CHAPTER - VI

SUMMARY

During last two decades [1970-71 to 1989-90], there have been remarkable policy changes in the quick succession influencing different aspects of banking and monetary system in India. This period witnessed considerable increase in bank resources, extension of banking, diversification integration and reorientation of the policy of the RBI. Continuous rise in money supply [M3] and prices had been the important characterstic feature of the period.

Our study period has two distinct phases. From 1970 to 80, there was a phase of significant institutional and structural changes in the banking and finance supporting the stance of many structuralists in the conduct of monetary policy. The other pahse 1981 onwards, is a phase during which we have followed the process of liberalisation and opening up of the Indian economy, to give a fair trail to market forces.

The development in banking sector and the development of new financial instruments have paved the way for gradual financial deepening of the Indian economy.

A marked shift in public's preference from currency to banks deposits has resulted into excessive expansion in money supply in the country. In this regard, our main findings are :

1. Institutional and structural changes in the Seventies have resulted into monetisation of the Indian economy. A gradual fall in currency to deposit money ratio and currency to reserve money ratio in the Sevenites and attaining relative stability in Eighties. The currency-deposit ratio had fallen from 66.7% to 33.6% between 1970-71 to 1979-80 and then attained stability around 25% during Eighties. The currency with the public used to constitute more than 90% of RM in 1970-71 and its relative share had fallen considrably during the period of study. In the year 1989-90, it was 59.7% of the total RM have resulted in relative stability of money multiplier [Table - 3.1 and Annexure - 6].

2. Ms = m.RM . Multiplier "m" remaining constant variation in money supply would be caused by the variation in RM. The same is found in Indian context. The relationship between RM and M3 shows a very strong positve co-relation a unitary change in RM leads of 3.1 time increase in M3. Further, M3 - RM elasticity is around unity, [1.09]. Hence, RM truns out to be a very storng explanatory variable of M3 and supports our hypothesis that the monetary base RM, has strong positve impact on the change in Money Supply.

3. Money stock, under the strong influence of RM, varies as and when RM varies. M3 and RM have grown nearly at the same rate. The growth rate of M3 was 16.08 per cent while that of RM was 14.58 per cent. Therefore, the factors which bring about changes in RM ultimately cause change in money stock. Though,

all the sources of change in RM have strong relationship with total RM, some of them having a very small share in total, their ultimate influence over M3 was relatively less as it was in the case of Government currency liability. Though, it exibits more than proportional influence over RM, its share in total RM variation was hardly 2% [Table 3.1].

4. Commercial Banks and Commercial Sectors borrwoing from the RBI influences the Reserve money in a sizeable manner. In this case too, the variation is positive and more than unity, but over years the relative share in total RM has attained stability around 16% to 17%. Moreover, from the annual variation in the RBI's credit to different sectors, it seems that the RBI restricts the expansion of credit to Banks and Commercial Sector keeping in mind the availability of its own resources at its disposal i.e. the NNML of RBI. Except for the year 1970-71, the total credit to these sectors was certainly lower than the total net non-monetary liability of the RBI, [NNML > RBI credit to Banks and Commerical secotr]. These two sectors take away as much as 64% of the RBI's own funds. Even on year to year basis, there seems a strict discipline being followed by the RBI [Table 4.3]. Hence, we deduce that though the RBI credit to Banks and Commercial sector exhibit very strong relationship with RM, they can be treated as to be policy controlled variables.

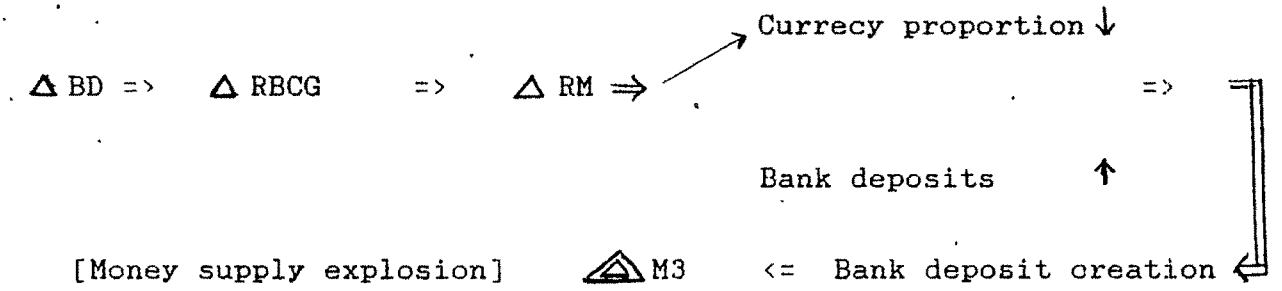
5. RBI credit to foreign sector is another source of change in RM; At times infact it's relative share in total RM was

as high as 41.4%, in the year 1977-78. Over years, the study shows that the influence of foreign sector over RM variation is less predictable. Moreover, the trend after 1979-80 is very noticeable. Foreign sector's influence over RM as estimated by its share in total RM has fallen continuously from 38.6% in 1978-79 to 7.9% in the year 1989-90 [Table 4.4].

6. Our study clearly highlights that the principal source of change in RM was the Net RBI credit to Government. It is evident from the fact that on one side RBI credit to government [Net] constitutes more than 90% of the total RM and on the other side the relative growth in the RBI credit to government is higher than the growth in RM. During the period of our study, RM has grown at the rate of 14.58%, where as the net RBI credit to government has grown at the rate of 15.71%, [Table 3.3].

