Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Why Redefine the M's?

Everyone is becoming more sophisticated about money and finding new ways to economize on checking-account balances. Many of the recent regulatory changes and financial innovations permit individuals, as well as businesses and governmental units, to improve cash-management practices. But the very effectiveness of these innovations is causing problems for the Federal Reserve, as it attempts to use money-supply measures in achieving its monetary-policy goals.

Deposit shifts are occurring among the demand, savings and time components that make up the monetary aggregates (M_1, M_2, M_3, et al.), and shifts are also occurring among depository institutions, and between deposits and non-deposit substitutes. These changes alter the previously observed relationships of the money aggregates with GNP, income, and interest rates, and thus make aggregate behavior difficult to interpret. To reflect the impact of recent financial innovations, the Federal Reserve Board of Governors presented a proposal in the January *Federal Reserve Bulletin* for redefining the "M's" by "grouping together similar kinds of deposits at all depository institutions."

Changes in demand balances

Many of the recent innovations and regulatory changes have limited the growth of demand deposits at commercial banks. At the same time, they have caused shifts to new-type transaction balances tied to interest-bearing accounts — such as negotiable orders of withdrawal, automatic transfers from savings, and credit union share drafts — at all types of depository institutions. The impact of these innovations has varied widely among the major sectoral holders of demand balances, causing significant changes in the composition of demand deposits, the major component of M_1. For some sectors, substantial economies in demand balances have already taken place; for others, the process is far from complete or just getting underway, and these shifts will further alter the behavior of M_1.

The nonfinancial business sector, which accounts for about 40 percent of total demand deposits, for years has economized considerably on its demand-balance holdings. By utilizing a wide-range of short-term options for investment of balances in excess of immediate needs, large corporations are approaching the potential minimum in their holdings of transaction balances. In addition, their "required" demand balances are declining as banks, in response to competitive pressures for corporate loans, substitute fees in lieu of requiring "compensating" demand balances on loan extensions.

Medium- and small-sized business firms have not matched, in relative terms, the demand-deposit economies achieved by large corporations, mainly because size constraints limit their access to the wide range of short-term investment options available to larger firms. However, they have been able to improve their cash-management practices by shifting funds from demand balances to savings accounts, as a result of a November 1975 regulatory change that permits businesses to hold up to $150,000 in savings deposits.

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A similar cash-management tool became available to local governmental units in November 1974 through a regulatory change that permits domestic governmental units to hold savings deposits. At the state level, the spread of sophisticated cash-management techniques, utilizing pooled-investment accounts, has significantly constrained the growth of public demand deposits. For both state and local governments, further declines in demand-deposit use can be expected because of legislative and regulatory trends liberalizing investment alternatives for governmental units, and because of the spread of the pooled-investment concept to local units as well as to more and more states.

Shift in consumer deposits

Recent regulatory changes have had their most dramatic impact on the consumer sector, which accounts for about one-fourth of total demand deposits. In its money-supply redefinition proposal, the Federal Reserve listed a number of changes that have enhanced the ability of individuals to economize on demand balances — either directly through issuance of negotiable instruments drawn on interest-bearing accounts or indirectly by automatic withdrawals from savings to checking accounts, or by pre-authorized telephone and point-of-sale transfers from savings accounts. The greatest impact came last fall from the authorization of automatic transfers from bank savings accounts and the extension of NOW authority to depository institutions in New York State. Mutual money-market funds, which provide limited withdrawal privileges in negotiable form, also have been attracting significant amounts of consumer funds.

The extent to which consumers use the new transaction-type accounts — NOW's, CU share drafts, and ATS accounts — depends on their effective cost compared with the cost of regular checking accounts. When minimum-balance requirements are met, most such accounts impose no transaction or fee charges on withdrawals. Consumers using these new interest-bearing transaction accounts can effectively reduce their demand-deposit holdings to a "zero" amount. This projected economizing of consumer demand deposits will significantly affect the elasticity of current M_1's response to income growth.

