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# Inflation: Role of Monetory Supply & Financial Market

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**ABSTRACT**
Inflation is a matter of concern in a number of developed countries. During 1950s it started from low, rises for a time & then attained speak in 1970s and then fall back to initial level. The study aims at knowing the inflation dynamics in Indian content. The purpose is to investigate the role of monetory & financial market in inflationary tendencies in India. The interest rate changes with rupee depreciation, money supply create inflationary pressure which indicate that in the economic growth and price stability monetary policy plays an important role. There is a strong interplay b/w financial market & monetary policy. Market provide a medium to the companies to invest & grow.

**Keywords:** Inflation, Money Supply, Financial market, Interest rate, Monetory policy.

## INTRODUCTION

Inflation is no stranger to Indian economy. The Indian economy has been registering steady growth after the laberalization of Indian economy.

Infact till early 1990 Indian used to ignore inflation but after mid 1990s controlling inflation has become a priority the opening up of Indian economy has increased India industrial output and has raised the inflation rate.

Inflation was basically caused by domestic factors today it has changed to global factor as the Indian economy undergoes structural change the causes of domestic inflation to change at a sharp rate.

The monetary framework revolves on the inflation being a totally domestic money driven phenomenon. The inflation arises only when bank creates a large supply of money over demand. Due to this huge credit is increased pushing up the aggregate demand. Increase in aggregate demand will force the prices to go up.

There is substantial evidence that inflation is negatively correlated with financial markets economy with average rate of inflation have less well developed financial system then economy with inflation rate below.

Due to this there is always a question of money supply acompained by high inflation rates.

Monetary policy refers to a collection of activities that the central bank take to control money suppy & long term growth.

For the smooth running of the economy Financial market plays a major role. The market make it easy for byer & seller to exchange their financial holdings.

With the evaluation of financial market the economy has become more stronger. When these fail it result to recession & unemployment. The market provides return for the Excess Fund & making them available to those who need money. Basically the market rely on prices that are efficient and appropriate.

## BACKGROUND

### Monetary Policy Framework

- The Reserve Bank of India and government of India signed a monetory policy framework agreement in 2015.
- It was set up for setting target for monetory policy.
- The main goal was to maintain price stability with achieving growth.
- The initial monetory policy framework was set for 5 years which ended in 2021.
- The government set the same target of 4% for inflation between 2021 -26 by entending another 5 years.

**Types of Monetory policy**

Expansionary
(Dovish Policy)

Contractionary
(Hawkish Policy)

### Expansionary policy

1. This type of policy is used to increase money supply.
2. This is done by lowering interest rate and increasing liquidity.
3. This is used when economy is under recession.
4. During covid-19 in March 20 the Reserve Bank of India reduced repo rate by 75 b.p. from 5.15 to 4.40%
5. Is also reduced reserve repo from 4.9% to 4%

### Contractionary policy

1. This type of policy is used to decrease the money supply.
2. This is done by increasing the interest rate.
3. This is used when economy is inflated.
4. In August 2018 due to inflation and falling rupee the RBI increased repo rate by 25 b.p from 6.25% to 6.50%
5. It also reduced reverse repo from 6.1 % to 6.25 %

### Goal of monetary policy

The primary objective is to maintain price stability with the objective of growth
To maintain price stability inflation need to be controlled. The inflation target is set for every 5 years

- Flexible inflation targetting framework- after the 2016 amendment
- The inflation target to be set by government of India in consultation with RBI

**Monetary policy process**

- The monetary policy committee determines the policy interest rate required to achieve the target.
- The Reserve Bank department assist the Monetory Committee in formatting the monetary policy
- The financial market operation department operationlises the monetary policy

The financial Market committee meets daily to review the liquidity condition to ensure that the operating target is kept close to policy repo rate

**Monetary Policy Tool**

The basic tool to regulate the amount and growth rate of money supply. These tools are used to regulate unemployment and inflation. They are basically of two types:-

**Tools**

Quantitative
Bank rate
Statutory liquidity ratio
Cash reserve ratio
Repo rate
Reverse repo
Open Market Operation

Qualitative
Change in margin
Regulation of credit
Rationing of credit

**Monetary policy tool**

**Bank rate**

- It is a rate at which RBI is willing to purchase or sell bills or other commercial paper to banks. It is the rate at which RBI extend loan to other banks
- It directly impact customer as it impart long term lending
- A bank rate is the interest charge by country Central Bank to financial institution when borrow money to meet reserve requirements and preserve liquidity banks turn to the central bank for loans. Interest rate charged are designed to keep the economy stable. The current rate is 6.75%

**Open market operation**

The purchase and sales of government securities by RBI.

- **Statutory Liquidity Ratio**

Minimum percentage of deposit that every Bank need to keep in form of liquid cash

- **Cash Reserve Ratio**

Every bank has to maintain some liquid cash the liquid cash percent is Cash Reserve Ratio.

- **Repo Rate**

Rate at which commercial bank take loan from RBI.

- **Reserve Repo**

Rate at which RBI gives loan to bank. Current rate is 3.35%
The Quantitative tool influence the amount of credit available in the economy.
Through these tools government Combat inflation, lower unemployment rate and increase growth.
Causes of inflation (after inflation and interest rate) when the Government of country print money in large prices increase to keep us with currency
Increase in production and labour cost have direct impact upon price when country borrow money they have to cope with interest burden high Taxes can also lead to inflation.
Debt, war and other issue also cause the inflation.
Open Market = purchase and sale of government sector by RBI

**Problem due to inflation**
When the balance between supply and demand goes out of control consumer change their buying habit
Price increase can worsen economy affecting low income household

**Curbing inflation**
India is facing the problem of inflationary pressure because of increase in aggregate demand while supply is constant RBI plan that liquidity from the market can be drained by decreasing money supply and for this RBI is increasing CRR, repo rate, reserve repo by raising the reserve rate money cannot be multiplied and loans become costaler.

