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A STUDY ON MONEY SUPPLY, INFLATION RATE AND GDP – AN EMPIRICAL EVIDENCE FROM INDIA

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ABSTRACT

Money, a vibrant tool in society that can do anything and everything in country's economy, the inflation rate and GDP also having equal partake along with money supply. Bump up in money supply will result in prices increment, which will pilot to fall in people's standard of living. With this in mind, it is important that the authorities set particular prominence on the control of money supply. In order to control the money supply, the monetary authorities must evaluate the amount of money within the country by time to time. If the money supply is in control, the inflation rate and GDP also in the line as they are next of kin to money supply. In this study I just covered the objective of eloquent about money supply, inflation rate and GDP of India with the help of secondary data through simple statistical methods and graphs for the period of ten years from 2000-01 to 2009-10. Virtually explain about the elected task I have had started with theoretical aspects and then moved into numerical data calculations. Hope exhibiting the facts and figures may lead to get the answer for the question we had in the introduction part of the study with no trouble. Lets we go into the study and finally reach the conclusion with the understanding about the money supply, inflation rate and GDP.

KEYWORDS

Consumer Price Index, Economy, GDP, Inflation Rate and Money Supply.

INTRODUCTION

Does the money supply inflation rate and GDP playing vital role in the economy of the country? For this question we can say the answer as "YES" without open the eye. But how much it implies? That is the question need to be answer with evidence. Here in this study I have attempted to reveal the facts and figures on money supply, inflation rate and GDP of India. Excess supply of a commodity or product usually reflected in downside pressure on its price, and the same is true for money. Excessive supply of money leads to its debasement, to a decline in its value that otherwise is known as inflation. Where money supply generally is an underpinning of economic activity, it also is the ultimate determinant of prices and inflation. On another hand, the gross domestic product (GDP) is one the crucial sign used to determine the strength of a country's economy; it represents the total value of all goods and services produced over a specific time period.

MONEY

By simply, money means more than the coin, paper or plastic to acquire goods and services. Money can be defined as any medium which facilitates the exchange of goods and services between people. Now in modern era money is any object or record, that is generally accepted as payment for goods and services and repayment of debts in a given country or socio-economic context. On another hand, money is often defined in terms of the three functions or services that it provides. Money serves as a medium of exchange, as a store of value, and as a unit of account.

MEDIUM OF EXCHANGE

Money's most important function is as a medium of exchange to facilitate transactions. Without money, all transactions would have to be conducted by barter, which involves direct exchange of one good or service for another. The difficulty with a barter system is that in order to obtain a particular good or service from a supplier, one has to possess a good or service of equal value, which the supplier also desires. In other words, in a barter system, exchange can take place only if there is a double coincidence of wants between two transacting parties. The likelihood of a double coincidence of wants, however, is small and makes the exchange of goods and services rather difficult. Money effectively eliminates the double coincidence of wants problem by serving as a medium of exchange that is accepted in all transactions, by all parties, regardless of whether they desire each others' goods and services.

STORE OF VALUE

In order to be a medium of exchange, money must hold its value over time; that is, it must be a store of value. If money could not be stored for some period of time and still remain valuable in exchange, it would not solve the double coincidence of wants problem and therefore would not be adopted as a medium of exchange. As a store of value, money is not unique; many other stores of value exist, such as land, works of art, and even baseball cards and stamps. Money may not even be the best store of value because it depreciates with inflation. However, money is more liquid than most other stores of value because as a medium of exchange, it is readily accepted everywhere. Furthermore, money is an easily transported store of value that is available in a number of convenient denominations.

UNIT OF ACCOUNT

Money also functions as a unit of account, providing a common measure of the value of goods and services being exchanged. Knowing the value or price of a good, in terms of money, enables both the supplier and the purchaser of the good to make decisions about how much of the good to supply and how much of the good to purchase.

MONEY SUPPLY

The money supply or monetary aggregates or money stock is the total amount of money available in an economy at a particular point in time. A number of items may qualify as media of exchange. The decision as to what items are to be included in the money supply remains an issue in economic debates. There is no universally applicable empirical definition of money supply and the choice may vary dependent on what issue is being examined. There are varying degrees of liquidity or 'moneyness', depending on how easily an asset can be converted into other assets. With the most liquid assets being notes and coins established as medium of exchange by legal fiat, "moneyness" of other assets depends on how easily they may be converted to notes and coins. Furthermore, as the degree of liquidity falls, the distinction between monetary assets and other financial assets becomes increasingly blurred. Therefore, in this context, the International Monetary Fund (IMF) has sought to outline standards for the measurement of the amount of money in an economy.

