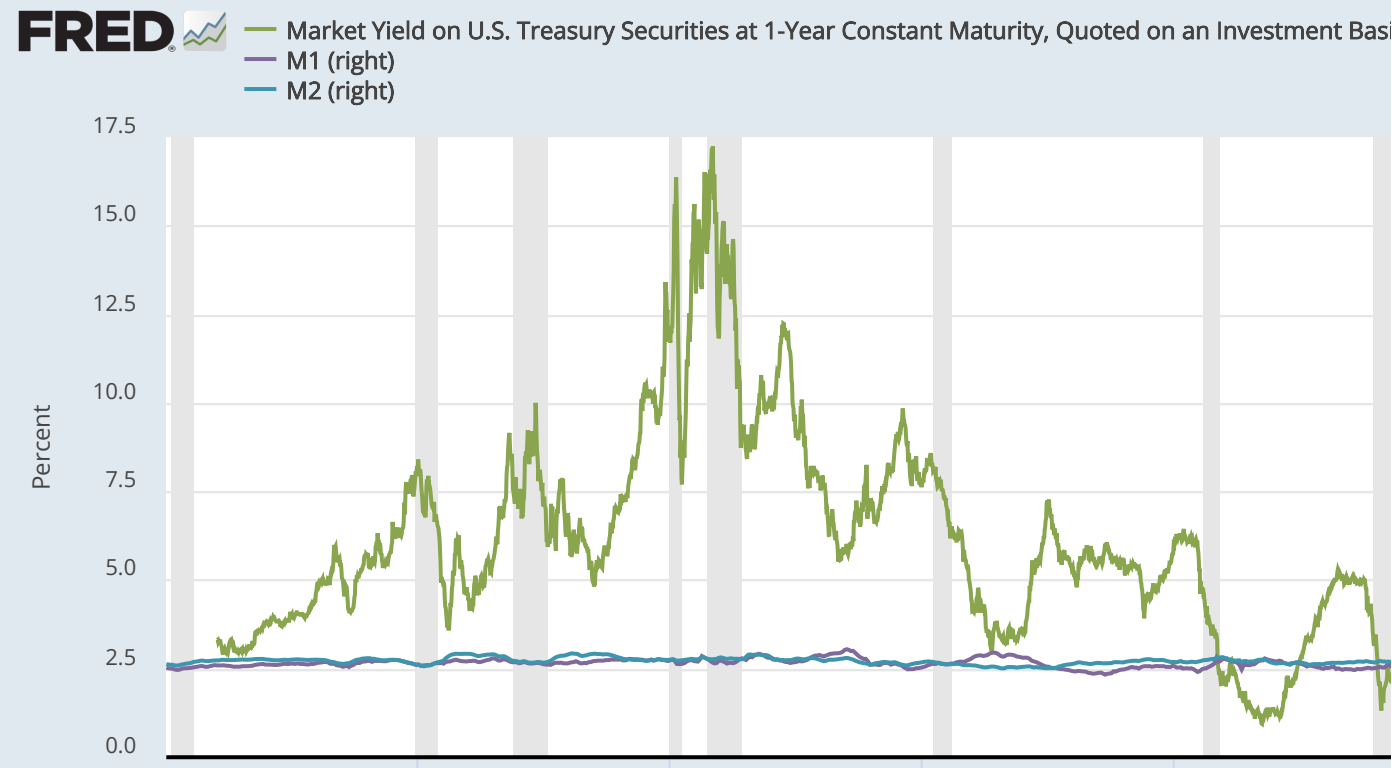
IP +0.1 % Chg.
on Feb 2024

Payroll Employment +275 Chg., Thous. of
Persons on Feb 2024

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While the terms “money” and “wealth” often mean the same thing in everyday parlance, economists define money more narrowly as the component of wealth consisting of “transaction balances.” That is, if you can use it to buy goods and services and to settle debts, then it’s considered to be money.

Money is distinct from other forms of wealth that first need to be liquidated—that is, *converted into money*—before their value can be spent. According to this definition, physical currency and checkable bank deposits constitute money. And, indeed, these objects make up the definition of what economists label as the *M1* money supply.

Because money is valued as a payment instrument, people are willing to hold a fraction of their wealth in money form for the sake of convenience, even though money earns relatively little interest and cash usually earns no interest at all.

If M1 carries the opportunity cost of not earning much interest, then why has the M1 money supply been increasing?

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This increase is shown in the FRED graph above (purple line), where we measure M1's opportunity cost as the one-year U.S. Treasury yield (green line). In late February and early March of 2020, the Fed cut its policy interest rate dramatically to help ease credit conditions during the COVID-19 crisis. The resulting acceleration in the supply of M1 can be understood largely as banks accommodating an increase in people's demand for money. However, the opportunity cost of money has remained more or less constant throughout 2020, over which time M1 growth has accelerated. What might account for this behavior?

To help answer this question, we'll need to talk a bit about banking regulations...

One factor responsible for this behavior may be related to a change earlier this year to [Regulation D](#): The Federal Reserve requires banks to hold reserves against checkable deposits. But the regulation does not require banks to hold reserves against savings and money market accounts, which restrict depositors to no more than six transfers or withdrawals per month. These latter accounts are highly liquid (and in the case of some money market funds, even checkable). But because they're not as convenient as checkable deposits, they typically compensate depositors with a more attractive interest rate.

Another measure of the money supply adds these savings deposits and checkable money funds to M1: It's known as, you guessed it, *M2*. From the graph, we see that the growth rate of M2 has remained relatively stable since May 2020. This suggests that the rapid acceleration in M1 since May 2020 is mainly from money moving out of the non-M1 components of M2 into M1, rather than reflecting any acceleration in the demand for transaction balances.

For even more about the role of banking regulations, read on...

On April 24, 2020, the Federal Reserve Board announced that Regulation D would no longer impose limits on the number of transactions or withdrawals permitted on savings deposit accounts. According to this ruling, if a bank suspends enforcement of the six-transfer limit on a savings deposit, the bank may report that account as a "transaction account" on its FR 2900 reports. However, the bank may instead, if it chooses, continue to report the account as a "savings deposit" ([See Board of Governors FAQ #6](#)). Since banks have been flush with excess reserves since 2008, reporting savings deposits as transaction balances incurs no cost. On the other hand, it's not immediately clear what advantage there is from the bank's perspective in relabeling savings accounts as transactions balances. In any case, it seems that the modification of Regulation D in late April has

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effectively rendered savings accounts almost indistinguishable from checking accounts from the perspective of depositors and banks. Accordingly, the composition of M2 between M1 and non-M1 components conveys little economic information.

How this graph was created: From FRED, search for “M2 Money Stock” and select the first search result. To add the other series, select “Edit Graph,” “Add Line,” and search for “M1 Money Stock” and “1-Year Treasury Constant Maturity Rate.” For the latter, change the frequency to weekly (ending Monday, last value), to match the other series. To change the M1 and M2 money stock units select “Edit Graph” and “Edit Lines.” Then select the lines corresponding to the M1 and M2 series and change the value under “Units:” to “Percent Change from Year Ago.” To move the y-axis for the M1 and M2 series on the right, select “Edit Graph” and “Format.” Then scroll down and select “Right” under “Y-Axis position” for the lines corresponding to the M1 and M2 series. Finally, to change the time span, click on “5Y” above the graph.

Suggested by [David Andolfatto](#) and [Joel Steinberg](#).

View on FRED, series used in this post: [DGS1](#), [M1](#), [M2](#)