**History of inflation**
**1950s** - All under control
After independence the inflation was less than 2 %. After a decade it came under the control of 3-7 %.
**1960s - war and famine effect**
In 1960s the inflation was rise of about 6%.
This was due to war which China and Pakistan.
**1970 - high rise**
The 17th were the most inpredictable period in terms of inflationary uncertainity inflation was averaged 7.5% and for the first time in 1973 to 74 it crosses 20%.
**1980s - post reform effect**
Economic crisis of 1991 by balance of payment problem the inflation was around 13.9% inflation continue to rise from 1992 to 1996 of around 9.5% later from 1996 2005 it came down to around 5.4%
**1990s – Post reform effect**
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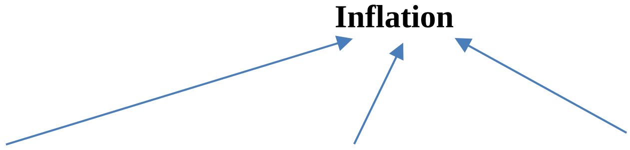
**2000s and beyond**
From 2003 onwards the economy started growing at 7%. Between 2008 to 2013 the Inflation was around 10%.
In 2020 among pandemic inflation increased to 6.6%

**Inflation**



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Demand pull Coast push Inflation expectation

Reserve Bank of India considers these three causes when forecasting inflation and determines its actions accordingly.

**Types of inflation (after inflation diagram)**

**Demand pull**

This describe how demands for goods and services can drive up their prices. If something is in short supply people pay more for it.

A country experience demand pull due to rising wages and citizen having money in their saving account

Consumer demand pulls prices higher because firm cannot keep up

**Cost push**

When raw material cost increase the business in turn raise their prices regardless of demand

**Current Inflation**

Record inflation is basically upon higher wages, energy prices and interest rate. The covid 19 pandemic the match that lit the inflation flame.

As people got sick and could not work that affect the supply chain which in turn affected prices. The Ukraine war caused a ripple effect that made oil and food prices go up.

The RBI has been raising interest rate to make borrowing more expensive to control inflation

**Inflation and interest rate**

When there is a risk of elevated inflation the bank increase the level of risk free reserves limiting the money supply available. When central bank reduces its target interest rate it increases the money supply available in the market by increasing borrowing cost rising interest rate discourage business spending.

Interest rate and inflation tend to move in same direction but with lags

**Financial Market**

For the smooth working of capitalist economy financial market are very important.

These are the market where basically trading of securities occur.

These market include asset or securities that are either listed or trade ever the counter.

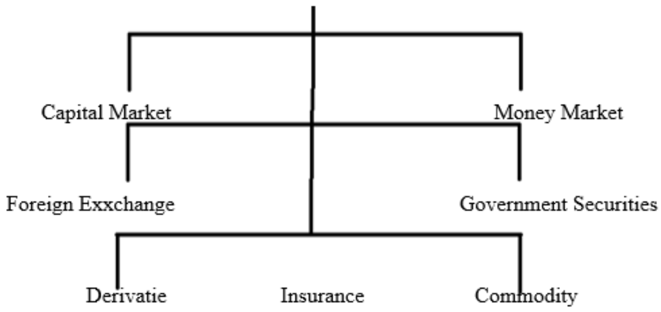
These market allocate resources and create liquidity for business and entrepreneurs.

**Types of financial market**

Stock market Over the counter Bond money Derivative Forex commodity Crypto currency

The main function of financial market is to allow efficient allocation of capital and asset.

**Financial Market**




**Types of financial Market (after financial market diagram)**

**Stock market**

The most common market are stock market they are venues were the company list their shares and are bought and sold by traders and investors.

**Over the counter market**

They are decentralized market and trading is conducted electronically broker are not involved.

**Bond market**

On this investor takes loan for a defined period at a define rate

**Money market**

They are traded with highly liquid short term maturities with low risk and low return

**Derivative market**

Their secondary security whose value is derived from primary security which are linked

**Forex market**

This is the market in which participant speculated on exchange rate between currency.

**Commodity market**

This market venue where producer and consumer meet to exchange physical commodity

A good financial market help in creation of wealth and provide a link between saving and investment through efficient allocation of funds

When RBI takes the decision to inc/dec interest rate the effect can be seen on the bond/equity market

Financial market are used in developed economy to maintain their economic and social stability and increase their economic level

## Result

The monetary policy framework was designed to keep the inflation in the bond of 2% and below 4% target. Interest rate are the primary tool to manage inflation high interest rate help in reducing inflation while low interest rate lead to rise in inflation. When inflation RBI increases bank rate to reduce money supply in economy. RBI sells out government securities to suck out excess liquidity from the market RBI increases cash reserve ratio to keep more money that cannot be lend. An increase in repo rate increase borrowing cost thus reducing money supply. By allowing free market for the flow of capital the financial market make the economy run smoothly while allowing investor to participate in gain over time.

Financial market is a fuel for economic activity, investment and growth & without them it would get diminished.

## Conclusion

The study aimed at examining the growth in the economy with the tools of monetory and financial market. The monetory supply and inflation and financial market are interconnected with each other. Inflation is not the devil. A controlled rise in inflation is a sign of growing economy. From the past data a rising inflation rate is good with an improvement in gross Domestic product. High inflation have adverse effect on GDP decreasing the purchasing power moderate inflation level should not be taken as a fear as they are n necessary for steady growth. Monitory policy measure employed by government influence economic activity government and to achieve through them high level of employment price stability

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