Velocity and Interest Rates

Before taking up some rather faulty assumptions upon which the money supply theory seems to me to rest, I'd like to absolve the theory of one such assumption that is, however, embraced in the associated policy prescription of a constant growth in the money supply. That is the assumption of a stable link between money and income. Stress is placed in the prescription not the theory on the stable long-run relationship between income and changes in money. Price and interest impacts on money demand under normal circumstances are said to be slight. While the velocity of money admittedly fluctuates in the short run, emphasis is on its stability over the long run.

It is this assumption that allows the relationship to be turned on its head. Money can be thought of as the tail which wags the dog. Money is exogenously determined by the Federal Reserve System. To make the public willing to hold the money stock, income must adjust to the level of money. This leads to the concept that if money grows at a constant rate, income will also grow at a constant rate. Discretionary monetary policy should be replaced by one based on a more or less constant growth in the money supply.

The theory itself points out that the demand for money depends upon interest rates as well as upon income. As a result, adjustments to changes in either the supply of money or the desire to spend can occur by alterations in interest rates and in the velocity of money. The demand for money changes with interest rates. A change in the supply of money may alter interest rates, not income.