STANDARD MEASUREMENTS OF MONEY SUPPLY

According to the IMF's manual, money supply is measured as the combined deposit liabilities of the banking system and the currency liabilities of the central bank, both held by households, firms, nonprofit institutions and all public sector entities outside of the central government. In this official or standard representation of money supply, there are three monetary aggregates delineated; M0, M1 and M2. M0 includes only currency in the hands of the public, banks'

statutory reserve deposits held at the central bank and banks' cash reserves. This aggregate represents the monetary liabilities of the central bank and is usually referred to as the monetary base or reserve money. The second aggregate M1 comprises currency held outside the banking system and the current account deposit liabilities of commercial banks held for transitive purposes. It may also include some foreign currency deposits that are used for domestic transactions. This definition implies that only assets that are directly used in making payments should be considered as money. It should be noted that although most current account deposits do not attract interest, they provide a convenient and safe alternative to cash as a means of payment.

The M2 aggregation of money supply seeks to broaden the range of liquid assets to include some interest earning items, such as savings deposits and fixed or time deposits. This broad monetary aggregate, M2, comprises M1 plus short-term (usually a year and under) savings and time deposits, certificates of deposit, foreign currency transferable deposits and repurchase agreements.

In some countries, broad aggregation of money has been extended beyond M2 to include some less liquid financial assets. These aggregates add to M2, long-term foreign- currency time deposits, travelers cheques, short-term bank notes and money market mutual funds. Although these instruments are primarily used to promote long-term savings, they can be easily converted into currency or demand deposits at little cost. As such, they are said to facilitate the exchange of goods and services among individuals. The primary monetary aggregates outlined above all satisfy the liquidity criteria. While some assets could not be directly employed as payment for goods and services, the conversion costs were minimal. There are other less liquid financial assets, which satisfy the store of value criterion and their inclusion allows for broader measurements, such as M3 and M4.

MONEY SUPPLY FROM INDIA

Money supply data are recorded and published usually by the government or the central bank of the country; in India, Reserve Bank of India (RBI) doing that as its central bank of the country. First which measure of money supply RBI follows? There are four measures as listed below:

- M1: Currency with the public + Demand Deposits + Other deposits with the RBI.
- M2: M1 + Savings deposits with Post office savings banks.
- M3: M1+ Time deposits with the banking system
- M4: M3 + All deposits with post office savings banks (excluding National Savings Certificates).

RBI reports both M1 and M3. As M3 is broader in scope, it is taken as measure of money supply in India. The below table will exhibit the total components of money stock in India, from that we can take money supply from India during the study period.

TABLE NO: 1: COMPONENTS OF INDIA'S MONEY STOCK

Year	Currency in Circulation	Cash with Banks	Currency with the Public (2-3)	Other' Deposits with the RBI	Bankers' Deposits with the RBI	Demand Deposits	Time Deposits	Reserve Money (2+5+6)	Narrow Money (4+5+7)	Broad Money (8+10)
1	2	3	4	5	6	7	8	9	10	11
2000-01	218205	8654	209550	3630	81477	166270	933771	303311	379450	1313220
2001-02	250974	10179	240794	2850	84147	179199	1075512	337970	422843	1498355
2002-03	282473	10892	271581	3242	83346	198757	1244379	369061	473581	1717960
2003-04	327028	12057	314971	5119	104365	258626	1426960	436512	578716	2005676
2004-05	368661	12347	356314	6478	113996	286998	1595887	489135	649790	2245677
2005-06	429578	17454	412124	6869	135511	407423	1893104	571958	826415	2719519
2006-07	504099	21244	482854	7496	197295	477604	2342113	708890	967955	3310068
2007-08	590801	22390	568410	9054	328447	578372	2862046	928302	1155837	4017883
2008-09	691153	25703	665450	5570	291275	588688	3535105	987998	1259707	4794812
2009-10	799549	31516	768033	3839	352299	722739	4105151	1155686	1494611	5599762

Source: Reserve Bank of India, Note: Data for 2009-10 are provisional (# are Rupees in crore).

