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A study of RBI's approach to money supply

Sunita Devi

Assistant professor in economics

K.R.M degree college for girls, Jamal (Sirsa)

Abstract

There is a never-ending discussion about the money supply process and its effect on macroeconomic variables, and the factors that influence the money supply are always under scrutiny. To that end, this article investigates what factors affect India's money supply and how policymakers have responded. This study provides a thorough evaluation of the primary factors that have historically determined the size of the money supply and how these factors have evolved through time. Using RBI's yearly data from 1990-1991 to 2014-2015, a monetary multiple process analysis was conducted. The article identified two primary factors—one that is close at hand and another that is policy oriented—but concluded that the latter had more influence than the former. The most crucial insight here is that the type and mix of both determinants have altered, which has policy implications.

Keywords: Money Supply, Determinants, Money Multiplier, Proximate, Policy Oriented.

Introduction

Central bankers, policymakers, and academics are all interested in the monetary supply. There is always heated discussion on how much weight to give to research into money supply when examining any given economic system. Extreme monetarists, on the one hand, hold that the money supply plays no role and that all assets, both real and financial, are near replacements for money, notwithstanding their differences in ideology. However, the foundation of extreme Neo-Keynesianism is the idea that money is irrelevant and that only changes in interest rates on a narrow collection of financial assets count. The money supply is a basic concept in economics since it is one of the primary drivers of the fluctuations of macroeconomic variables. The issue over whether or not the money supply should play a role in setting prices is as ancient as economics itself, and it remains relevant in every era. According to the "quantity theory of money, inflation is always and everywhere a monetary phenomenon, produced in the first instance by an unduly rapid growth in the quantity of money assertion does not hold that an increase in money supply growth rate is the sole cause of inflation in long run, but just the most important cause. However, the debate over the connection between money and inflation or money and other macroeconomic factors is beyond the scope of this article. But because of the

strong link with the macroeconomic variable of the economy it is now pertinent to offer two significant concerns which need to be addressed. When looking at the time period under investigation, what factors most strongly influence the money supply? What changes in the underlying factors have occurred in the money supply during the same time frame? The study attempts to address these issues by using a money multiplier strategy. In we provide some theoretical context for the factors that affect the money supply. explains the multiplying effect of money. The conducts the trend analysis of money multiplier (m) and the high powered money (H), both the primary factors of the money supply process. In Parts V and VI, we break out what goes into determining both m and H. Finally the gives the final observations.

Determinants of Money Supply

Researchers have mentioned two main schools of thought when discussing how India's monetary policy is set: the balance sheet method (also called the structural approach) and the money multiplier approach. The structural method favors investigation of individual items in the consolidated monetary sector's balance sheet to explain variation in money stock, while the money multiplier approach focuses on the link between the money stock and reserve money. The money multiplier method arose forcefully as a critique to the balance sheet approach, which sparked a heated and fruitful discussion in the 1980s between two camps of academics: those headed by Gupta, who supported the idea of money multiplication, and those supported by RBI economists, who did not. The theoretical difference between the two may seem to be restricted to be two separate places of departure; the divergence to some extent, however, also represents the deeper cleavage between monetarist and non- monetarists. It was particularly who in his paper severely criticises the method in which RBI carries out the examination of money supply in India. Gupta contends that the RBI's analysis is tautological, and that the RBI's whole methodology, which is merely an accounting analysis, is empirically meaningless and therefore in favor of total methodological revision. A major argument in favor of the proposed methodological change was the need to account for leading (real) variables like consumer behavior when analyzing the money supply. This addition is crucial because it will form the basis of the true analysis and the elements that control the money supply in the economy. In order to effectively implement monetary policy and gain insight into the economy's broader macroeconomic framework, it is important to analyze the factors that influence the money supply, the banking system, and the public's participation in the creation of the monetary

aggregate. In this light, we're also curious in the post-reform period's money supply and will do our best to analyze it in depth. The entire study is based on the money multiplier process. By using a novel definition, we analyze the endogeneity of commercial bank loan and its sensitivity to structural determinants peculiar to the Indian setting. With this specification, we can separate the roles of the Reserve Bank of India (RBI) and the Commercial Banks in the money supply process while still identifying money supply in a single equation. Features of the Indian financial system aid in the design of the test and highlight the influence of structure on the money supply process. Prior to the nineties high powered money was endogenized by the automatic funding of the Government deficit. However, direct supervision of banks' credit creation and measures like reduced public investment to dampen demand were proposed as ways to implement monetary control. Did it work? To what extent did commercial banks endogenize lending in pursuit of profit even when doing so went against the goals of the central bank? How much did they increase loans to satisfy demand? What kind of authority did the RBI really have? Exactly how have the process's structural factors played a role?

Banks now have more leeway thanks to financial reforms; capital inflows make it more difficult to regulate high-powered money; and as near financial alternatives emerge, the demand for money is likely to fluctuate. However, even in the modern day, modeling the underlying structural characteristics of bank activity might be helpful for creating policy. Although loans result in deposits, their availability is subject to market forces as well. They are reliant on the RBI's monetary policy, which alters the base money supply, and the banks' pursuit of maximum profit. It's often assumed that macroeconomists either consider the money supply endogenous or think it's under control of central banks. But the facts appear to lay halfway between these viewpoints. We learn that while the RBI has been able to alter the base money, banks have been able to avoid regulations and extend credit when there were profits to be earned.

