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THE MONEY SUPPLY

Characteristics of money

People's ideas as to what constitutes money have varied considerably over the years and from place to place. For several thousand years, in fact, until very recently, money was primarily associated in most sections of the world with the precious metals, particularly gold. Even though no nation, today, is on the full gold standard, gold is still the ultimate balancing item between trading countries. You all know, of course, that the Federal Reserve must maintain a statutory percentage of its note and deposit liabilities in gold certificates.

In those sections of the world where there was an absence of metals, some local commodity in universal demand, either for ornamental purposes or because it filled some indispensable need in the local economic life, has served as money; for example shells, furs, salt, pots or hoes. As recently as a few years ago in the case of Germany after the war cigarettes performed some of the functions of money.

So long as money was considered practically synonomous with precious metals and finally gold, the particular properties of gold which, in combination distinguished it from other commodities and most precious metals came to be considered as the criteria for money. Briefly these properties attributable to money (gold) were (1) scarcity, but capable of some increase; (2) divisibility, that is, capable of being divided into units which would permit their use in small as well as large transactions; (3) homogeneity, that is, all units would be of the same quality, hence, units of the same size would have the same value; (4) portability, that is, efficient physical transfer should not be prohibitive because of bulk either too large or too small. Finally, money must have durability, that is, it should by physically capable of withstanding much use without deterioration of quality or weight.

These characteristics of money it should be recalled refer to money as a physical entity. With the rise of deposit banking and the resultant large-scale substitution of payment by check for payment by transfers of metals, money quite naturally began to lose, in people's thinking, the very close affinity to precious metals (mostly gold) which had obtained for many generations.

In moder times emphasis has shifted from the physical characteristics of money to what it does; i.e., the functions it performs. These are briefly:

(1) It serves as a unit of account or common measure of value. This enables us to measure in quantitative terms the values of economic goods just as a unit of linear measure such as a foot or year enables us to measure the height or length of something, and

(2) It serves as a medium of exchange.

Once we have departed from associating money exclusively with gold, however, it becomes a difficult task to determine which among the very liquid assets which the public holds shall be counted as money. For example, gold is a medium of exchange between countries but in most countries its domestic use as a medium of exchange is forbidden.

No one would disagree that coins and currency are money and that for all practical purposes bank deposits would be so considered even though it may be somewhat more difficult to persuade a stranger to accept a check for five dollars than a five dollar bill.

The public holds many other types of very liquid assets which come very close to performing money functions. To name only a few -- U. S. Government securities, shares in savings and loan associations, bankers' acceptances, cash values of life insurance policies. But there is one important difference between these types of very liquid assets and bank deposits and currency. Ordinarily these assets must be turned into their deposit or currency equivalents (money) before they can be used for transaction purposes.

The supply of money then in this country is the sum of bank deposits and currency in the hands of the public.

The creation of money

You have all heard remarks such as "money is created", "banks create their own deposits, hence banks create money". What do these remarks mean? Perhaps the easiest explanation is to review relatively recent developments in this country.

With the establishment of the Federal Reserve System member banks which had previously been required to keep their reserves in the form of currency, coin, and gold either with other banks or in their own vaults were required to transfer these to the Federal Reserve Banks. The Federal Reserve Banks then had assets of gold and currency and offsetting liabilities in the form of deposits to the credit of member banks.

Once this system was established how could the money supply, in the form of either deposits or currency be increased or decreased?

Let us look at deposits first

In a fractional reserve banking system banks can create deposits, i.e., money, up to the limit provided by their reserve requirements. How is this done? The answer is not simple.

Assume a deposit is made at a bank. The bank's statement will show, after the transaction, a plus on the asset side and a plus on the liability side. However, the bank needs to hold only about 15 per cent of the new asset; it is free to lend the rest. It may, for example, make a loan of the size of the 85 per cent of the original deposit setting up a deposit credit to the borrower and an equivalent amount on the asset side in the form of a loan. After this transaction the bank finds itself with greater liabilities and greater assets but only 15 per cent of the new liabilities need to be held in the form of reserves and the operation is repeated. It might appear, at this point, that the bank can increase deposits about six-fold, up to the point where reserves equal the size of the initial deposits.

