CHAPTER 7

CONCLUSION, IMPLICATIONS AND SUGGESTIONS

7.1 Introduction:

The findings of the study have been summarized and results have been concluded in this chapter. The study sets out the impact of financial liberalization on money supply, its components, lending rates, deposit rates and prices. Money supply is most important variable and has been analyzed in detail.

Concept of demand for money and optimum money supply, as laid down by Chakravarti-Rangrajan Committee has also been discussed. Besides, it brings out the difference between money supply and money supply calculated on the basis of theory of multiplier has also been discussed along with its causes in the light of financial reforms. Relationships between money supply and prices, money supply and national income, and prices and national income have also been discussed.

7.2 Conclusion:

Money Supply:

As we all know four measures of money supply has been adopted by RBI, in decreasing order of liquidity criteria; M1, M2, M3 and M4. Only M1 and M3 are important from the point of view of policy making.

There had been a positive effect of liberalization on M1 and M2. Average growth rate of M1 and M2 had been higher in the post liberalization compared to that of in pre liberalization. But it has been lower in post liberalization era for M3 and M4 as compared to that of in pre liberalization era.

Components of Money Supply:

Currency and demand deposits are important components of M1. Share of currency had been exhibiting roughly an increasing trend during pre-reforms period but had been fluctuating around 55 percent during post liberalization.

Share of demand deposits had been fluctuating around 40 percent except two or three years during pre-reforms period but around 43 percent during post-reforms period, a
slight improvement is there in share of demand deposits. This corroborates the fact that more an economy is developed higher the ratio of demand deposits. This corroborates the fact that more an economy is developed, higher the ratio of DD.

Currency, demand deposits and time deposits are important components of M3. Shares of currency and demand deposits had been fluctuating and exhibiting roughly decreasing trends, not only during pre-reforms period but also during post-reforms period. Share of time deposits had been increasing continuously in pre as well as in post-reforms period.

**High Powered Money:**

Growth rate of H had been fluctuating in pre as well as in post-reforms period. Its average growth rate decreased from 17.6 percent during pre-reforms to 13.6 percent during post-reforms period. Cash with banks and banks' deposits with RBI are very important components of H and increasing continuously. But a slow growth of banks' deposits with RBI resulted in a lower growth of H during post-reforms period.

**Money Multiplier:**

Value of narrow money multiplier had been fluctuating throughout the time period under consideration, but it had been more volatile during post-reforms period. Comparatively broad multiplier had been less volatile during the post-reforms period. Average value of narrow multiplier has been decreased slightly, while it has been increasing for broad money multiplier during the post-reforms period.

**Monetary Ratios**

Currency ratio, reserve ratio and time deposit ratio are three important monetary ratios. All the three ratios affect narrow money multiplier inversely. First two ratios affect broad money multiplier inversely while last one affects positively. Average of first two ratios decreased in post-reforms period, while time deposit ratio has exhibited a great increase.

**Optimum Growth of Money Supply:**

Growth of income has been widely accepted as a major determinant of growth of demand for money. Supply of money should be in accordance with demand for money.

Optimum growth of money supply is calculated on the basis of growth of GDP and with the help of formula provided by Chakravarti-Rangrajan Committee (income
elasticity of demand for money is 2 and 4% inflation should be there.). A comparative analysis is made and it was found that mean of deviation of growth of M1 from optimum growth of money supply is 0.28, while it is -2.78 for M3.

Cheap Monetary Policy:

Cheap monetary policy had been adopted during post-reforms period to ensure the adequate supply of money to fulfill the increasing need of economy. Cheap monetary policy means decrease in cost of borrowing from banks, which results an increase in borrowing from banks and increase in money supply.

Bank rate was not below 9 % in the pre-reforms period but it was declined to 6 % in the post-reforms period. CRR was 15 % in 1989-90, but it was reduced to 5 %, SLR was 38.50 % which was reduced to 25 %. Money supply was following the changes in high powered money in the pre-reforms, but we can't ignore effect of monetary policy too.

