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Empirical Evidence on Money-Price Relationship in India: Cointegration and Causality Approach

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Abstract: In recent years, the study of the causal relationship between money supply and price level has attracted the attention of economists, researchers, and policy makers. This study shall be significant in deciding whether price stability is the primary objective of monetary policy in India. Using the sample data on consumer price index and broad money supply for the period 1950-51 to 2015-16, this study provides the evidence of long-run equilibrium relationship between money and general price level. It further suggests the existence of unidirectional causality running between money supply to general price level in the long-run. And, also confirms the presence of bidirectional causal relationship between money and price in the short-run. But it is very interesting. The causality from money supply to price is positive whereas in the reverse direction it is negative. Thus, any increase in money supply would raise the rate of inflation and hence, price stability should be considered as the primary objective of monetary policy in India. On the contrary, rising inflation can be controlled through curtailed money supply implementation of appropriate monetary policy in the country.

Keywords: Money Supply, Price, Cointegration, Granger Causality, Error Correction Model

JEL Classification Code: C32, E31, E40, E51

INTRODUCTION

In recent years, the empirical study of the dynamics of short- and long-run relationships between money supply and price level in the context of developing countries has attracted the attention of economists, researchers, and policy makers due to the fact that maintaining price level stability is now considered the foremost objective of the central bank of a country. Over the past few decades, policy makers have become more aware of the socio-economic costs of inflation, and thus, more concerned with the price level stability. Price level stability is desirable because a rise in price level creates uncertainty in the economy, and leads to lower economic growth (Fisher, 1993). The Reserve Bank of India can effectively contribute to the