

## 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?**



- 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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