Debunking the Velocity of Money Myth

By Ed Bugos • January 15th, 2009 • Related Articles • Filed Under

The markets got off to a bad start Wednesday following the news that some members of the Federal Open Market Committee slipped the word "deflation" into the minutes of its last meeting, in December.

Thus, the media jumped all over the deflation theme. Although there was only one mention of "deflation" in the entire 6,000-plus word release, it prompted headlines like this one from MarketWatch: "FOMC Members Discussed Mounting Risks of Deflation, Depression at Mid-December Meeting."

The stock markets crumbled. Most commodities fell. And even though the dollar fell, gold prices fell $24 on the Comex in response to all this noise Wednesday, while the gold stocks were among the worst performing sectors on the board. Recovery sentiment halted in its tracks as the deflation trade came back with a vengeance. Of course, I've been more cautiously bullish with gold prices approaching the resistance points controlling their intermediate downtrend. But my reasoning is that the reflation trade will win out and drive up both stocks and commodities broadly, at gold's expense, but only short term.

The bulk of the evidence supports this trade, but it has ebbed a little this week because of the news flow - none of which says anything new about the prospects of "deflation" in the Fisherine sense of a liquidation of debts and contraction in deposits. It was just more of the same drivel about falling prices and the shrinking economy, profits and employment, with commentators dragging in long-discredited concepts like velocity of money, the multiplier or even Japan's alleged deflation during the '90s.

Of course, as with any other "bubble" - if I am right to call it that - it implies an extent of irrational exuberance or popular delusion, and then there is the sustainability feature... bubbles simply don't last.

In the reader comment section in response to the MarketWatch report on the minutes of the FOMC, there were example after example illustrating that people believe deflation is caused by a slowing in the economy; rising unemployment; or falling wages and prices, including asset prices... or that deflation is bad; or saving is bad; or deflation existed throughout the '30s, despite the Fed's efforts.

I have already dealt with most of these misunderstandings in past issues. My influence must be waning, because they're not fading away!

Now let me take this opportunity to emphasize something. I do not mean to seem stubbornly fixed to the inflation paradigm. I'm not, in fact. I worry about the deflation possibility. I am always considering new facts and old premises as part of an analytical check to my evolving outlook. My recent tirade is not against the "possibility" of deflation - which cannot be denied. It is a reaction to the nonsense that underlies the great many bad arguments for deflation, which are either littered with factual errors about history or rely on theoretical concepts that are outdated, obsolete and have been long discredited.

The best argument for deflation, given the current monetary system, is if central banks decide that they want to take liquidity out of the system one day (i.e., run a deliberate deflation policy) or be serious enough about fighting inflation, they might overshoot. But no one is making this case.

Unlike the period 1929-33, central banks today can print "reserves" up. You can see this yourself.

There is nothing much to check this process but the will of the populace or the prudence exercised by politicians. The original deflationist, Irving Fisher, made sure of that. He scared America off the gold standard much like the deflation calls of the day have scared the Fed into ballooning its balance sheet!

Speaking of Fisher, I want to deal with one of the most ancient nonsensical theories about money that underpins the deflation scare today: the "velocity of money," a concept that Fisher himself resurrected.

According to proponents, an increase in money supply doesn't necessarily mean that money will lose its purchasing power if the velocity of circulation slows down, which happens if people don't spend.

David Rosenberg, Merrill Lynch's chief economist, recently put it this way:

"Money supply will increase, but money velocity will not. We are getting asked repeatedly these days how it is that the government debt creation we are about to see is not going to be inflationary. After all, aren't we going to see a boom in the money supply? Well, we're sure that the money supply is going to increase, but at the same time, we are going to see the turnover rate of that money, or what is called money velocity, decline." [Emphasis added.]

And in a segment on CNBC Wednesday discussing the grave threat of deflation, Art Cashin said:

"Even if you walked over and gave somebody a trillion dollars and they either put it in the mattress or just in their pocket, it doesn't help the economy. You need the velocity of money to move. You gonna give people money, they gotta go out and begin to use it. And we're seeing some of that worry coming home to roost here in the market today. We saw Intel..." [Emphasis added.]

With people like this, big credentials and all, promoting such ideas, it's no wonder the deflation scare has teeth, even though it can't bite through the flesh. Contrast their words with those of former Wall Street Journal reporter and economist Henry Hazlitt, who brought the Austrian School to America:

"Monetary theory would gain immensely if the concept of an independent or causal velocity of circulation were completely abandoned. The valuation approach, and the cash holdings approach, are sufficient to explain the problems involved."

Hazlitt wrote that in 1968 in an essay in which he demolished the velocity of money notion.

