CHAPTER I

INTRODUCTION
In the history of human civilization money has played a significant role. It has removed the constraints of the barter system and served as a convenient medium of exchange. In the course of time, money has emerged from being more as a medium of exchange, via the liquidity preference, to become the most preferred asset. As an asset its accumulation, distribution and productivity have become important considerations in the pursuit of economic development of the nations — both developed and developing. Necessarily therefore, monetary policy is a powerful instrument for change helping growth and distribution of income, as much as the fiscal policy.

**Monetary policy**

Monetary policy refers to the management of money in furtherance of the economic policy of the state. It means defining the objectives of sound management and the measures adopted in pursuance thereof. Monetary policy operates through changes in the stock of money, which changes influence the level of aggregate demand for output in money terms, either directly or indirectly. It has two noteworthy features, one is that it is aggregative policy, that is, any allocational or sectoral problems are beyond its domain; the other is that it operates on
the demand side and not on the supply side of the commodity market. Changes in the stock of money deserves to be carefully watched and controlled because such changes exert a powerful influence on changes in money income, prices, output, employment, distribution of income and wealth, and balance of payment. Thus given the stable demand function for money, an autonomous change in money supply leads either to a direct change in money income or first to a change in the rate of interest, which then to a change in the level of income. However, there may be several structural difficulties for the free working of the policy and the result may be inflation or deflation, requiring further adjustments in money supply.

The main goals of monetary policy are: (a) Maximum feasible output; high rate of growth; fuller employment; price stability or the optimal rate of inflation; greater equality in the distribution of income and wealth; and a healthy state of balance of payments. There are some broad tenets which need to be satisfied for proper conduct of monetary policy. First, changes in money supply causes changes in aggregate nominal income. Second, the aggregate demand function for money has to be stable. In other words, the amount of money people wish to hold bears a stable relationship to their money income in the

aggregate. However, if the relationship becomes unstable, the conduct of monetary policy generally veers from targeting of quantity of money to that of rate variables, eg. interest rates, exchange rates, etc. And third, expectations about the future price level play a critical role in determining the current level of inflation and the way the expectations are formed would be central to monetary analysis.

In India

Monetary policy is an arm of economic policy. Broadly the three major objectives of economic policy in India have been (a) growth, (b) Social justice implying a more equitable distribution of income, and (c) price stability. Faced with multiple objectives that are equally relevant and desirable, there is always the problem of assigning to each of the several policy instruments, the most appropriate target or objective. Of the various objectives, price stability is the one that can be pursued most effectively by monetary policy².

The broad money measure (M₃) has been the target variable for purpose of monetary control and the source of reserve money creation (usually the Reserve Bank credit to government) was the operating variable. However,

control was also exercised through bank credit as an intermediate target. Thus Cash Reserve Ratio (C.R.R), Statutory Reserve Ratio (S.R.R) and refinance policies were combined with selective credit control, credit target, and administered interest rates to achieve the monetary goals.

The promotional facet of monetary policy is demonstrated in this country in the measures taken to enlarge the institutional supply of rural and industrial credit.

The focus of monetary policy in the first decade (1951-60) of planning was on revival of the traditional weapons of monetary control. In the second decade, (1961-70) the emphasis shifted to economic growth and control of the increase in money supply; since 1970 the objective of faster economic growth with price stability was evolved to meet the credit needs of the growing economy and to keep a check on inflationary prices. This policy has come to be known as "Controlled Expansion (of money supply) Policy".

In India, monetary policy is attracting increasing attention in recent years. Since monetary policy acts

---

through influencing credit and money, its effectiveness depends on the institutional framework available for transmitting impulses released by the Central Bank and this institutional framework has been modified significantly in the last (1980's) decade and after.

Monetary policy is best suited to achieve the goal of price stability in the economy. It has also been recognised that, in the long run the objectives of price stability and growth do not necessarily conflict with each other. Rather in today's altered economic context, a low and stable price environment is being increasingly regarded as an essential condition for improving the growth and productive potentials of the economy.

In today's world, the nature of the working of economies has changed radically due to the pressure of competition and globalisation. This has made firms extremely conscious of price competition. Since firms, workforce and countries compete at the margin, public policies for providing a stable background to the economy has assumed critical importance for promoting growth and productivity. These developments have made the countries, across the world, more conscious of the hidden costs of inflation and their adverse implications for growth.

Perhaps the single-most important contribution that monetary policy can make under these conditions is to maintain a low and stable rate of inflation that would provide the necessary condition for promoting competition, efficiency and growth in the economy.\(^5\)

**Significance of Money Supply**

The importance of money in developing countries goes beyond its conventional role as a medium of exchange and a store of value. In developing countries, money performs a crucial function in the process of economic growth by providing a channel through which the resources of surplus units are transmitted to those in greatest need of these resources. Rather it acts as a conduit of resources from savers to investors and contributes to economic development.

In a monetary economy, where each single transaction is valued in terms of the unit of national currency, it is nothing but a truism to say that money supply has a role in determining the price level in the economy. Analytically viewed, in the short run, with output fixed, the price level is essentially determined by the excess demand condition in the economy, which depends on the level of demand and supply of real money balances. It is

thus natural that once the real money balance is increased above what is demanded by people the pressure would be felt on the demand for goods and services or assets, leading to an increase in their prices.  

Several developing countries have experienced chronic and at times, accelerating inflation in recent years. The inflation has been due to increasing deficit financing also. There is a renewed concern regarding fiscal - monetary policy nexus in these countries, including India. This study is an attempt to analyse the dynamics and inter-relationship of government deficit, money supply, inflation and economic growth in the Indian context.