In the post-reforms period, cheap monetary policy was adopted and there had been a positive effect on M1. But monetary policy is not only factor affecting money supply. Other factors had also been affecting money supply as; high powered money and monetary ratios.

During 1979-80 monetary ratios had been affecting growth of money supply. Growth rate of H had been enough high (20.83%) and there was no change in monetary policy even then growth of M1 had been negative in the same year. It was due to very high monetary ratios. In fact currency ratio stood at its maximum in the same year.

Again in 1989-90, even after adopting a tight monetary policy, growth rate of money supply stood at its maximum. It was due to very high growth rate of H and very low monetary ratios.

External Sector:

Various liberal policies has been adopted regarding external sector during the liberalization. As a result, foreign exchange reserves have increased to a very huge amount. Its growth rate had been higher in post-reforms period as compared to that of in pre-reforms period.

FDI had been playing very important role in boosting the growth rate of foreign exchange reserve. Though, growth rate of FDI had been fluctuating. Net NRI deposits
had not only been positive but in substantial amount. We can conclude that liberalization of external sector had a positive effect on money supply.

**Money Supply on Theoretical Basis:**

Money supply is calculated on the basis of theory of money multiplier and compared to actual money supply. There had been difference between both during pre as well as in post-reforms period.

But important thing is that difference had increased in post-reforms period. It had not exceeded Rs.100 crore during pre-reforms period except two years. But it had not been below Rs.100 crore except one year during post-reforms period.

Decreasing credit deposit ratio in post-reforms period, increasing external borrowing, NPAs, reserves & surplus along-with increasing investment in government securities can answer the question why the difference between money supply on the theoretical basis and actual money supply has been increasing substantially in the post-reforms time period. Increasing investment in Government securities and increasing NPAs have a negative effect on credit creation and FCBs have an offsetting affect on demand for credit.

**Rate of Interest:**

**Deposit Rates**—nominal deposit rates had been more stable in pre-reforms period but volatility in real deposit rate had been higher during pre-reforms period as compared to that of in post-reforms period. During pre-reforms period, time deposits had been following behaviour of nominal deposit rates except three to four year, but during the post-reforms period other factor affecting time deposit had been dominating.

Many times real deposit rates had been negative during pre as well as in the post-reforms period. Time deposits are popular in low level income group, who are not able to diversify their portfolio to reduce their investment risk and wants to play safe with fixed earnings. Thus a negative return is unjust with them.

**Lending Rates**—nominal lending rate varied within a narrow limit during pre-reforms as compared to that of in post-reforms period. But situation is different for real lending rate, it had been more volatile during pre-reforms period. Nominal lending rates had been exhibiting roughly an increasing trend during pre-reforms period, but a decreasing trend during post-reforms period.
Rapid growth of banking sector during post-reforms period and increasing competition among banks and deregulation of lending rates had been affecting lending rate. Though nominal lending rates had been decreasing during post-reforms period, even then real lending rate had been very high during post-reforms period. If we compare situation of 1991-92 to 2001-02, nominal lending rate decreased from 19% to 11%-12% but real lending rate increased from 5.3% to 7.4-8.4%.

Nominal lending rates had been almost stable during pre-reforms period but rate of investment and growth rate of credit had been fluctuating during the same time period. So we can conclude here that both had not been following nominal lending rate. But both had not also been following real lending rate. Both are neither sticky to nominal lending rate nor to real lending rate.

**Illusion among Investors**— though investment rate had not been sticky to real or nominal lending rate for a long time, from 1990-91 to 1993-94, yet investors had been following normally nominal lending rate, it seemed that investors had been suffering from interest rate illusion.

**Growth Rate of Credit:**

While adopting a cheap monetary policy, bank rate, CRR and SLR had been decreased to ensure a smooth and high growth rate of credit. It was a big change in monetary policy but it could not result in any miracle.

Growth rate of credit had been above 10% during pre-reforms period but it had been below 10% for three years during post-reforms period, there had been an unsatisfactory growth rate of credit during post-reforms period. It had been fluctuating and remained below the expectation level many times.

**Rate of Interest on Government Securities:**

Yield on Govt. Securities never exceeded 12% except two or three years during pre-reforms period, but it had been above 12% except two years during post-reforms period.