Simply put, the idea "refers to the rate at which money circulates, changes hands or turns over." It is a very old idea, harking back to the days when the "mechanistic quantity theory" of money predominated. That is, before we understood how individual judgments determined value, this concept of velocity explained variations in the value of money that were out of proportion with the variations in its supply. Under the mechanistic quantity theory, such changes were to be proportional.

Fisher adopted the idea of velocity in his dubious formulation MV=PT (where M is the supply of money, V is its velocity of circulation, P is the general price level and T is the volume of trade).

Both the mechanistic quantity theory and Fisher's equation have long since been refuted. No credible economist takes either of them seriously. But the idea of the velocity of money has survived, nevertheless, and today it's a pain in the neck. Hazlitt's insights were as follows.

First, as far as Fisher's equation goes, velocity (V) is not an independent variable. It is always exactly equal to the volume of trade T, and is driven by trade, not vice versa - it does not drive trade:

"What we have to deal with, in the so-called circulation of money, is the exchange of money against goods. Therefore, V and T cannot be separated. Insofar as there is a causal relation, it is the volume of trade which determines the velocity of circulation of money, rather than the other way around... the velocity of circulation of money is, so to speak, merely the velocity of circulation of goods and services looked at from the other side. If the volume of trade increases, the velocity of circulation of money, other things being equal, must increase, and vice versa."

Changes in the velocity of circulation are thus the effect, and not the cause, of changes in the demand for money and/or goods. The concept is a makeshift explanation for the factors affecting the demand for money. For example, if the price level did not change in direct proportion to the money supply, the "Fisherine quantity theorists" would explain it with reference to changes in the velocity of circulation.

Yet the statistic has no more bearing on the value of money (its purchasing power) than the concept of "inventory turnover" has on the price of the individual units of inventory. It cannot cause anything.

Second, as Ludwig von Mises explained, money doesn't really circulate at all. Nor is it idle. It is always in someone's possession, but ready to be exchanged (or used). It only spends a fraction of the time changing hands - i.e., without an owner. And when it is exchanged, someone else wants it for the same reason: to keep on hand for future use. It does not simply circulate on its own, as if by some unexplained force, and especially not independent of human judgments of value or expressions of the demand for money, as von Mises pointed out in his famous treatise Human Action:

"The service that money renders does not consist in its turnover. It consists in its being ready in cash holdings for any future use. The main deficiency of the velocity of circulation concept is that it does not start from the actions of individuals, but looks at the problem from the angle of the whole economic system. This concept in itself is a vicious mode of approaching the problem of prices and purchasing power. It is assumed that, other things being equal, prices must change in proportion to the changes occurring in the total supply of money available."

Third, neither does velocity measure the willingness of people to hold or get rid of their cash, because for everyone who is rendering their cash, someone is taking it, so that at all times, Hazlitt tells us:

"Average individual cash holding must always be the total supply of money outstanding divided by the population... People who are more eager to buy goods, or more eager to get rid of money, will buy faster or sooner. But this will mean that V increases, when it does increase, because the relative value of money is falling or is expected to fall. It will not mean that the value of money is falling, or prices of goods rising, because V has increased... It is the changed valuation by individuals of either goods or money or both that causes the increased velocity of circulation as well as the price rise. The increased velocity of circulation, in other words, is largely a passive factor in the situation."

He did find, however, that increases in money velocity corresponded with periods of intensifying speculation, whether that speculation was a bullish or bearish extreme. That is, this velocity has no directional significance even as a byproduct - it was just as likely to rise with too much speculation on the bearish side as on the bullish side. Consequently, since it is tied to the volume of speculation and trade, "velocity of circulation cannot fluctuate for long beyond a comparatively narrow range."

In summary, I am not saying deflation is impossible - only that if the Fed is inflating, we'll have inflation.

This truth is so simple that it is bewildering to see so many people take the other side of that bet. It is a testament to the effectiveness of the Fed's propaganda campaign that the deflation argument tends to recruit some of its otherwise potentially most ardent critics.

Keep your eye on the ball, and in the end, you will see that the deflation bogeyman is just that - a myth - used by politicians and central bankers to fear monger the masses into allowing them to inflate.

It has never been anything more.

Irving Fisher was one of its earliest authors, and it was he who lobbied for creation of the Fed, and advised the subsequent abandonment of the gold standard. Certainly, there is no precedent for what the Fed is doing today, but that by itself is no reason to summon the deflation bogeyman.

As for why the reserves the Fed is creating have not been multiplied, the answer is simple: Interest rates are too low! If you fixed the price of oil at 50 cents per barrel, supply would run out quick too.

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