Velocity Lacks Veracity

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Typically defined as "the number of times one dollar is spent to buy goods and services per unit of time," historically low monetary velocity is blamed for stymieing the Federal Reserve's ability to achieve a targeted rate of price inflation.[1] It is cited as delaying the onset of price inflation which was imminently predicted by some financial commentators in the aftermath of the Great Recession. It is viewed by all as problematic as it is powerful, as vexing as it is valid. Yet, despite its nature and magnitude having been debated for decades between Keynesian and Monetarist economists, monetary velocity is simply a pervasive and damaging myth.

The concept of velocity derives from the Fisher Equation of Exchange: MV=PT, where the quantity of money (M) times the velocity of its circulation (V) equals prices (P) multiplied by their related transactions(T). Initially developed by Copernicus, its modern manifestation was promulgated by the economist Irving Fisher in 1911.[2] [3] The equation attempts to explain increases (or decreases) in the price level: if the quantity of money expands, then prices will rise unless velocity decreases (or if transactions increase).

Valid criticisms of velocity are numerous: that the equation is merely tautological (it should be self-evident that prices paid for goods and services equal the prices charged for such goods and services), that the velocity of money cannot exist apart from the circulation of goods and services, that velocity is an effect and not a cause of price movements, etc. All of these arguments, while completely correct, avoid the primary reason velocity confuses mainstream economic prophets and financial prognosticators alike, for any theory of prices cannot ignore the demand for money. Murray Rothbard recognized this as the Fisher Equation's fatal flaw: "it is this profound mistake that lies at the root of the fallacies of the Fisher equation of exchange: human action is abstracted out of the picture."[4] The abstraction of human action means the absence of monetary demand.

Why the Fisher Equation is Wrong

Without the foundation of the Fisher Equation, velocity loses any theoretical justification. Historical examples of price inflation failing to correspond with the mechanistic workings of the Fisher Equation demonstrate the equation's falsehood. In the "Velocity of Circulation" (from *Money, the Market, and the State*), Henry Hazlitt shattered the Fisher Equation and underscored the importance of monetary demand by describing the historical behavior of price inflation:

What we commonly find, in going through the histories of substantial or prolonged inflations in various countries, is that, in the early stages, prices rise by less than the middle stages they may rise in rough proportion to the increase in the quantity of money . . . but that, when an inflation has been prolonged beyond a certain point, or has shown signs of acceleration, prices rise by more than the increase in the quantity of money.[5]

In losing the formulaic correlation of the Fisher Equation, velocity drops all claims to causation. But not only does the Fisher Equation fail to comport with historical fact patterns, it also rejects basic economic theory. Almost all economists today recognize that the price for any particular good or service derives from the interaction of supply and demand. The Austrian economists, since the 1912 publication of Ludwig von Mises' Theory of Money and Credit, have applied this logical and consistent principle to the concept of money:

The changes in the purchasing power of the monetary unit are brought about by changes arising in the relation between the demand for money, i.e., the demand for money for cash holding, and the supply of money.[6]

The “price” of money derives from the same supply and demand dynamic as any good or service. In excluding monetary demand, the Fisher Equation loses all explanatory authority. And velocity cannot purport to act as a proxy for monetary demand.

Why Velocity is Not Monetary Demand

Velocity is not a substitute for demand, but rather of volume. Lots of goods and services may transact at low prices just as they may trade at high prices. In either scenario, “velocity” is high while the demand for money may be low or high. The situation is analogous to daily price changes in the stock market: equity indices may fall or rise significantly (largely a function of demand as the supply of shares is fairly consistent from day to day) with large or little trading volume. In either scenario, price levels are invariant to volume. As such, velocity lends no insight or description of demand for any good or service — or money.

What is the demand for money, and what influences it? The demand for money is the desire for particular levels of cash holdings. In *Man, Economy, and State*, Rothbard detailed monetary demand’s constituent parts as the *exchange demand for money* (the degree to which holders of goods and services wish to trade for money) and the *reservation demand for money* (the degree to which current holders of money wish to keep it). Regardless, the desire for cash holdings depends upon an ever-changing determination of values and preferences by economic actors. It is certainly influenced by future uncertainty, expectations as to future purchases, and anticipated future price levels. The criteria influencing monetary demand are as myriad and complex as the nature of the various economic actors desiring cash holdings.

Conclusion

In divorcing monetary demand from the determination of purchasing power, the Fisher Equation detaches price level analysis from reality. Rothbard recognized its negative potential when he described it as “at best . . . superfluous and trivial, at worst . . . wrong and misleading.” The latter situation exists with the Federal Reserve’s false focus on monetary velocity as an impediment to their stated price inflation targets. To overcome this bogus barrier, the Federal Reserve will continue to increase the money supply. When significant price inflation develops, the realization of this mistake, if they realize it at all, will be too late.

Endnotes:

1. St. Louis Federal Reserve.
2. Rothbard, Murray. *Economic Thought Before Adam Smith* (Edward Elgar Publishing Ltd., 1995).
3. Fisher, Irving. *The Purchasing Power of Money* (New York: Macmillan, 1911).
4. Rothbard, Murray. *Man, Economy, and State* (William Volker Fund, 1962).
5. Hazlitt, Henry. “Velocity of Circulation” from *Money, the Market, and the State*, (Athens, Georgia: University of Georgia Press, 1968).
6. von Mises, Ludwig. *Theory of Money and Credit* (New Haven, Connecticut: Yale University Press, 1953).

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