Savings and time shifts

Financial innovations have also affected the savings and time-deposit components of current M_2 and M_3, the broadly defined money measures. The new transaction accounts (ATS, NOW's and CU's) are drawing funds from regular savings accounts at both banks and thrifts, as well as from demand deposits. Households also have shifted massive amounts of funds from savings into the more attractively priced "money-market certificates" (MMC's) which have been available since mid-1978 at banks and savings and loan associations. (These floating-rate 6-month time certificates, in minimum denominations of $10,000, are tied to the 26-week bill auction rate). Since thrift institutions could offer MMC's at a favorable rate differential prior to last month, substantial amounts of funds also shifted from banks to thrifts. If the concept of applying money-market rates spreads to smaller-denomination time certificates, the shift out of the savings component into time deposits will accelerate further.

The heavy issuance of MMC's is further altering the liquidity of the time-deposit component of the money supply by concentrating funds in 6-month maturities. This component had become significantly less liquid as a result of the lengthening of maturities at both banks and thrifts following the 1973 and 1974 increases in regulatory rate ceilings on longer-term certificates. But market-rate certificates affect the broadly defined monetary aggregates most significantly in another way, by making consumer time deposits less subject to disintermediation when interest rates rise.

Proposed M's

The new M_1 aggregate, as proposed by the Board, would include the current components — currency and demand deposits — plus all other transaction-type accounts at banks and thrift institutions (less deposits of foreign commercial banks and official institutions). Inclusion of all these accounts would eliminate the effects of the shifts from consumer demand deposits to the new interest-bearing transaction accounts. But since these accounts consist of savings-type funds as well as those needed for transaction purposes, the proposed M_1 would be greater than the current M_1. If the proportion of these highly interest-sensitive savings balances becomes significant, the demand elasticities of the proposed M_1 with respect to interest rates will tend to differ from those of the current M_1 measures.

The proposed M_2 aggregate would include the components of the new M_1 aggregate *plus* regular savings deposits (i.e., savings deposits as currently defined less transaction-type accounts) at both banks and thrift institutions. The addition of "regular" savings deposits would "wash out" the effects of shifts from regular savings accounts to transaction-type balance accounts. It would also cancel out the effect of fund transfers between banks and thrift institutions for all the deposit components included in M_2.

The proposed M_3 would add to the new M_2 aggregate the time deposits of all maturities and denominations at both banks and thrift institutions. It would include large-denomination ($100,000 and over) negotiable CD's, which currently are excluded from both M_2 and M_3. Since this broader proposed aggregate would include all types of accounts — demand, transaction-type, savings and time — at all depository institutions, its movements would not be affected by the shifts occurring among deposit categories or among institutions.

The public's monetary-asset holdings are becoming increasingly fluid, at least partly because of the continued rapid pace of regulatory and financial innovations. No one aggregate or group of aggregates will be optimal for all purposes. In recognition of this fact, the Board proposes to publish separately the "building block" components of the aggregates, so that financial analysts will be able to monitor the impact of financial changes in more detail.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/4/79	Change from 3/28/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	123,612	1,312	+ 17,258	16.22
Loans (gross, adjusted) — total#	101,211	1,236	+ 16,781	19.87
Commercial and industrial	29,689	275	+ 3,898	15.11
Real estate	35,855	59	+ 7,670	27.20
Loans to individuals	20,797	80	NA	NA
Securities loans	1,869	308	NA	NA
U.S. Treasury securities*	7,855	81	+ 31	0.40
Other securities*	14,546	− 5	+ 446	3.16
Demand deposits — total#	43,499	4,392	+ 2,451	5.97
Demand deposits — adjusted	30,961	2,061	+ 1,373	4.64
Savings deposits — total	30,219	319	− 569	− 1.84
Time deposits — total#	49,891	− 352	+ 8,473	20.45
Individuals, part. & corp.	40,588	− 153	+ 7,981	24.47
(Large negotiable CD's)	17,664	− 217	+ 2,620	17.42

Weekly Averages of Daily Figures	Week ended 4/4/79	Week ended 3/28/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	52	28	94
Borrowings	65	19	15
Net free reserves (+)/Net borrowed(−)	− 13	9	79
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 1,506	+ 866	+ 332
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	+ 222	+ 481	+ 467

* Excludes trading account securities.
\# Includes items not shown separately.
@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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