VELOCITY OF MONEY

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Here's a thought… Money on the move has no fixed abode!!

- **From one wallet to another, from one shopper to the next, that is the life of money.**
- **But we often forget that money is like a lubricant that makes the economy move smoothly.**
- **Therefore, if the money is parked in our pocket, in effect, the economy slows down.**
- **Thus money needs to move and therefore needs velocity (velocity is another word for speed)**
- **This concept of movement of money is also called the 'Velocity of Money'.**

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Understanding

the Velocity of Money

– By Prof. *Simply* Simple

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VELOCITY OF MONEY

- ‘Velocity of money’ is a term used to denote the number of times a unit of money in an economy changes hands during a certain period, say, one year.

- Here, by money, economists generally mean currency and coins in circulation and bank reserves with the central bank.

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Also…

- **Different measurements of money supply would show different velocity.**

- **But if you are not too comfortable with the nuances of money supply, then for understanding the concept of velocity of money, you can just think of money as the value of the total stock of currency notes and coins available in an economy.**

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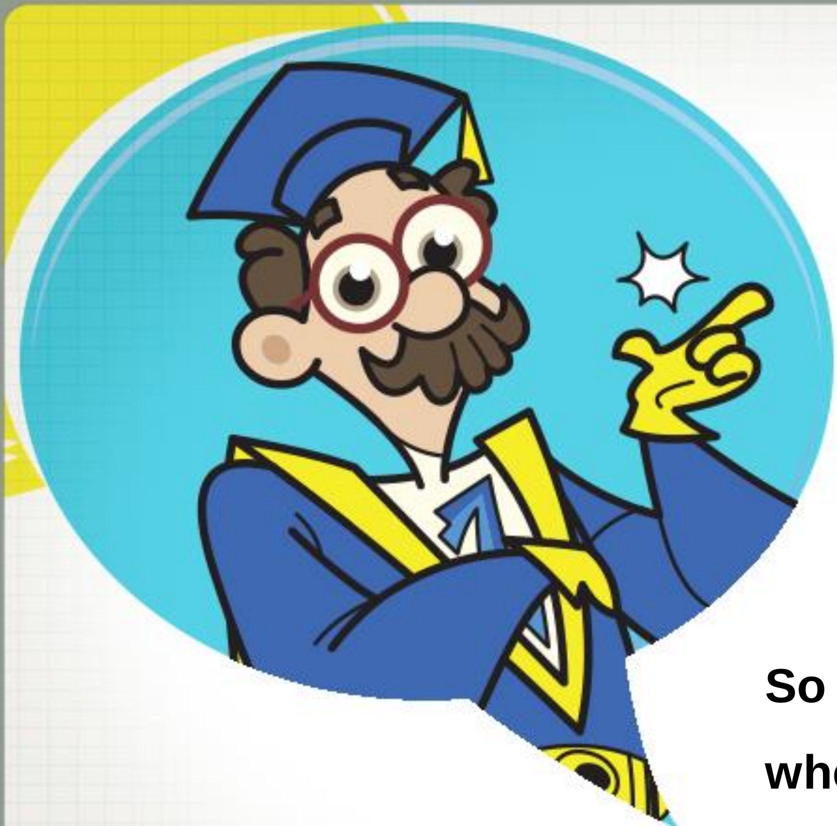

So just like the game of soccer, where just one ball gets kicked again and again, in the game of money the same unit of money keeps on rolling around.

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To give an example…

- **Suppose an economy consists only of three people A, B, and C, and the total value of all goods and services produced by them is Rs300.**
- **Suppose A is a barber who currently holds all the stock of money valued at Rs100 in our imaginary economy.**
- **The barber needs bread so he goes to B, the baker, and hands over his Rs100 and takes bread worth that much in exchange.**

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Now…

- **The baker needs clothes so he goes to C, the merchant, and exchanges his Rs100 for clothes.**
- **The merchant badly needs a haircut and so he goes to the shop of A, the barber, and the Rs100 note is back with its original owner.**

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You might have noticed that among A, B and C, the Rs100 note changed hands three times, generating a total transaction of Rs300.

In this example, therefore, the velocity of money is three.

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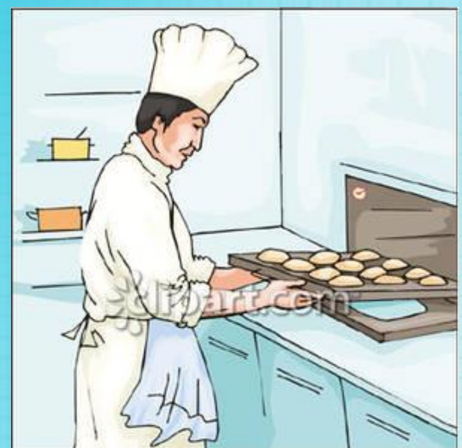
How Money Moves!

Barber buys bread from the baker

Rs. 100



Baker buys clothes from the cloth merchant

Rs. 100

Rs. 100

Cloth merchant gets a haircut from the barber

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The life of money looks so simple when it is just moving from the baker to the barber.

But what about the actual economy, where countless number of people are using different units of money for small and big transactions? How do we actually calculate the velocity of money in a real economy?

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- The velocity of money is what is called a derived statistic, which means that in the real economy, the velocity of money can be known only after all buy and sell transactions are over.

- There is no way we can directly know about the velocity of money on a real-time basis.

- We calculate velocity of money by dividing the value of the Gross Domestic Product, or GDP, which represents the total value of all goods and services produced by an economy, by the value of money supply.

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But how does one calculate different measurements of money supply such as M0, M1, M2, M3 and so on?

Don’t worry, I will cover all of that & more in my next lesson.

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To Sum Up

- **What: ‘Velocity of money’ is a term used to denote the number of times a unit of money in an economy changes hands during a certain period.**

- **How: Velocity of money is calculated by dividing the value of GDP with the value of money in circulation.**

- **Why: Money needs to move and therefore needs velocity for the economy to move ahead smoothly.**

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Hope you have now understood the concept of The Velocity of Money

Thinking of Investment

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