

Demand for Money in India during the period of rapid Inflation

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The period 1972-74 is characterised by the presence of an inflationary trend. The latter though persistently visible after 1962, was much different during 1972-74 in that the rate of change of price level became positive - a stage of inflation when the economy deviates from the path of stable moving equilibrium.¹ The period, 1972-74 is therefore being termed as that of rapid inflation.

An explanation of the demand for money during this period needs to be done in view of a persistent but erratic decline in the amount of monthly holdings of real cash balances and small variance in income (at constant prices) and all but one of the opportunity costs of holding money.

The amount of real cash balances held started declining from May 1972 and continued to do so up to July 1974.² A small variance in income (at constant prices) is revealed by its rate of growth which has been +.4% and -4% in 1972-73 and 1973-74 respectively.

Most of the opportunity costs (represented by the rates of return on various forms of wealth in which money can be held) approximated by the rates of return on financial assets also exhibited a small variance.³ An extreme example of this is constancy of the bond rate of 5 per cent p.a. By contrast, the rate of increase in general price level (represented here by the wholesale price index, which is presumed to be more responsive to market conditions than the consumer price index) has been tremendous, as evidenced by the monthly average increase of 1.6 per cent. The money supply (in nominal terms) averaged an increase of 1.15 per cent per month during the same period.⁴

The downward trend of real cash balances (the amount of these balances set equal to 1 in Feb. 72) when the rate of change of the rate of change of price level became positive for the first time within the preceding two decades and opposite to that in the actual rate of price increase, is revealed by the scatter diagram.