



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 28, 2007

BEN S. BERNANKE
CHAIRMAN

The Honorable Ron Paul
House of Representatives
Washington, D.C. 20515-4314

Dear Congressman:

I am responding to your letter of March 13, 2007. You noted that the growth of two monetary aggregates (M2 and MZM) substantially exceeded that of the monetary base over the period from February 20, 2006, to February 19, 2007, and posed three questions:

- How can the money supply increase at a rate three times that of the monetary base?
- What is the source of the additional reserves that do not show up in the monetary base figures?
- Because this has happened, according to the data, how does FOMC policy affect the actual money supply today?

The monetary base can be viewed essentially as the sum of currency held by the nonbank public and reserves of depository institutions. Of that sum, currency held by the nonbank public is by far the largest component, accounting for more than 90 percent of the monetary base. As a result, the monetary base moves closely over time with currency in the hands of the nonbank public (that is, the currency component of the money stock), but not necessarily with broader money stock measures. The relatively small reserves component of the monetary base does move closely with measures of reservable deposits (demand deposits and other checkable deposits), but those deposits make up only a small fraction of broader measures of money such as MZM and M2. These monetary aggregates include large quantities of funds held in accounts that are not subject to reserve requirements, such as retail money funds, savings deposits, and small time deposits. As a result, these money supply measures can expand or contract over time with little or no impact on total reserves and the monetary base. In fact, the growth of broad monetary aggregates over time is largely determined by factors such as the growth of aggregate income and wealth in the United States as well as the forces shaping U.S. households' desired composition of financial assets. In contrast, more than one-half of U.S. currency is estimated to be held abroad, and consequently currency growth is determined to a large extent by forces outside our borders. The relatively slow currency growth over the past few years appears to be due in part to the recent relative economic and political stability in some nations that previously had been heavy users of U.S. currency. For these various

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reasons, it is not surprising that the growth of broad measures of money such as MZM and M2 sometimes differs quite substantially from the growth of the monetary base.

The Federal Reserve conducts monetary policy principally by influencing the level of short-term market interest rates over time so as to achieve its long-run objectives of stable prices and maximum sustainable employment. In formulating monetary policy, the Federal Reserve monitors the monetary aggregates, but it takes account of a great deal of additional information on economic and financial developments. Changes in short-term interest rates affect the monetary aggregates by influencing some of the key determinants of the public's demand for money balances—the opportunity cost of holding money and the levels of aggregate wealth and income.

I hope these comments are helpful. Please let me know if I can be of further assistance.

Sincerely,

A handwritten signature in black ink, appearing to be 'Ron Paul', written in a cursive style.