As to Post Keynesian monetary theories, financial organizations will only provide credit when it is needed, and they will do it in a way that maximizes profits. illustrates how banks may increase broad money supply with no change to the base by offering different incentives to depositors. A stable aggregate money supply function may be derived and estimated by using a structure-oriented approach to the relationship between bank assets and the monetary base. The latter captures the enduring trends, coming from a historical process, in which banks adjust according to their evolutionary advantage. His final equation is similar to ours. He calculates a

supply function, which includes the structural variable of real estate prices. A conventional money supply function does not contain such a variable.

The model and its empirical testing are based on basic concepts in macroeconomics. Parsimony is the goal of our specification. It provides data on the endogeneity of bank loans and the significance of structural factors. All inside a simple mathematical style that sidesteps identifying issues. For both annual and quarterly data, OLS is used to estimate the model. We also use ARIMA models for time data. This permits us to separate the effects' duration from their onset. A cointegrating vector and long-run regression are achieved. The findings are described in . The appendix has the details.

Review of literature

(Zamrodah, 2016) studied money supply in indi~: concepts, compilation and ~nalysis" discovered, and It is necessary to re-view the appropriateness of the different notions underpinning the current series on money supply in light of recent advancements in monetary theory and recent experience in monetary management. For these reasons, the Bank established the Second Working Group on Money Supply to do the following: I review existing concepts and definitions of money supply with an eye toward tailoring them to the Indian monetary data in order to improve the quality of analysis and policy formulation; (ii) propose changes to the methodology used to compile money supply data; and (iii) generate a new set of monetary data time series. I'm pleased that the Working Group was able to investigate this thoroughly and come up with a unified report. The publication of this report is motivated by a desire to encourage greater dialogue on this crucial topic among academics and policymakers.

(Ahmad & Yadav, 2016) studied "Determinants of Money Supply in India: A Post Reform Scenario" discovered, and There is a never-ending discussion about the money supply process and its effect on macroeconomic variables, and the factors that influence the money supply are always under scrutiny. To that end, this article investigates what factors affect India's money supply and how policymakers have responded. This study provides a thorough evaluation of the primary factors that have historically determined the size of the money supply and how these factors have evolved through time. Using RBI's yearly data from 1990-1991 to 2014-2015, a monetary multiple process analysis was conducted. The article identified two primary factors—one that is close at hand and another that is policy oriented—but concluded that the

latter had more influence than the former. The most crucial insight here is that the type and mix of both determinants have altered, which has policy implications.

(Goyal & Dash, 2000) studied "the Money Supply Process in India: Identification, Analysis and Estimation" discovered, and Commercial bank credit's endogeneity and its reaction to structural factors important in the Indian context are tested using a novel specification. By using our specification, we can separate the roles of the Central Bank and the Commercial Banks in the money creation process, allowing us to determine money supply in a single equation. Bank credit responded differently to changes in commodity costs and industrial output as opposed to financial variables. Major factors were not interest rates but rather returns on various industries. In general, monetary policy was successful in halting inflationary expectations and stemming the tide of a monetary supply explosion. However, real output was hurt because it was aimed at manufacturers' prices. According to the estimated framework, it would be more effective to regulate inflation by focusing on agricultural prices. The timing of a monetary contraction and the subsequent increase in food prices should be accelerated relative to historical norms. Monetary policy can benefit from the insights provided by the systematic structural features.

(Personal & Archive, 2010) studied "Determination of Money Supply in India: The Great Debate" found that and Researchers reported that - in India, there were two approaches to money supply determination: the balance sheet or structural approach, which looked at individual items in the consolidated monetary sector's balance sheet to explain changes in money supply, and the money multiplier approach, which looked at the relationship between money stock and reserve money. Bhattachary.

(Outcomes, n.d.) studied "concept of money supply" discovered, and The ideas behind monetary demand were covered in the last lesson. It would be impossible for an economy to run normally without money. Economists and policymakers pay close attention to variations in the money supply since it is widely believed that these shifts are the root cause of fluctuations in other major macroeconomic variables. In order to keep the economy stable, the money supply must always be just right. In order to do this, it is necessary to routinely and precisely assess the level of money stock and to control it so that it meets the country's monetary needs. We'll be exploring many facets of the money supply in this lesson.

Conclusion

The demand for speculative credit is shown to have prompted a response from Indian banks providing loans. Price and output responses to food and non-food items are distinct. The inflation of non-food prices has been the target of monetary policy, which has been successful in preventing an inflationary money supply boom. A more effective method of reducing inflation would be to focus on lowering the cost of food and other agricultural goods. A contraction of base money finished sooner than in the past, coinciding with an increase in food costs, would enhance the timing of the monetary base's expansion. Specifics of such a targeting rule are straightforward to determine. Monetary policy in India may benefit from the wealth of data contained in the country's well-organized economic infrastructure.

When financial institutions were financially motivated to increase their credit card limits, they circumvented a number of quantitative restrictions. The market may be used as both a "carrot" and a "stick" to prevent asset price bubbles that lead to monetary growth. Increasing incentives for productive investment may be the "carrot," while increased taxes and regulation may be the "stick." Credit is an endogenous result of agent incentives. However, these incentives were embedded in a wide variety of pricing variables in our data set because interest rates were imperfectly flexible. Moreover, there was evidence that Reserve Bank monetary regulation had exacerbated shocks to actual production while failing to stop the growth of credit spurred by speculative profit motive.

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