There is, however, another limiting factor so far as the individual bank is concerned. Presumably borrowers spend the proceeds of their loans. It would be unlikely that borrowers would have all their transactions with depositors of the bank from which they borrowed. Some of the borrowed money in the form of checks would find its way to other banks. The lending bank would lose money in the check clearing process and its lending practices would have to be curtailed unless other banks were expanding credit and it had offsetting claims against these banks. Thus, it would appear that for any one bank to create deposits through its lending activities to the level described above, a simultaneous development at other banks is required. Once a credit expansion is under way, however, this development may be almost automatic. Banks not expanding credit will find themselves with more reserves than they need to support their existing level of deposits and assuming banks are in the business for profit, will be under pressure to increase their lending activities.

The description above explains how banks create deposits. How else can deposits be created or an atmosphere be created favorable to deposit expansion? It appears from the foregoing that any addition to bank's reserves permits the expansion of bank credit, i.e., an increase in the supply of money. Banks' reserves can be increased principally by a return of currency from circulation, by gold inflow into the country, by a decrease in Treasury balances at the Federal Reserve Banks and by an extension of Federal Reserve Bank credit.

Currency

Currency in this country now consists of United States notes, Treasury notes of 1890 and silver certificates, Federal Reserve notes, Federal Reserve Bank notes and National Bank notes. About eighty-five per cent of all currency is represented by Federal Reserve notes.

You will recall that banks were required to shift their holdings of reserves to Federal Reserve Banks, thus creating at the Reserve Banks deposit liabilities and offsetting assets of gold and currency. Against these assets Federal Reserve Banks, in order to provide an elastic currency, were permitted to issue currency with certain limitations as to amount. In the early 'thirties and again in 1945 these limitations on amount were considerably eased. Reserve Banks may now issue currency to an amount which taken together with deposit liabilities is four times the amount of their holdings of gold certificates.

The amount of currency in the hands of the public depends upon the wishes of the public. In other words, the people can hold their money either in the form of bank deposits or currency.

Velocity

We have now explained how banks create bank deposits, i. e., money, and how the bulk of our currency is created. We must now introduce into this discussion of the money supply the factor which is least susceptible of control. It is a very important concept, but it is impossible to measure precisely in the sense that we can measure bank deposits and currency in circulation. I am referring to the velocity of the money supply. By velocity of the money supply we mean the number of times each dollar of deposits and currency is spent in a given period. For the monetary authorities this is a very important concept, for action to reduce the money supply in inflationary times can be completely negated by an increase in the number of times the reduced supply is spent. By the same token, increases in the money supply resulting from Federal Reserve action to promote credit expansion can be negated by a reduction in velocity. There is very little that monetary authorities can do about money velocity. In certain fields of credit known to add to money velocity, notably, stock market transactions, the Board's authority is only partly effective. In other credit fields and in currency transactions the effect of Board action on reserves, for example, is likely to be ineffective.

The money supply and the Government's fiscal policies

In an earlier section I described briefly how Federal Reserve Bank credit influenced the volume of reserves available to banks and thus influenced the money supply. We can now discuss more directly the influence on the money supply of certain alternatives of Government fiscal policy.

Government deficits are financed by borrowing from the non-bank public or by borrowing from the banks. When the non-bank public buys Government securities there is no necessary net change in the money supply. Bonds are purchased by drafts on banks thus leading to a reduction in the money supply, i. e., in bank deposits. Almost immediately, however, other individuals' bank deposits are built up when the Government spends the proceeds of the security issue. However, when banks purchase new issues of Government securities in effect they create a deposit credit in favor of the Government. The Government calls these deposits in periodically but in spending them they are returned to the banks in the form of individual deposits. Deposits are increased by the size of the deficit thus financed. There is another method, too, by which the Government debt can add to the money supply without their being any new financing whatsoever. This is called "monetizing the public debt". Whenever banks or other holders of Governments sell to the Federal Reserve Banks, bank reserves are increased by the amount of the sale. We saw earlier what banks can do with additional reserves by way of increasing deposits, i. e., the money supply. Whenever Federal Reserve Banks stand ready to buy these securities at par you can appreciate that it is easy for banks to sell to the Federal Reserve for purposes of acquiring more lucrative assets, real estate loans, for example. You may have heard that some holders of Government securities took advantage of this opportunity after the war.

(A brief discussion summing up Federal Reserve controls over the money supply and Federal Reserve policy in general, that is aiming at maintenance of the highest sustainable level of employment.)