The Basic Idea of Fast Money

This handout explains the idea of “fast money,” and uses it to give one reason why \( V \) goes down during recessions.

The demand to hold money (\( M^d \)) arises from the convenience of transacting leisurely, holding money between transactions as a store of purchasing power. While holding money has an opportunity cost \( r \) in terms of foregone interest, at least for small everyday transactions, this cost is not significant. So \( V < \infty \), i.e., money is not like a “hot potato” that people just spend or put into their savings accounts as soon as they get it. By contrast, for big ticket transactions—purchases of expensive indivisible commodities—the opportunity cost of holding money is a significant factor. The following example illustrates.

EXAMPLE: Imagine an individual who on average holds \$700 in money for transaction purposes. She plans to purchase a new automobile at the beginning of month \( t \), and must give the auto dealer \$4,000 as a down payment. To avoid losing interest, she takes the \$4,000 out of her savings account \( (T) \) and puts it into her checking account \( (D) \) immediately before making the payment. See Figure below. Notice that since her deposit and expenditure for the car are almost perfectly synchronized, her average transaction balances remains at \$350—even in month \( t \); the purchase does not significantly affected her average transaction balances.

![Figure 1: The Individual Buys Her Car at the Beginning of Month \( t \).](image)

Similarly, when the car dealer gets the buyer’s \$4,000 check, to avoid losing interest, he will immediately put the money into his savings account rather than sit on it.

A fast money transaction is one that involves a very high velocity: people don’t \textit{hold} the money very long. As the example illustrates, big ticket transactions are typically fast money transactions: the money used for these transactions is roughly like a “hot potato,” its turnover is very fast.

The \$4,000 transaction is a fast money transaction

\[ V \approx \infty \text{ for fast money transactions.} \]

Notice that the Example relaxes the assumption that all final spending is \textit{continuous} through the month. This assumption may be appropriate for the purchase of consumer nondurables like food, but not for purchases of big ticket items such as consumer durables and investment goods.

We can use the idea of fast money to give one reason why \( V \downarrow \) during recessions. A well-documented fact is that the most volatile components of GDP are spending on

- investment goods, and
- consumer durables (investment by households),

that is, big ticket items. Why? During recessions people try to keep their purchases of consumer nondurables like food fairly steady, but they cut back severely on their big ticket purchases. For example, when faced with the uncertainties of recession, households try to keep their old cars and old refrigerators running—rather than purchasing new ones,—until their uncertainty clears. Similarly firms keep operating their old equipment, making it last a bit longer, rather than purchase new equipment until their uncertainty clears. Thus during recessions the economy mainly loses its fast money transactions rather than its slow money transactions. Since \( V \) is the turnover of the average dollar, the upshot is that during recessions the average dollar turns over less rapidly because it is relatively more involved in slow money transactions.

\[ ^1 \]Later in the class, we will learn how to formalize the idea of fast money using IS-LM analysis. We also will learn a bit more about why “uncertainty” causes people to cut back on their investment expenditures.