Research Department
Federal Reserve
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FRB SF Weekly Letter

Decomposing the Aggregates

In recent years, even without major definitional changes, market forces have dramatically altered the composition of financial assets included in the narrow (M-1) and broader (M-2) monetary aggregates. The widespread consumer acceptance of interest-bearing checking accounts—NOW accounts, automatic transfer (ATS) accounts, and share drafts—has led to strong growth in "other checkable deposits," and accounted for nearly all the growth in M-1. Similarly, the popularity of money market funds and market-return small-denomination time deposits has accounted for all of the strength in the broader M-2 aggregate. Indeed, the strength in these various components has profoundly affected the traditional separation of deposit-type money balances into the two basic aggregates—one (M-1) composed of transaction balances, and the other (M-2) composed of both savings and transaction balances.

Throughout most of the recent period of record high inflation rates and interest rates, market forces have spurred a flight from the traditional "core" deposits—checking, passbook savings, and fixed-rate time certificates. Record interest rates have led consumers to press for market-return financial instruments; financial institutions have responded by offering new types of financial assets, i.e., money-market fund shares provided by the securities industry, and retail repurchase agreements and deposit-sweep accounts provided by depository institutions. In addition, to permit depository institutions to compete, the regulatory authorities have authorized them to offer a myriad of new deposit instruments. However, these new instruments tend to have either transaction or savings characteristics, but not both.

The intense market forces described here have determined the growth of the major M-1 and M-2 components over the last several years. Lower interest rates at times have caused reverse flows back into the traditional core deposits, but these flows have been swamped by the pervasive switch into a variety of new accounts, some of them developing in response to the gradual deregulation of interest-rate ceilings. These include fixed-interest paying transaction balances (NOW accounts and ATS accounts), market-return investment balances (6-month money market certificates, 30-month small savers certificates, and tax-free 12-month all savers certificates), as well as instruments that exhibit both payments and savings characteristics (money-market funds, deposit-sweeps, and retail repurchase agreements).

Other checkable deposits

Since the last (1980) revision of the monetary aggregates, "other checkable deposits" have been included as a component of the narrow M-1 aggregate, in addition to the traditional currency and demand deposits. This category now includes a variety of interest-earning transaction accounts: automatic transfer service (ATS) accounts that link checking and savings balances to provide both transaction services and a positive return (presently 5.25 percent); negotiable orders of withdrawal (NOW), which are basically checking accounts paying 5.25 percent interest; share drafts, which are interest-bearing checking accounts offered by credit unions; and demand deposits at thrifts.

"Other checkable deposits" have risen sharply since December 1980, when banks and thrifts became able to offer NOW accounts nationwide. Indeed, other checkables showed the only strength among M-1 components during this period. They rose by $60.4 billion from year-end 1980 to mid-year 1982, whereas the total M-1 increase was only $36.5 billion over this same period (see Chart 1). These figures reflected some switching by consumers from non-interest-bearing demand deposits to NOW and ATS accounts, as well as a slight decline in business demand balances and a strong increase in currency.

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Some proportion of the funds in NOW accounts also came from savings balances. Accordingly, households' $87 billion in interest-bearing transaction accounts this June apparently exceeded their holdings in non-interest-bearing checking accounts.

Market return

Similarly, M-2 components that pay market returns have accounted for all of the growth in the broader aggregate over the past four years. These have included, in particular, small-denomination time deposits and general-purpose money-market mutual funds transferred from other M-2 components—passbook savings deposits and fixed-rate time certificates. From the introduction of money-market certificates in June 1978 until mid-1982, market-return small-denomination time deposits plus money-market funds rose from virtually zero to about $940 billion, or roughly one-half of the M-2 aggregate.

Market-return consumer time deposits and money-market fund shares may continue to show much more rapid growth than the remaining below-market-return consumer deposits included in M-2. By 1986, interest-rate ceilings on time and savings deposits are scheduled to be phased out under the Depository Institutions Deregulation and Monetary Control Act of 1980. Ultimately, then, all consumer time and savings deposits should bear a market return. In the interim before complete deregulation, however, market forces may lead consumers to continue transfering investable funds from controlled-return instruments to those offering market-determined rates.

Exceptions

The runoff in core deposits might possibly be slowed (or even reversed) if interest rates dropped substantially. (For that matter, investors might be willing to settle for a lower return in today's uncertain economy because of increased liquidity preference.) The general reduction in interest rates from their mid-1981 peak reduced the opportunity cost of holding traditional transaction or passbook-savings balances. In the fourth quarter of 1981 and first quarter of 1982, household-checking and passbook-savings balances showed renewed strength along with other checkable deposits. (A similar pattern appeared during the summer of 1980, when interest rates bottomed out following the spring peak in rates.) But at the same time, growth rates declined for the market-return components of M-2—small-denomination time deposits and money-market fund shares.