**Problem Focus**

Studies on inflationary process in developing countries have argued that causation between money and prices may not be uni-directional as postulated by the monetarist model but it may be viewed as running both ways. It is found that government expenditure adjusts more rapidly than receipt to a given change in price level and as a result, inflation widens the fiscal deficit, leading through the Central Bank loans to the government deficit financing; the larger money supply exacerbating inflation further. Thus inflationary process
in developing countries is found to be characterised by the self-perpetuating cycle of deficit-induced inflation followed by inflationary-induced deficit. The situation in India is not much different. The growth process has been accompanied by inflationary situation due to the uncontrolled expansion of money supply.

So the experience of Indian economy marked by growth coupled with inflationary situation, due to the expansion of money supply is a fertile area for research.

Money supply in India has shown a high growth rate in the years following independence. There could be several factors leading to the growth of money supply. So an attempt to study the determinants of money supply is felt appropriate as the growth of money supply extends itself by affecting the process of economic growth and being affected by the growth.

Then, factors that affect money supply make a balancing between money supply, GDP and inflation a difficult task. Hence it is necessary to study these factors or determinants of money supply. With this focus, the objectives of the study are formulated.

**Objectives**

The overall objective of this study is to understand the dynamic changes in the key economic variable
viz., (i) money supply, (ii) GDP, (iii) inflation and (iv) deficit financing and inter-relationship among them, so as to suggest ways for a non-inflationary growth of Indian economy. Specific objectives are:

1. to assess the trend in GDP, Money supply, General Price Level and Deficit Financing since 1970 (This refers to the fiscal year 1970-71, i.e. April 1, 1970 to March 31, 1971);
2. to study instability in the above macro variables;
3. to understand the inter-relationship between these variables; and,
4. to evaluate the scope for a balancing between money supply and growth rate in GDP, so that the real growth rate is non-inflationary.

**Hypotheses**

Above objectives suggest the following hypotheses for empirical verification in this study.

1. There is significant growth in each of the variables viz., Money Supply, GDP, General Price Level and Deficit Financing. The growth in money supply and consequent rise in general price level, along with rapid growth of human population have caused a very slow growth of real GDP per capita - the measure of economic growth of the economy.
2. Interaction among the key variables and interventional policy of the government have resulted in a wide interyear variation in the variables. It is a sign of instability in the growth process.

3. The relationship between money supply, GDP and general price level are bidirectional.

4. The stability in price level is possible through monetary policy.

5. The stability in money supply will ensure stability in economic growth (real income per capita).

Scope of the Study

There are several issues of monetary policy which are debated continuously. These issues are related to the effectiveness of monetary policy in maintaining price stability and achieving faster economic growth, the method of implementation of monetary policy, effectiveness of the direct and indirect instruments of monetary control and what should be the intermediate target of monetary policy.

A noted monetary economist had once said, "The first and the foremost lesson that history teaches about what monetary policy can do - and it is a lesson of most profound importance - is that monetary policy can prevent money itself from being a major source of economic
disturbance ... to provide a stable background for the economy... and to contribute to offsetting major disturbances in the economic system arising from other sources.

The study analyses the changes in the money supply, GDP, General Price Level and Deficit Financing. The growth level in these variables and their inter-relationship would enable to evaluate the effectiveness of monetary policy as an instrument of promoting economic growth with stability. The study would identify the major components of money supply and their effect on inflation. The study would focus special attention on the effect of fiscal deficit on inflation. Thus the study attempts to evaluate the effectiveness of monetary policy in bringing stability in money supply to ensure stability in economic growth.

Limitations

The study is based entirely on secondary data collected from different published sources. Efforts have been made to choose the better among the different sources without any personal bias. The limitations inherent in the secondary data are to be recognised.

The study is based on time series data for the period from 1971 to 1998. Since the number of observations
is small, it has left a small degree of freedom restricting the scope of multivariate analysis. The problem of multicollinearity, autoregressive errors and co-integration of variables which are common in time series analysis have been identified and solved.

**Organisation of Thesis**

This thesis is organised into seven chapters as follows:

**CHAPTER I - INTRODUCTION**

The choice of the problem, problem focus, objectives hypothesis, scope and limitations of the study are stated and the organisation of the thesis is described.

**CHAPTER II - REVIEW OF LITERATURE**

An objective review of the past studies relating to the subject, viz., impact of money supply, is presented, to delineate the scope of this study and to identify important inferences useful to the analysis of data.

**CHAPTER III - METHODOLOGY**

Important concepts of money supply, monetary policy, economic growth, and inflation and their inter-relationships are stated. Sources of data, tools of analysis, models used and statistical texts employed in the study are presented.
CHAPTER IV - MONEY SUPPLY

The results of analysis of money supply, its sources, composition, trend and instability and fiscal deficit are discussed, decade-wise for pre and post economic reform periods.

CHAPTER V - ECONOMIC GROWTH AND INFLATION

The growth in nominal and real GNP, GDP, GDP per capita, General Price Level and the rate of inflation decade-wise are presented and discussed. The trend, cycle and instability are also discussed.

CHAPTER VI - INTER RELATIONSHIP

The interrelationships between money supply, GDP and General Price Level are studied, with the help of cointegration analysis, Granger’s test for uni or bidirectional relationship is applied and inferences drawn.

CHAPTER VII - SUMMARY, CONCLUSIONS AND IMPLICATIONS

A summary of inferences drawn is presented, conclusions are drawn with reference to the hypotheses of the study and their policy implications are studied.