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# Why does the velocity of money move pro-cyclically?


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## Notes

The overwhelming evidence that durable consumption and investment have greater cyclic amplitudes than NDGS has been clearly emphasized by R. J. Barro: 'most of the movement of output in the business cycle is in a component we call investment or, more broadly, durables—I would want to include consumer durables and inventories. If you look at consumer non-durables and services, they move very little' (see Snowdon et al., [1994](#), p. 274). These facts may in turn be (at least partly) explained by the accelerator principle.

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which can be also written in the form of a velocity function:

where  $M$  is money (however defined),  $p$  is the price level,  $w$  is the ratio between human wealth and all other forms of wealth (a ratio that is fixed) and  $V$  is the velocity of money.

Keynesian economists tend to take a different view on this issue. First, instead of considering many assets as alternative to money and including their returns separately in the money demand and velocity functions, Keynesian economists tend to lump financial assets into one big category (bonds) because they regard their returns as generally moving together. Second, Keynesian economists do not view money and goods as substitutes, and therefore do not include the return on goods relative to money (inflation) as a term in the money demand and velocity functions (on these two—and other—differences between Keynesian and monetarist theories of the demand for money, see Mishkin ([2004](#), pp. 530-531)).

Why? Non-GDP real estate transactions (e.g. existing-home transactions) require the transfer of funds through checkable accounts, and thus lead to an increase in the demand for M1 but not for M3 assets. On the other hand, 'even after recognizing that very little financial market trading requires the transfer of funds through transaction

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not found an explanation for this statistical result; it may however be somehow offset by the positive sign of the opportunity cost variable in the long-run equation.

This seems to be the view taken both in the USA and in the UK. For example, Arestis and Sawyer ([2002](#), p. 539) argue that in the day-to-day setting of monetary policy in the UK 'the money supply is not mentioned, and the demand for money [and velocity] is viewed as either unstable (Treasury) or is treated residually (Bank of England)'.

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