Observing Money Supply Growth for Understanding Inflation

What is the issue?

- The view that inflation is always and everywhere a monetary phenomenon has now shifted its momentum.
- There is a need to understand that the process of money creation is a process of credit creation.

What is inflation targeting?

- The principle of inflation targeting is based on the belief that long-term economic growth is best achieved by maintaining price stability, and price stability is achieved by controlling inflation.
- The tools of monetary policy such as open market operations and discount lending can be employed for inflation targeting.
- **Quantity** - The focus of policy these days is more on price (interest rate) than quantity (money) and the two are interrelated.
- But the monetary authority cannot in effect order interest rate. Hence the quantity (money or liquidity) is adjusted to achieve the desired level of interest rate.
- The central bank follows a form of unconventional monetary policy called **Quantitative easing**.

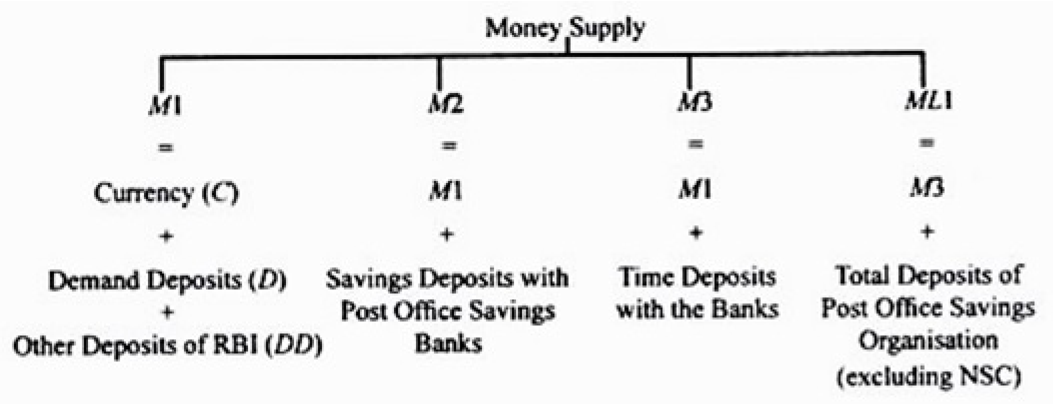
  In Quantitative easing, the central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment.

- **Liquidity** - The recent discussions on inflation in India in the Monetary Policy Statements tend to ignore money, even though there is reference to liquidity.
- If inflation is to be kept under control, the authorities need to have control over liquidity or money.

What is the role of money supply in inflation?

- The money supply reflects the different types of liquidity each type of

money has in the economy.
- Studying monetary aggregates can generate substantial information on the financial stability and overall health of a country.



- Reserve money represents the base level for money supply or it is the high powered component of money supply.

Reserve money = Currency in Circulation + Bankers' Deposits with RBI + 'Other' Deposits with RBI

- Since it is mostly currency in circulation with the people , reserve money decides the level of liquidity and price level in the economy.
- M1, also as called narrow money and includes coins and notes that are in circulation and other money equivalents that can be converted easily to cash.
- M2 includes M1 and, in addition, short-term time deposits in banks and certain money market funds.
- M3, also called as broad money includes M2 in addition to long-term deposits.

Why inflation targeting has to be looked beyond reserve money growth?

Growth in Reserve Money and Broad Money

Table 1

Year	Reserve Money: Stock at the end of the period (₹ cr)	Reserve Money: Y-o-Y growth (%)	Broad Money (M3): Stock at the end of the period (₹ cr)	Broad Money (M3): Y-o-Y growth (%)	CPI (Combined) inflation 2012=100
2011-12	14,26,344	3.6	73,84,831	13.5	-
2012-13	15,14,886	6.2	83,89,819	13.6	-
2013-14	17,32,742	14.4	95,17,386	13.4	9.3
2014-15	19,28,463	11.3	1,05,50,168	10.9	5.8
2015-16	21,80,740	13.1	1,16,17,615	10.1	4.9
2016-17	19,00,485	-12.9	1,27,91,940	10.1	4.5
2017-18	24,18,779	27.3	1,39,62,587	9.2	3.6
2018-19	27,70,481	14.5	1,54,32,067	10.5	3.4
2019-20	30,29,707	9.4	1,67,99,963	8.9	4.8
2020-21	35,99,981	18.8	1,88,44,578	12.2	6.2

- When we look at the recent data, there is a distinct difference between the rate of growth of Reserve Money and Money Supply .
- The latter shows a much slower growth which is to be attributed to lower credit expansion and greater currency withdrawal.
- Also the CPI inflation has gone up when there is a pick-up in money supply.
- If money supply grows in tandem with the Reserve Money growth, it would have ended up with a much higher level of inflation but here, the inflation has largely remained within the zone of comfort.
- One reason is in the behaviour of individual prices while the other is the unintended moderation in money supply.

What is the significance of expansionary fiscal?

- Expansionary policies involve the increase in money supply through measures such as open market operations, where the central bank purchases short-term Treasuries with newly created money, thus injecting money into circulation.
- But timing with respect to when to moderate it is also important
- This is because, after the 2008 crisis, many countries including India continued with an expansionary policy over an extended period, which resulted in inflation.

What is the need for moderating the Reserve Money growth?

- As the economy moves towards a normal situation, money multiplier will

rise with credit growth.
- There are enough excess reserves now which will also trigger growth in money supply, once activity picks up.
- Currently, the policy rate is negative adjusted for inflation and continuance of this can lead to financial repression which will keep the interest cost low and inflate the economy.
- The quantum of money or liquidity at large is critically important for understanding the inflation, since supply dynamics with respect to individual commodities does not provide the full answer.
- For an understanding of inflation, observing money supply growth is as important as reserve money growth.

Reference

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