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Why does the velocity of money move procyclically?

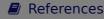
PEDRO LEÃO

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Velocity of money money demand business cycle monetary policy endogenous money

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Notes

assum

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., 19 y the accelera In this w omply with v variable in the enco e proportion a regres of the va For surveys r (1993) and of eco Erics Friedm and for service' money (Friedr iect to his budge hat are alterna

as well

as long-term bonds, this optimization problem leads to the following demand function for money:

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

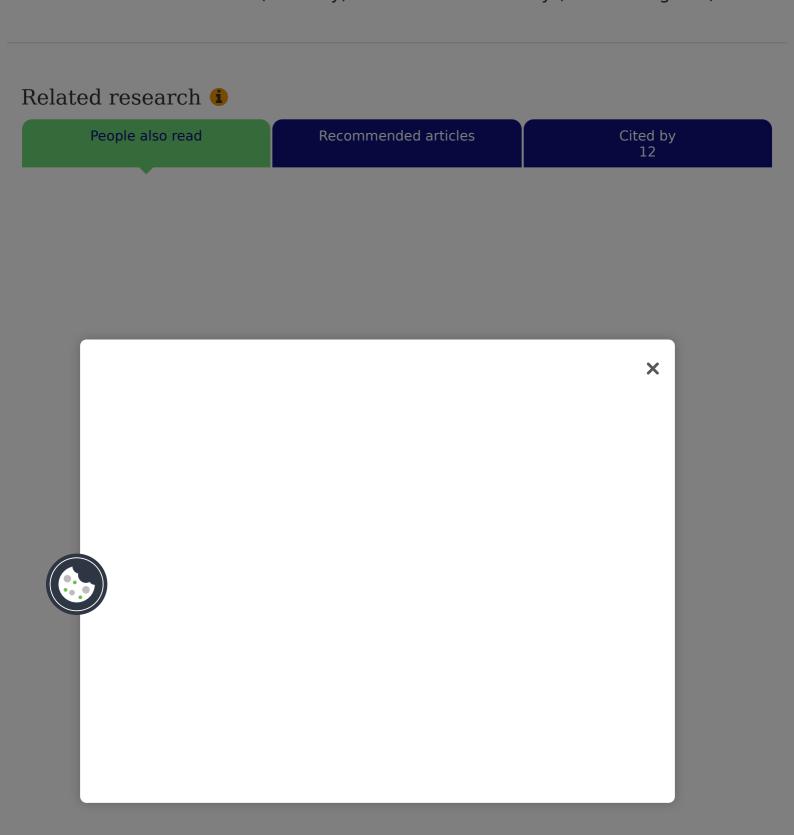
where M is money (however defined), p is the price level, w is the ratio between human wealth and all other forms of wealth (a ratio that is fixed) and V is the velocity of money.

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 to 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? No quire the transfer in the demand nizing that insaction very littl heless must accounts (Pollin & yield a s Schaber ude that an incre onversely, that & that is an increase transactions reduces ity of M1. The theo Theorem, which sa error correction

Two points should be noted. First, the contemporaneous short-term interest rate was not statistically significant. On the other hand, the two-period lagged short-term interest rate should have a positive instead of a negative effect on M1 velocity. We have 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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