Table No: 1showing the total components of India's money stock from the year 2000 to 2010, in that we having the option to see the Reserve Money, Narrow Money and Broad Money as focal and currency in circulation, cash with banks, currency with the public, other deposits with the RBI, banker's deposits with RBI, demand deposits and time deposits as the source to give the key totals. Out of them Reserve Money comprises currency in circulation, other deposits and banker's deposits with the RBI.

Narrow Money consists of currency with the public, other deposits with RBI and demand deposits. Finally Broad Money incorporates time deposits with Narrow Money. Based on the above table we can go for some graphs, calculations and inferences further related to study.

CHART NO: 1: TREND LINE OF COMPONENTS OF INDIA'S MONEY STOCK

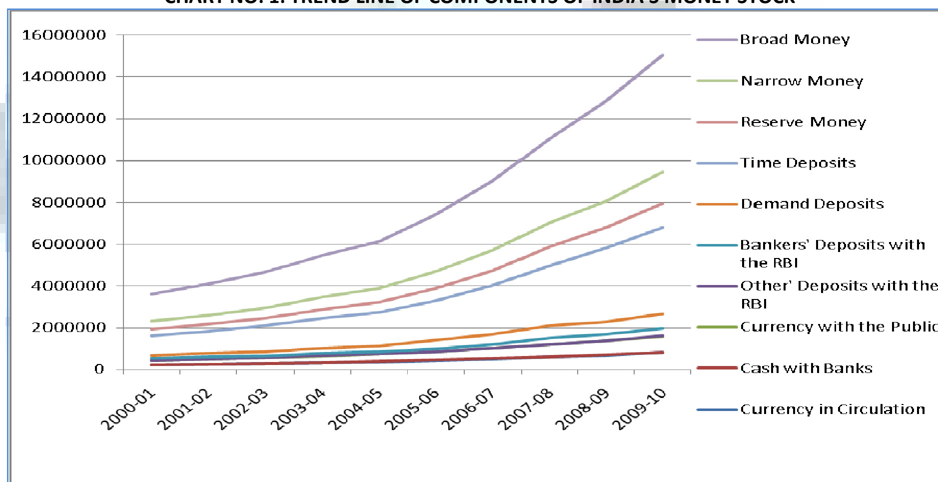


TABLE NO. 2: CAGR OF RESERVE, NARROW AND BROAD MONEY

Year	Reserve Money	Narrow Money (M1)	Broad Money (M3)
2000-01	8.11%	11.02%	16.82%
2001-02	11.43%	11.44%	14.10%
2002-03	9.20%	12.00%	14.66%
2003-04	18.28%	22.20%	16.75%
2004-05	12.06%	12.28%	11.97%
2005-06	16.93%	27.18%	21.10%
2006-07	23.94%	17.13%	21.72%
2007-08	30.95%	19.41%	21.38%
2008-09	6.43%	8.99%	19.34%
2009-10	16.97%	18.65%	16.79%

Source: Computed based on Reserve Bank of India data

Table No: 2 embody the Compound Annual Growth Rate (CAGR) of Reserve, Narrow and Broad money of India from the year 2000-01 to 2009-10. Reserve Money started with 8.11% in the year 2000-01 and reached 16.97% in 2009-10 by crossing many ups and downs. Narrow Money opened up with 11.02% and attained 18.65% in 2009-10. As already mentioned M3 is the reckonable unit for money supply in India, its founded 16.82% in 2000-01 and 16.79% during the year 2009-10, in-between 2000-01 to 2009-10 M3 accounted the highest CAGR of 21.72% in 2006-07 and lowest of 11.97% in 2004-05. By the way Table No: 2 explaining more that the Money Supply in India is in down trend from the year 2008-09.

INFLATION RATE

The inflation rate is one of the most important economic forces consistently weighing on the value of a nation's currency. By mean, the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Inflation, strictly defined, is the rise in prices over time due to the growth of money supply relative to money demand. In economics, the inflation rate is a measure of inflation, the rate of increase of a price index (for example, a consumer price index).

