ABSTRACT

This dissertation examines several approaches to modeling the money supply process in India. An examination of the determinants of the money supply process, especially in the context of an economy undergoing the process of financial liberalization, is an important but often over-looked area in monetary research.

In the first substantial chapter of the dissertation we review the literature and distinguish three competing models of the money supply process, namely, 'Pure Portfolio Approach', 'Pure Loan Demand Approach' and 'Mixed Portfolio Loan Demand Approach'. On an examination of Indian monetary data, we find support for the 'Mixed Portfolio Loan Demand Approach' signifying a feedback relationship between bank lending, money multiplier and reserve money on the one hand and broad money on the Other.

Another potential source of endogeneity of the money supply is the influx of foreign capital that affects the balance sheet of the central bank. In the presence of significant capital flows into the economy concurrent with the on-going process of financial liberalization in India, we find that capital flows imparted an endogenous impact on monetary aggregates through the route of variable interest rates in a deregulated interest rate regime.

The post-reforms period of the 1990s has been characterized by a significant disassociation between growth in broad money and reserve money, and broad money Movement was found to be in line with that of the money multiplier. This necessitates an analysis of the innovations in the money multiplier, which could be useful to explain some complexities of the money supply process in recent years. We examine the extent to which the instability in the money multiplier could be attributed to the endogeneity of the money multiplier process. We introduce a feedback process between select macroeconomic variables and the money multiplier.

Having established that the money supply in India is endogenous and having identified some of the factors responsible for such endogeneity, we examine the

implications for intermediate targeting procedure of monetary policy. We formally examine the target misses associated with the monetary targeting (MT) strategy. Given the theoretical superiority of inflation targeting (IT) as the most efficient policy rule and in view of the potential of flexible and medium-term IT to accommodate other policy concerns (like asset price and exchange rate volatility), we have examined the suitability of direct targeting of inflation in India with reliance on an appropriate measure of inflation for targeting purposes.