7. The variation in net Reserve Bank Credit to Government is determined by the extent of the Budgetary Deficit of the Government. So the Government's fiscal operations and debt management activities influence monetary base very strongly. Our study shows that Net RBI credit to government and the Deficit Financial need of our government are highly co-related. The statistical estimates show that 1% change in BD leads to 0.85% change in net RBI credit to governmen, which very strongly supports our hypothesis that the government's monetary and fiscal operation have strong influence on monetary base. According to our estimates 85% of the budgetary deficit of the government is monetised automatically. [Table - 3.4]

8. Based on the various behavioural equations estimates, it seems that budgetary deficit of the government causes almost equal change in government's borrowing from the RBI, which inturn leads to around 90% variation in RM. The given change in RM finally brings about more than two and half time increase in money supply.



[Chapter 5.I]

9. The interaction between monetary and real forces, in the country, reveals that during our study the real sector variables were less sensitive to the monetary expansion, particularly the variation in real output was not sufficiently sensitive to changes in money stock [Table 5.2].

10. The rapid rise in money supply, during the period of our study, accompanied by slower growth in output resulted sharp rise in price level. [Table 5.2]

11. Money and output when compaired with prices either in nominal terms or in real terms the outcome does not change much. Unit change in money supply results into Ø.51 unit, increase in real net national output while the influence on price level is much more [Ø.943].

12. Finally, it was observed that money stock variation brings about similar impact on output and prices even after one year lag adjustment. Which makes us to believe that in our country. Monetary expansion has relatively strong positive impact on the price level than on real output.

Conclusion :

From the work carried out so far in Inida's monetary and real sectors using quantitative technique for varities of estimates, we are now in a position to deduce some conclusions which we hope, would be useful to individual research workers in particular and policy makers in general.

[i] Unlike the belief that money multiplier in less developed economies is highly unstable at least in the short run, we find that money multiplier has remain stable and predictable during the last decade of the study. Though some variation in its value were observed in the preceding decade it could be attributed to structural and institutional changes. Thus, our study supports the RBI cotention with regard to the behaviour of money multiplier in recent year.

[ii] The RM has strong influence over money stock in Inida [M3]. The reserv money multiplier has got stability at its estimated value of 3 [Three]. Also, in terms of elasticity, the degree of responsiveness of M3 with respect to RM is around unity.

[iii] Our analysis of sources of change in RM has revealed relatively strong influence of RBI credit. We also observed that monetary authority has successfully kept balance in the credit allocation among other domestic sector so as to serve the mounting need of government. RBI has played permissive role with respect to government borrowing. Highest possible changes in RM were due to the single source namely RBI credit to government which has caused enormous change in money stock. It is hardly necessary to stress that the mounting budgetary deficits of the government has forced the government to borrow enourmous amount from the RBI.

[iii] It has been shown earlier that the RBI has successfully controlled credit availability of domestic sectore [excluding government] during the period of our study. Thus there is better management of credit allocations which can be attributed to effective use of policy instruments available at the disposal of RBI. Hence, unlike the general belief that the instrument of central banking policy are less effective in credit management, we find an evidence that they have greater role to play in India context.

[iv] As mentioned earlier, the structural and institutional reforms which wre carried out in seventies and with substantial improvement in banking habits of the public in eightees together with stability of banking sector, there was a marked shift in the preference of the public in holding of currency. This component came to dominate the structure of RM. It was this shift in

public's preference and continiously growing share of deposits has caused enourmous credit creation by the banking system leading to overall increase in the money supply.

[v] Economsits and policy makers have been debating for a fairly long period on the relationship betwen output, prices and money supply. There is no dearth of liturature on these aspects we have made a modest attempt to identify the influence of change in money stock on price level and output. We find that during the period of our study change in money stock has relatively strongly influenced the price level than the level of output. The estimate in terms of lag relationship also confirms the above statistical relationship. Thus, we are of the opinion that inflation in India is a monetary phenominan.

Policy recommendation :

[1] Not only in theory but also in practice the RBI should play more autonomous role in monetary managment. It should refrain from playing permisive role with respect to making credit allocation to government sector.

[2] In view of the strong influence of budgetary deficit on RM, we recommend that all efforts should be made by the fiscal authority to restrict the budgetary deficit to the required minimum level, which in turn requires - scientific estimation of deficit.

[3] Government should explore other sources of finance to meet its budgetary deficits, reliance on market borrowing rather than from the RBI, which would make government more accountable and reduce the pressure on RM creation by the RBI.

[4] In order to achieve price stability the RBI should restrict the growth of Money Supply particularly by restricting the volume of credit created by the banking system. This aim can very well be achieved by judicious use of policy instruments at its disposal in this direction.

[5] In view of the fact that despite enormous credit expantion the output has not shown much responsiveness, there is a need for proper alloation of credit particularly to those sector of our economy having more productive potentials. Hence, the monetary policy should not only be directed toward quantitative control but also towards better credit allocations. Thus, this dual approach hopefully would reduce infationary pressures and impart economic stability to our economy.

While we have made several recommedation, we are aware of the fact that there is an urgent need to undertake emperical study in the field of budgetary deficit so as to identify the relevant economic and non economic forces, which underlien budgetary operations. Though this is an important areas but it certainly lies outside the scope of our study.