Bank rate had been decreasing and yield on Govt. Securities increased after the reforms. Many times during post-reforms period bank rate had been less than rate of interest on Govt. Securities.

It was gain without pain for banks to borrow from RBI and invest in Govt.
securities. Ratio of banks' investment in Govt. securities to aggregate deposits had been higher during post liberalization period compared to that of in pre liberalization period; in fact it had been exhibiting an increasing trend too.

**Causal Relationship between Money Supply and Prices:**

According to results of Granger test; money supply (M1) had been affecting prices (WPI) during pre-reforms period but this relationship had not been existing during post-reforms period. Affect of prices on money supply had not been seen either in pre and or in post-reforms period.

**Causal Relationship between Money Supply and National Income:**

Impact of money supply (M1) on national income (NNP) is statistically significant only at 10% level of significant for the pre-reforms period. But the relation is significant at 5% level of significant for post-reforms period.

National income had been affecting money supply inversely during pre-reforms period but no such affect had been seen during post-reforms period.

In case of broad money supply, no relationship between money supply and national income is statistically significant for pre and post-reforms period.

**Causal Relationship between Prices and National Income**

As far as relationship between NNP and prices is concerned, only effect of prices on NNP is statistically significant for post-liberalization period. It means impact from supply side had been absent.

As far as impact of liberalization on prices is concerned, prices had been monetary determined phenomenon during pre-reforms period and became an important determinant of national income.

**7.3 Implications:**

1. Share of currency in narrow money has decreased and share of demand deposits has increased in post-reforms period as compared to that of in pre-reforms period. It implies that people have started using more demand deposits and less currency in transactions during post-reforms as compared to that of in pre-reforms period. It is sign of improvement of banking habits of people.

But there is only a slight increase in share of demand deposits in money
supply and a slight decrease in share of currency in money supply. A slight improvement is not enough because still share of currency is more than that of demand deposits. It shows underdeveloped banking habits of people. These types of undeveloped banking habits of people even after a long time of adopting liberalization raise a question on the impact of liberalization on our banking system.

2. Value of narrow multiplier which had been less in post-reforms period than that of in pre-reforms period, implies that people’s choice in form of currency ratio and time deposit ratio and banks’ choice in the form of reserve ratio had been affecting money multiplier negatively and thus money supply too.

   H is another determinant of money supply and its growth rate exhibited a decrease in post-reforms period due to a slow growth of banks’ deposits with RBI. Decrease in CRR may have been affecting these deposits.

3. Comparative analysis of actual money supply and optimum money supply by using technique of mean of deviation has provided the result that M1 is closer to optimum money supply than M3.

   It implies that narrow money should be taken as policy target instead of broad money. Here important thing to pay attention is that demand deposits which are important part of narrow money have an element of endogeneity, because its supply depends on its demand. Here growth of narrow money is close to growth of demand for money or optimum growth of money. Thus we should take it as monetary policy target.

4. Cheap monetary policy had been adopted during post liberalization period. But other factors had also been affecting money supply as; high powered money and various monetary ratios etc. It implies that monetary policy alone is not enough to affect money supply but other factors can also play an active role to hinder the effectiveness of monetary policy.

5. External sector had been affecting money supply positively due to increasing inflow of funds. FDI had been playing important role in growing foreign exchange reserves.

   But a lot of fluctuations in growth of FDI imply that only liberalization is
not enough to ensure the smooth and continuous inflows of funds. These kinds of fluctuations can be harmful for our economy.

6. Increasing gap between actual money supply and money supply on the theoretical basis, implies that money supply could have been higher than what it had been during post liberalization. We can not ignore this kind of negative impact on money supply due to adopting those policies, which had not been compatible with each other; as increase in yield on Government securities and decrease in bank rate and SLR etc.

7. Growing competition among banks due to expansion in banking sector and deregulation of lending rates could bring down only nominal lending rate. It was not enough to boost the investment rate because even after a substantial decrease in nominal lending rate, real lending rate had been very high during post-reforms period.

   Moreover lending rate had not been the only factor affecting investment.

