THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
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MEMORANDUM FOR THE PRESIDENT

The money stock is again back in the news. After an expansion from January to August, at the annual rate of 10.8 percent, it has been drifting downward since.

This needs watching. Both logic and the empirical evidence do suggest that there is a relationship between the amount of money held by individuals and businesses (the money stock) and the volume of economic activity. The typical individual or company, of course, has a more or less specific idea about how much money he needs to hold in order to conduct his business affairs. If the cash position is thin, he is more apt to be cautious and diffident in spending. If the cash position is on the ample side, additional spending comes more easily.

For the whole economy this all seems to work out so that when the money stock is equal to somewhat over one-fifth of GNP things are in reasonable balance -- though the ratio has been declining slowly, and in the short run it is somewhat erratic.

Money Stock as a Percent of GNP
(Seasonally adjusted, dollar amounts in billions)

Year-Qtr.	GNP	Money Stock: Amount	Money Stock: Percent of GNP
1965	$684.9	$163.8	23.9%
1966	749.9	171.0	22.8
1967	793.9	177.8	22.4
1968	864.2	190.4	22.0
1969	929.1	201.8	21.7
1970	974.1	210.0	21.6
1971 - First	1,020.8	217.2	21.3
Second	1,043.1	223.5	21.4
Third	1,059.0	227.6	21.5

Sources: Department of Commerce and Board of Governors of the Federal Reserve System

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While the Federal Reserve is responsible for policy actions that influence the money supply, no Administration can ignore these developments. It is the President who tends to be held politically accountable for the economic consequences of monetary policy. In looking at current movements of the money stock, we here need to keep certain things in mind.

No concern about inflation whatsoever.

1. The "right" rate of monetary expansion depends on the rate of economic expansion that we want to achieve. For 1972 we need to get at least a 6 percent gain in real GNP if we are to have any assurance of even a modest decline in the unemployment rate. This would allow for gains in productivity, which should be larger than the 3 percent long-run average, and the normal growth of 1-1/2 percent or so for the labor force. A growth of 7-8 percent in real output would be better. Less than 6 percent would court the risk of no decline or even a rise in unemployment. With 6-8 percent of real growth plus a 2-3 percent rise, GNP needs to increase 8-10 percent next year. That should be our objective.

2. For something like a $100 billion (8-10 percent) increase in GNP from 1971 to 1972, the money stock will need to rise at a 7-8 percent rate.

3. There is some empirical evidence that changes in economic activity come along two or three quarters after the change in the money stock. This is also logical. Time is required before changes in money holdings can be translated into spending decisions. We need to keep these lags in mind. If they persist, "now" for changes in the money stock is mid-1972 for changes in the GNP path.

4. We must avoid too much mechanistic a view about the money-GNP relationship. There is a hen-and-egg problem. More money tends to create higher spending and a larger GNP, but a more active economy means greater demand for bank credit, which tends to expand the money supply. Moreover, short-run swings in GNP and in the money stock are only loosely correlated with each other. While recently on the average the money stock has been equal in magnitude to about one-fifth of GNP, in our three years here the ratio of the quarterly <u>change</u> in the money stock to the quarterly <u>change</u> in GNP has varied from a low

of 6.0 percent in the third quarter of 1969 to a high of 40.8 percent in the fourth quarter of 1970.

5. The recent tendency of the money stock to decline must be watched, but it is not yet cause for alarm. From January to September it has shown an 8.9 percent per year rise.

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