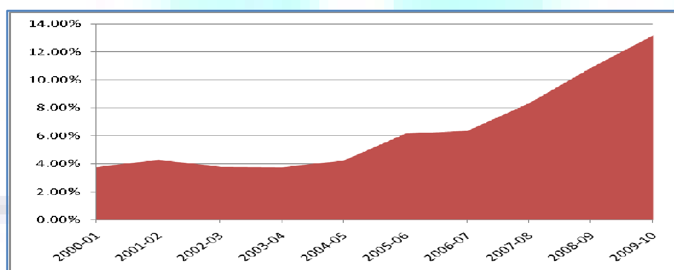
By trouble-free, it is the percentage rate of change in price level over time. The rate of decrease in the purchasing power of money is approximately equal. Without careful monitoring, there may be too much money chasing too few goods, thus placing upward pressure on prices that is inflation. Excessive inflation undermines business planning and leads to a decline in living conditions. There are two general methods for calculating inflation rates - one is to use a base period, the other is to use "chained" measurements. Chained measurements adjust not only the prices, but the contents of the market basket involved, with each price period. More common, however, is the base period reference. The most well known measures of Inflation are the CPI which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy.

TABLE NO: 3: INDIA'S INFLATION RATE (Average Consumer Prices)

Year	Inflation Rate (average consumer prices)
2000-01	3.78%
2001-02	4.30%
2002-03	3.81%
2003-04	3.77%
2004-05	4.25%
2005-06	6.18%
2006-07	6.37%
2007-08	8.35%
2008-09	10.88%
2009-10	13.19%

Source: International Monetary Fund (IMF)

CHART NO: 2 INDIAN INFLATION RATE (AVERAGE CONSUMER PRICES)



Inflation affects an economy in the distribution of income and wealth, and production. The Table No. 3 and Chart No.2 showing the inflation rate in India, it was reported at 13.19% in 2009-10. From 2000-01 until 2009-10, the average inflation rate in India was 6.49% reaching an historical high of 13.19% in 2009-10 and a record low of 3.77% in 2003-04.

From 2005-06 onwards the inflation rate started to breed and continues its upward movement. The dramatic increase in inflation leads the country under individual's economic problem; the above mentioned rate reflects the general increase in prices, taking into account the purchasing power of the common man in the country.

GROSS DOMESTIC PRODUCT (GDP)

GDP is a measure of all of the services and goods produced in a country over a specific period, classically a year. The GDP considers the market value of goods and services to arrive at a number which is used to judge the growth rate of the economy and the overall economic health of the nation concerned. Typically, it is expressed as a comparison to the previous quarter or year. For example, if the year-to-year GDP is up 3%, this is thought to mean that the economy has grown by 3% over the last year. Computing GDP is complicated, but at its most basic, the reckoning can be done in one of two ways: either by adding up what everyone earned in a year (income approach), or by adding up what everyone spent (expenditure method). Logically, both measures should arrive at roughly the same total. The income approach, which is sometimes referred to as GDP (I) is calculated by adding up total compensation to employees, gross profits for incorporated and non incorporated firms, and taxes less any subsidies. The expenditure method is the more common approach and is calculated by adding total consumption, investment, government spending and net exports. The following formula can exhibit how to calculate the GDP by expenditure method:

where:

$$GDP = C+G+I+NX$$

"**C**" is all private consumption, or consumer spending, "**G**" is the sum of government spending, "**I**" is the sum of all the country's businesses spending on capital and "**NX**" is the nation's total net exports, calculated as total exports minus total imports. (NX = Exports - Imports).

TABLE NO: 4: INDIAN GDP (PURCHASING POWER PARITY)

Year	GDP (PPP) (Billion $)
2000-01	1805.00
2001-02	2200.00
2002-03	2660.00
2003-04	3033.00
2004-05	3319.00
2005-06	3666.00
2006-07	4156.00
2007-08	2966.00
2008-09	3478.00
2009-10	3736.00

Source: CIA World Fact Book

Table No: 4 illustrating the Indian GDP (PPP) during the year from 2000-1 to 2009-10, from that we come to know about Indian GDP that accounted 1805 billion $ in the year 2000-01 and started to grow up till the year 2006-07 with 4156 billion $, then its got down to 2966 billion $ in the year 2007-08. Even the hasty down in the year 2007-08, the Indian GDP climbed to 3478 and 3736 billion $ during 2008-09 and 2009-10 respectively. The above entry gives the gross domestic product (GDP) or value of all final goods and services produced within a nation in a respective year. A nation's GDP at purchasing power parity (PPP) exchange rates is the sum value of all goods and services produced in the country valued at prices prevailing in the United States.

