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Learning Journal Unit 5

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The money supply encapsulates the total quantity of money circulating in an economy through various liquid forms. It represents the money available in the financial system for transactions and spending. There are two primary ways to define and calculate the money supply based on different degrees of liquidity - M1 and M2.

M1 only includes the most liquid forms of money that can quickly be used for transactions. It is comprised of currency, demand deposits in bank accounts, and other highly liquid deposits. In contrast, M2 encompasses all M1 plus broader near money like savings accounts, short-term certificates of deposit, and money market mutual funds.

Of the two, M1 represents the highest level of liquidity and ability to make purchases, while M2 covers a wider spectrum of deposits with decreasing liquidity.

Changes in the money supply have significant impacts on macroeconomic conditions. Expanding the money supply generally decreases interest rates, spurring more borrowing and investment that can boost output and employment. However, increasing the money supply too rapidly risks inflation. Central banks must carefully calibrate the growth of the money supply to promote economic expansion without destabilizing prices.

Individuals and institutions also prefer to hold a portion of their wealth in the most liquid money forms for transactional ease, despite the lack of interest compared to savings accounts or other assets. When funds are transferred into highly liquid accounts like checking deposits, this directly expands the narrowly defined M1 measure of the money supply. Such M1 growth can stimulate near-term spending and economic activity, though at the risk of stoking inflation if unchecked. Tracking both M1 and M2 provides a comprehensive view of money supply dynamics.

When I transfer $2,000 from my mutual fund account to my checking account, it will have different immediate impacts on the M1 and M2 measures of the money supply.

M1 only includes the most liquid forms of money that can quickly be used for transactions. It is comprised of:

- Currency in circulation
- Demand deposits (checking accounts)
- Traveler's checks

My $2,000 transfer from a mutual fund into my checking account directly increases the balance in my checking account. Checking deposits are part of M1. Therefore, this transaction immediately increases M1 by the $2,000 that was transferred.

However, the transfer does not impact the overall currency in circulation. No new paper bills were created. And traveler's checks are unchanged. So, the full $2,000 increase in M1 is driven by the expansion of checkable deposits.

In contrast, M2 represents a broader measure of the money supply. M2 includes all components of M1, plus:

- Savings accounts
- Money market mutual fund balances
- Certificates of deposit
- Retail money market mutual funds

My mutual fund withdrawal removes $2,000 from a category included in M2 since mutual funds fall under "money market mutual funds." This reduces M2.

Simultaneously, the $2,000 transfer into my checking account increases M1 (as explained above). However, checkable deposits are already part of M1 and thus also included in M2.

So, the transaction has two countervailing effects on M2:

- Mutual fund withdrawal reduces M2 by $2,000
- Checkable deposit increase raises M2 by $2,000

The two $2,000 changes effectively cancel each other out. Therefore, the overall immediate impact on the M2 money supply is neutral.

In summary, the $2,000 transfer from a mutual fund to a checking account increases the narrowly defined M1 measure of liquid money by $2,000. But it leaves the broader M2 measure unchanged, as the shift between the two types of accounts counterbalances itself in M2.

These distinctions illustrate how the scope of what counts as "money" differs depending on whether M1 or M2 is used. Capturing a wider range of liquidity, M2 presents a more comprehensive snapshot of the money supply available to facilitate transactions and economic activity. The decision of which measure to focus on depends on the context and goals of monetary policy and economic analysis. Tracking both M1 and M2 provides insight into how changes ripple through the financial system to shape macroeconomic conditions in multifaceted ways.

Reference:

Greenlaw, S., & Shapiro, D. (2017). Principals of macroeconomics 2e. Openstax. Licensed under CC-BY 4.0. https://openstax.org/details/books/principles-macroeconomics-2e

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