

## Glossary entry: the velocity of circulation of money

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*I have posted this new glossary entry. It was created in response to a specific request. You are welcome to ask.*

The [whole glossary](#) is available here.

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### **Velocity of circulation**

The velocity of circulation of money is the average number of times a unit of money is used to purchase newly produced goods and services during a given period. It is commonly presented as a measure of how quickly money moves through the economy.

Although widely used in economic theory, the concept is frequently misunderstood and often given more significance than it deserves.

Its key features include the following.

First, velocity cannot be directly observed. Unlike the money supply or national income, velocity is not measured. It is calculated as a residual from an accounting identity:

$$\mathbf{Velocity = Nominal\ GDP \div Money\ Supply}$$

It is therefore whatever value is required to make that equation balance.

Second, velocity is not a property of money. Money does not literally move at a particular speed. A £10 note has no intrinsic velocity. What economists call velocity is simply a statistical description of how often money is used in transactions over a period of time.

Third, velocity reflects behaviour and institutions. Changes in velocity are the consequence of changes in saving, spending, lending, taxation, confidence, payment systems and financial markets. Velocity does not cause these changes; it summarises

their combined effect.

Fourth, velocity varies according to how money is defined. Different measures of the money supply produce different estimates of velocity. Using notes and coins alone produces one figure. Using broader definitions that include bank deposits produces another. There is therefore no single, objective measure of the velocity of money.

Fifth, velocity is unstable. Many economic models once assumed that velocity was broadly constant. Experience has shown this to be false. Velocity can change significantly during recessions, financial crises, pandemics or periods of financial innovation.

From a Funding the Future perspective, the velocity of circulation is often given an explanatory role that it does not deserve.

The quantity theory of money, for example, treats inflation as depending on the relationship between money, velocity, prices and output. This has encouraged the belief that changes in the money supply have predictable effects because velocity is assumed to be stable.

In reality, velocity is neither stable nor independent. It changes because people and institutions change their behaviour.

More fundamentally, the concept is of limited value in understanding a modern monetary economy.

Money is not a stock that is passed endlessly from hand to hand like a token in a game. Modern money is created and destroyed continuously through government spending, taxation, bank lending and loan repayment. Payments are settled electronically through changes in bank deposits and central bank reserves. In this system, the metaphor of money “circulating” can be misleading.

The important questions are therefore not:

- \* How fast is money moving?

but:

- \* Who is creating money?

- \* For what purpose?

- \* Who receives it?

- \* What real resources does it mobilise?

- \* Does it increase productive capacity or merely inflate asset prices?

Those questions tell us far more about inflation, growth and economic performance than any estimate of velocity.

For that reason, while the velocity of circulation remains a useful descriptive statistic, it should not be treated as a causal explanation of how the economy works. It is an accounting ratio, not a law of economics.