

Broad Money Versus Narrow Money

Much water has flowed under the bridge since John Exter, the author of Sri Lanka's Central Bank legislation, defined the money supply as currency and demand deposits held by the public. This definition was incorporated in the Monetary Law Act of 1949 and the Central Bank has faithfully followed it for the last three decades.

On the other hand, economists and bankers in practically all parts of the world had become increasingly dissatisfied with this definition and had begun to look for broader definitions of money supply. In fact, by the 1960's central bankers in US, UK and several other countries had already adopted broader versions of money supply. The reason for this change was that many highly liquid assets (that is, assets which can be easily converted into money) had become increasingly important in the monetary sphere and were in fact playing the role of money. In this way, most countries began to treat savings and time deposits, in particular, as part of the official definition of money supply.

A century or so ago, money supply would have covered only the legal tender money (that is notes and coins). With the growth of deposit banking, chequeable deposits (demand deposits) were admitted as a part of the money supply. You can pay for most things by cheque drawn on your demand deposit (current account) although cheques are not quite so generally acceptable as notes and coins. Since demand deposits are a means of exchange (they in fact economize on the use of currency), and since cheques are widely acceptable, they came to be regarded as part of the money supply. Savings and time deposits were not so regarded since cheques cannot be drawn on them and since, should the bank insist on its legal rights, the deposits cannot be turned into cash until after a lapse of time, that is, a period of notice. However, in practice, commercial banks waive the requirement of notice. The savings deposits can be turned into money without notice, merely by filling out a withdrawal slip that is tantamount

to withdrawable on demand. Even in the case of fixed or time deposits banks do allow withdrawals at some penalty (loss of interest) or grant advances against such deposits at higher rates of interest (rates higher than payable on fixed deposits). Hence the savings and time deposits so function as means of exchange. They are often termed as near money or quasi money in the same or 'almost but not quite' the same as currency or demand deposits. Hence, two versions of money supply emerged. The first labelled M1 or narrow money (currency and demand deposits) and the other labelled M2 or broad money (Currency, demand deposits, time and savings deposits). However, once the concept of near money is accepted, it becomes clear, that there are many other liquid assets (other than bank deposits) which, although themselves not generally acceptable as means of exchange, are easily convertible (into money. Such liquid assets include certain short-term government securities (eg. Treasury bills), deposits with finance companies, savings banks and loan associations and a host of such other assets that are readily convertible into money. The phenomenal increase in the use of credit cards in the developed countries has made 'trade credit' an important near money in these countries.

Hence many economists today are not content with even M2; they wish to include the whole spectrum of short-term liquid assets or near money in the definition of money supply and if so, one could have increasingly broader

versions of money supply — M3, M4, and so on — depending on what liquid assets one wishes to include.

There is no right or wrong about definitions, and the relevant question is how useful a particular definition is to the understanding of the behaviour of real world situations and for purposes of policy formulations (where definitions define the base for policy operation). In the case of the money supply the relevant criteria is the impact on the key macro-economic variables such as saving and spending in the economy and the latter is influenced by the entire liquidity of the economy rather than by the money stock as traditionally defined. Suppose X has Rs. 10,000 on demand deposit and Y has Rs. 5,000 on savings or time deposit and Rs. 5,000 on demand deposit. Will the saving and consumption levels of the two individuals be very different? Probably not; and that is why a broad version money is important. However, because it is difficult to draw a hard-and-fast line at direct bearing on spending, one exact definition of money supply is often difficult. What becomes the money supply then is a matter of taste rather than scientific necessity. Hence, many countries, have now adopted the practice of using a series of money supply versions rather than one or even two, so that each version supplements the others and a more meaningful overall picture of liquidity in the economy is thereby revealed. The Federal Reserve Bank of USA, for examples, uses four versions, namely M1, M2, M3 and M4, covering the whole spectrum of near money assets. Because of the widening role in financial transactions played by savings deposits in recent years, the US Federal Reserve has introduced an additional measure of money supply

Table 1
MONETARY INDICATORS: 1970-80

Currency	Demand Deposits	Saving and Time Deposits	M1	M2	M2/M1	
(Rupees Million)						
1970	935	1032	1148	1967	3115	1.58
1975	1610	1478	1689	3088	4777	1.55
1976	2081	2085	2155	4166	6321	1.52
1977	2792	2574	3351	5366	8717	1.62
1978	3016	2921	4956	5936	10892	1.83
1979	3774	3895	7388	7669	15057	1.96
1980 (Jan-May)	4162	4127	8027	8289	16316	1.97
Percentage Changes						
1970-75	72	43	47	57	53	
1975-79	134	164	337	148	215	
1977-79	35	51	120	43	72	
1978-79	25	33	49	29	38	
1979-80 (May)	10.3	6	8.6	8	-8.4	

(an intermediate category) labelled 'M1 Plus'. There is therefore a continuing search for improved versions of money supply.

In the case of Sri Lanka, the Central Bank thought it fit to switch over to a broad money definition (M2) only in May 1980. However, the limitations of relying on narrow money (M1) to understand the economic and monetary picture of the country was realized by economic writers very much earlier. In fact, the Economic Review of the People's Bank was the first to use the broad money version in the analysis of Sri Lanka's economy. (see July/August 1978 and Jan/Feb. 1979 issues of this Review). A similar change in the reporting of the money supply has been introduced by the Reserve Bank of India after the week ended May 23, this year (almost simultaneously with Sri Lanka's Central Bank). However, while the Central Bank of Sri Lanka attempted to explain the reasons for the change in a technical note published in the Monthly Bank Bulletin of June 1980, the Reserve Bank of India has made the change quietly and without an explanation of the reasons for the change. Hence, much curiosity has been aroused as to why the Reserve Bank adopted this sudden change.

An analysis of the monetary situation in Sri Lanka during the past five years (1975-79) clearly indicates that savings and time deposits held by the commercial banks have shown a sharp increase. They have increased by 337 percent during this period as against increases of 134 percent for currency and 164 percent for demand deposits. In fact, today the broad money supply (M2) has almost doubled that of the level of narrow money stock (M1). This situation is markedly different from that of the first half of the 1970's where M2 was only 50 to 60 percent higher than M1. The higher interest rates offered on savings and fixed deposits from late 1977 was the principal factor in this change. (see table 1). Now that the Central Bank has officially replaced M1 with M2, it is necessary to take the further step of using a series of money versions to include the whole spectrum of near money. An addition of a further version of money (M3) to include other highly liquid assets (short-term treasury bills, deposits in non-bank saving and finance institutions etc.) would prove highly useful.