Some of the reverse shifts of funds into core deposits have affected the growth of the aggregates in offsetting ways. In particular, the temporarily altered growth pattern of M-2 components has scarcely affected the M-2 growth rate, since a major portion of the shift represents growth in the other-checkables or passbook-savings components of M-2 at the expense of the small-denomination time deposit or money-market fund components. The effect of these shifts on M-2 should net out, but a different pattern may be evident for the M-1 aggregate. A shift from M-2 balances into demand deposits or other checkables, such as we witnessed in late 1981 and early 1982, thus would tend to boost the M-1 growth rate.

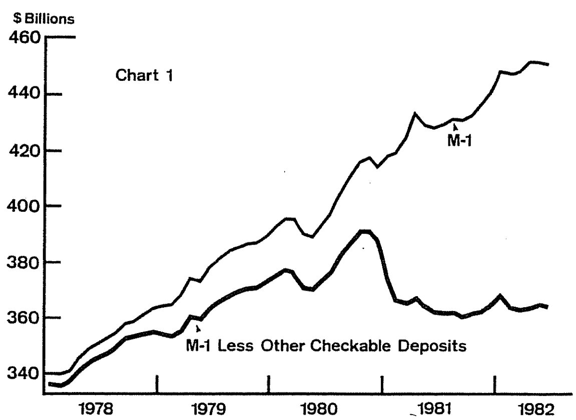
What next?

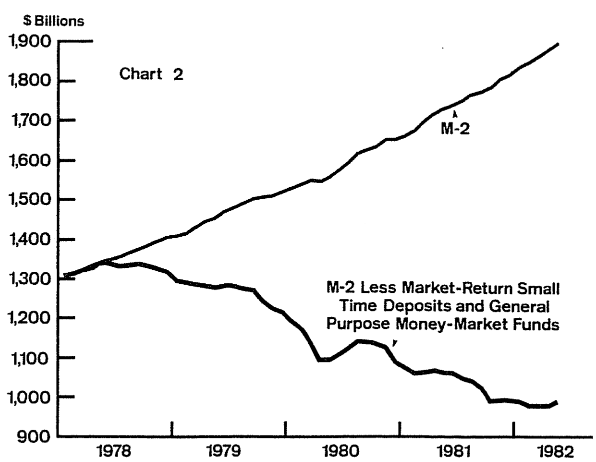
How has this revolution in the handling of household money balances affected various market participants? Certainly from the saver's vantage point, interest-bearing checking and market-return savings instruments provide both a wider array of investment options and more income than deposit balances would have provided in an era of below-market interest-rate ceilings. Financial institutions meanwhile find these new accounts are much more expensive than the traditional checking, savings and fixed-rate consumer time certificates. Moreover, in a high interest-rate environment, the trend toward more expensive funding certainly will continue as financial institutions continue to innovate around interest rate restrictions, and as the Depository Institutions Deregulation Committee proceeds with the gradual phaseout of interest-rate ceilings mandated by the Monetary Control Act.

Ultimately, with the further blending of consumer transaction and investment balances, the distinctions now used in defining M-1 and M-2 may become further blurred. There will always remain some distinction, of course. Transaction accounts will always pay a lower return, because of their higher reserve requirements and higher costs of servicing, compared to investment-type accounts.

With complete deregulation, households should have a wider array of transaction and investment services to choose from. Also, as with the current money-market funds prototype, many institutions may offer accounts providing both the checking services and the market rates that attract both types of balances. Consumers will have little incentive to separate their funds into the traditional checking and investment accounts if they can earn a high yield on an account that offers both services. Thus, we may no longer be able to define money along the familiar lines of M-1. But, we may still be able to define M-2 in the present manner, even while market forces reshape the aggregates—with more M-1 balances taking on the market-return characteristics of present M-2 balances and with more M-2 balances providing the payments services now associated with M-1 balances. However, the dramatic change in the nature of M-2 may create additional uncertainties in an environment of deregulation.

Gary C. Zimmerman





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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/7/82	Change from 6/30/82	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	160,462	– 141	9,760	6.5
Loans (gross, adjusted) — total #	140,016	– 67	10,724	8.3
Commercial and industrial	44,177	– 87	5,184	13.3
Real estate	56,970	– 12	3,788	7.1
Loans to individuals	23,393	– 62	568	2.5
Securities loans	2,186	– 88	744	51.6
U.S. Treasury securities*	6,585	114	393	6.3
Other securities*	13,861	– 188	– 1,357	– 8.9
Demand deposits — total#	42,256	256	67	0.2
Demand deposits — adjusted	28,037	169	– 2,285	– 7.5
Savings deposits — total	31,150	677	416	1.4
Time deposits — total#	96,116	636	14,074	17.2
Individuals, part. & corp.	86,778	808	13,729	18.8
(Large negotiable CD's)	35,718	664	2,964	9.0

Weekly Averages of Daily Figures	Week ended 7/7/82	Week ended 6/30/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	97	82	85
Borrowings	50	254	7
Net free reserves (+)/Net borrowed(–)	47	– 172	78

* Excludes trading account securities.
# Includes items not shown separately.

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