8. Increase in yield on Govt. securities has resulted in increase in ratio of banks’ investment in Govt. securities to aggregate deposits of banks. Banks had been investing a substantial part of their funds in Govt. securities, so there had not been use of decrease in SLR.

   There had been an offsetting effect of external commercial borrowings on the demand for credit of banks. Lending rate had been decreasing but even then had been very high as compared to that of on ECBs. Banks had not been able to reduce their lending rate due to very high NPAs. Lack of competitiveness had been affecting banks adversely.

9. Money supply had been affecting prices during pre-reforms period positively but effect is not statistically significant during post-reforms period. It implies that monetary policy along is not enough to ensure stability in prices after liberalization but relationship has become more complex during post-reforms period. And it is obvious in globalizing economy.

10. Positive impact of money supply on national income implies that monetary policy can be adopted not only to affect price level, but income level of an economy too. Negative effect of national income on money supply provides one more factor
affecting money supply and making it endogenous factor rather than exogenous factor. NNP had been affected by narrow money and prices, implies that inflation should be moderate but not too low, that no incentives are there for investors.

7.4 Suggestions:

1. Yield on Govt. Securities should be brought down to ensure the suitable results of policy of decrease in SLR, which had not been effective due to banks’ increasing investment in Govt. Securities due to very high yield on Govt. securities. Banks’ increasing investment in Govt. Securities is not a healthy activity for growth of credit too.

2. NPAs had been an important cause of in-competitiveness of our banks. Profitability is major objective of banks, so banks could not decrease their lending rate to be competitive in globalizing banking structure. NPAs had been resulting in huge losses to banks. Stapes taken by our Govt. to handle the problem, which had been inadequate during post liberalization period; some effective policies should have been taken.

3. Banking expansion during post liberalization had not been adequate to serve to a huge population, because banking habits of people are still underdeveloped. In Malaysia currency ratio had been greater than one, but with passage of time and expansion of banking facility it decreased to less than one. In India, only a little improvement had been noted during post-reforms period, currency ratio is still greater than one in India. An adequate growth rate of banking is still required in India.

4. We should restrict external commercial borrowings, until our banks are unable to compete with theses ECBs. External sources of borrowing had been adversely affecting demand for credit of domestic banks as a result unsatisfactory growth of credit had been during post-reforms period. Instead of restricting them, we can allow them in priority sector as infrastructure and export-oriented sector, which has been affected adversely by rising rupee.

5. We should not depend only on monetary policy to ensure stable prices in our economy because relationship had not been so simple during post-reforms period
as it had been during pre-reforms period. Other factors affecting prices had been dominating during post-reforms period which raised a question on effectiveness of monetary policy as a tool of controlling prices.

6. Various liberal policies in external sector had been adopted and as a result we can see a lot of unrestricted inflow of funds from different channels. But these types of uncontrolled inflow can render instability in economy. Data shows there had been wide fluctuations in FDI. Not only due to changing conditions of our economy but there had been effects of fluctuations in external economies too.

   It is just like inflow of fluctuations and instability. After allowing foreign inflows, it becomes a difficult job to ensure continuous and smooth inflow of funds. Thus we should be aware of adverse effect of external sector on our economy.

7. Cheap monetary policy and low lending rate are not enough to boost the investment rate. In fact investment rate had not been sticky either to nominal lending rate or to real lending rate. Other policies should be taken as complementary policies along with cheap monetary policy.

8. Monetary policy plays important role in enhancing the national income, because money supply (M1) affects national income positively. Thus we can use it in solving the problem of inadequate growth of national income in economy.

9. Money supply should not be taken as exogenous factor while making policies. Various factors have been affecting money supply as NNP and various monetary ratios make it endogenous to some extend.

10. Narrow money had been closer to optimum money supply than broad money so we should take narrow money for monetary targeting, instead of taking broad money.

11. A low inflation rate is good economic as well as political phenomenon. But being an important determinant of national income, too low rate of inflation is also not good. Even after a reduction in nominal lending rates, real lending rates had been very high due to a low inflation rate. It is not in favour of investors.