

Taking a closer look at money supply

For an understanding of inflation, observing money supply growth as opposed to just reserve money growth, is very important



C RANGARAJAN

Milton Friedman said in 1970 that “inflation is always and everywhere a monetary phenomenon”. The pendulum has now swung to the other extreme. Today’s discussions on inflation make no reference to money. Neither extreme positions are valid.

The Old Quantity Theory of Money assumed that any increase in the quantity of money will have no effect on output (transactions). This is consistent with the classical view that money is a ‘veil’. Real magnitudes are affected only by real factors. But this view is no longer accepted. We need to understand that the process of money creation is a process of credit creation. The two go together.

In the process of money creation, credit goes either to government or business sector. Depending on the situation, money creation may have greater effect on output or greater impact on prices.

It is true that the focus of policy these days is more on price (interest rate) than quantity (money). But the two are interrelated. At the equilibrium, both the quantity and price are determined.

The monetary authority cannot in effect ‘order’ interest rate. They need to adjust quantity (money or liquidity) so that the desired level of interest rate is achieved. In fact, more recently since 2008 ‘Quantitative easing’ has become popular. There are occasions when quantity works better. (For a more elaborate analysis of

the importance of quantity see, Rangarajan & Nachane, “Inflation, Monetary Policy and Monetary Aggregates”, *Journal of Indian Public Policy Review*, May 2021.)

The preceding discussion takes me to the main point that recent discussions on inflation in India in the Monetary Policy Statements tend to ignore money, even though there is reference to liquidity. The two (money and liquidity) are close but not identical, depending what definition of liquidity one takes. Mainly the discussions centre around the supply disruptions due to domestic or external factors. They do explain the behaviour of individual prices but not general price level which is what inflation is about.

If inflation is to be kept under control, the authorities need to have control over liquidity or money. The critical question is what happens to demand, that is, demand in monetary terms. Thus the quantity of liquidity or money is relevant. Analysts need to go beyond pointing out to price movements of food articles or crude oil.

Liquidity boost

The pumping of liquidity through various channels by RBI has been quite significant. In fact, what we need to look at is not what is happening at the discount window but at Reserve Money. Here, we need to make a distinction between ‘durable liquidity’ and temporary liquidity. Any purchase of government securities by RBI from banks adds to durable liquidity. This is more relevant than what is lent for a short period by RBI.

In my view, one factor that has contributed to the moderation in inflation between 2012-13 and 2019-20 is the moderation in Money Supply (Table 1). Obviously, one needs a more complicated model to explain inflation including output gap and

Growth in Reserve Money and Broad Money

Table 1

Year	Reserve Money		Broad Money (M3)		CPI (Combined) Inflation 2012=100
	Stock at the end of the period (₹ cr)	Y-o-Y growth (%)	Stock at the end of the period (₹ cr)	Y-o-Y growth (%)	
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

Growth in 2021-22

Table 2

Year	Reserve Money		Broad Money (M3)	
	Stock at the end of the period (₹ cr)	Y-o-Y growth (%)	Stock at the end of the period (₹ cr)	Y-o-Y growth (%)
April 2021	35,85,500	18.7	1,89,17,436	11.1
May 2021	37,05,431	18.3	1,90,10,395	10.3
June 2021	36,98,987	16.9	1,91,66,960	10.7
July 2021	37,15,957	16.8	1,93,71,595	9.9
August 2021	36,79,192	15.2	1,93,28,509	9.5
September 2021	36,59,299	14.7	1,93,92,124	9.3

expectations. But we cannot ignore money supply. As mentioned earlier, policy rate and Reserve Money creation are interrelated.

When we look at the recent data, two things stand out—there is a distinct difference between the rate of growth of Reserve Money and Money Supply (Table 2). The latter shows a much slower growth. This is to be attributed to lower credit expansion and greater currency withdrawal. The money multiplier has come down. Second CPI inflation has gone up when there is a pick-up in money supply.

However, it should be noted that inflation has largely remained within the zone of comfort. Had money supply grown in tandem with the Reserve Money growth, one would have ended up with a much higher level of inflation. In fact, several members of the Monetary Policy Committee in their Minutes have expressed satisfaction

about the fact that inflation had moderated. But they seek the reason for it in the behaviour of individual prices. But one reason is the unintended moderation in money supply. We have to draw the right lesson.

In a difficult situation like the one posed by Covid-19, an expansionary fiscal policy and a supportive monetary policy are needed. But timing with respect to when to moderate it is also important. Many countries including India made this mistake after the 2008 crisis. They continued with an expansionary policy over an extended period, which resulted in inflation.

Time has come to moderate Reserve Money growth. As the economy moves towards a normal situation, money multiplier will also 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. A continuance of this can lead to ‘financial repression’ with all the attendant consequences.

In fact, the growth since April 2021 is largely attributable to the relaxation of restrictions on mobility. So long as lockdown continued no policy can be effective. The crucial year will therefore be 2022-23 when policy actions can become relevant. However, my main focus is not on this aspect.

What I would like to urge is that for an understanding of inflation, supply dynamics with respect to individual commodities does not provide the full answer. The quantum of money or liquidity at large is critically important.

The writer is a former Chairman of the Economic Advisory Council to the Prime Minister, and a former Governor, Reserve Bank of India

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