TABLE NO: 5: THE RELATIONSHIP BETWEEN INDIAN INFLATION RATE AND GDP REAL GROWTH RATE

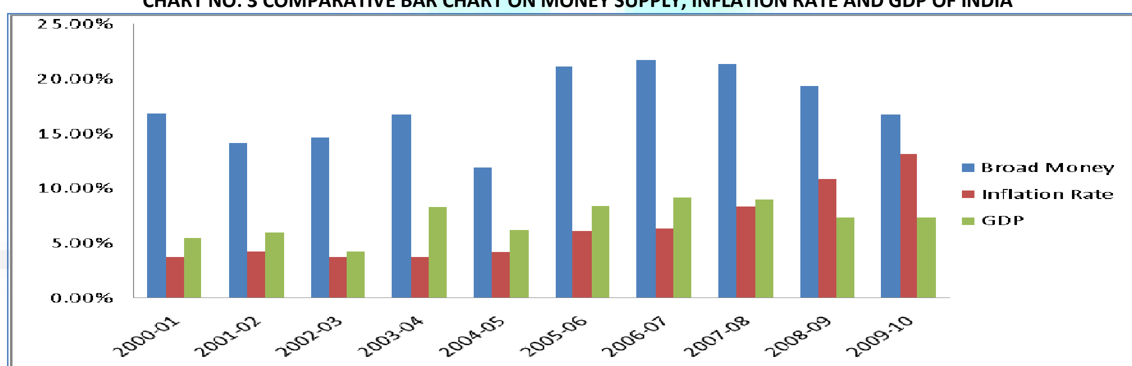
Year	Inflation Rate (average consumer prices)	GDP - real growth rate (%)	Correlation
2000-01	3.78%	5.50%	0.39582397
2001-02	4.30%	6.00%	
2002-03	3.81%	4.30%	
2003-04	3.77%	8.30%	
2004-05	4.25%	6.20%	
2005-06	6.18%	8.40%	
2006-07	6.37%	9.20%	
2007-08	8.35%	9.00%	
2008-09	10.88%	7.40%	
2009-10	13.19%	7.40%	

Source: IMF and CIA World Fact Book (computed).

Based on the data from IMF and CIA World Fact Book, I have attempted to reveal the relationship between the inflation rate and GDP real growth rate of India during the study period through statistical method called correlation. The table no: 5 demonstrating the Inflation Rate, GDP-real growth rate of India during the year 2000-01 to 2009-10 and also the correlation result between the both. The Indian Government seeks to reduce its deficit to 5.5% of GDP in FY 2010-11. By the receipt of 0.3958 correlation result we come to know that there is positive relationship between Inflation Rate and GDP real growth rate during the elected period but it seems not much influence on each.

To get a clear picture on money supply, inflation rate and GDP of India, I just formulated the graph and the same is putted below, with help from the chart we can straightforwardly compare the elements of the study took.

CHART NO: 3 COMPARATIVE BAR CHART ON MONEY SUPPLY, INFLATION RATE AND GDP OF INDIA



CONCLUSION

By latest RBI said that money supply was 64,327.53 billion rupees as of March 11, compared with 63,591.97 billion rupees on Feb. 25 and 54,744.89 billion on March 12, 2010. The inflation rate in India was last reported at 8.82 percent in February of 2011. Inflation affects an economy in the distribution of income and wealth, and production; it may controlled by monetary, fiscal and other measures. Monetary measures include adjustments in money supply and bank rates, open market operations and changes in reserve ratios. Fiscal measures include control on public expenditure, taxation, public borrowing and debt. Other measures include price control and rationing, changes in wage policy, etc. Apart from that as a citizen of the country every one should help to control the inflation rate by saving the money. As much as possible money should be saved, this will reduce the demand on the economy and hopefully reduce inflation. On other hand GDP, India's economy grew 8.2% compared to the same period a year earlier between October and December, government data showed on March 1, 2011. The Country's assorted economy includes customary village farming, modern agriculture, handicrafts, a wide range of modern industries, and a multitude of services. Services are the most important spring of economic augmentation, accounting for more than half of India's yield with less than one third of its labor force.

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With sincere regards

Thanking you profoundly

Academically yours

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