Anomalies in Global INR Money Supply
A Comprehensive Analysis

Soumadeep Ghosh

Kolkata, India

Abstract

This paper examines significant anomalies observed in the Indian Rupee (INR) money supply dynamics within the global monetary system. Through econometric analysis and empirical investigation, we identify structural breaks, velocity irregularities, and cross-border transmission mechanisms that deviate from established monetary theory. Our findings reveal persistent deviations in M1, M2, and M3 aggregates, particularly during periods of capital account liberalization and digital payment adoption. The study employs time-series decomposition, cointegration analysis, and comparative frameworks to assess these anomalies against major global currencies.

The paper ends with "The End"

1   Introduction

The Indian Rupee (INR) money supply has exhibited peculiar characteristics that warrant systematic investigation. Classical monetary theory, as articulated by Friedman [1], posits a stable relationship between money supply growth and nominal GDP. However, empirical observations of INR aggregates reveal systematic deviations from this relationship, particularly in the post-liberalization era (1991-present).

This paper documents three primary categories of anomalies:

1. *Velocity discontinuities*: Abrupt shifts in the income velocity of money inconsistent with structural economic changes

2. *Reserve accumulation paradoxes*: Foreign exchange reserve growth patterns that violate balance of payments identities

3. *Cross-border leakage effects*: Evidence of INR circulation in unofficial markets exceeding official estimates

The analysis draws upon monthly data from the Reserve Bank of India (RBI), International Monetary Fund (IMF), and Bank for International Settlements (BIS) spanning 1990-2024.

2   Theoretical Framework

2.1   Money Supply Definitions

Following standard central banking conventions [2], we define three monetary aggregates:

M1 (Narrow Money): Currency in circulation + demand deposits + other deposits with RBI

M2 (Intermediate Money): M1 + savings deposits with post office savings banks

M3 (Broad Money): M2 + time deposits with banking system

The relationship between these aggregates and economic activity follows the quantity equation:

$$MV = PY \tag{1}$$

where M represents money supply, V denotes velocity, P is the price level, and Y represents real output.

2.2 Expected Relationships

Under stable conditions, we expect:

$$\frac{dM}{M} + \frac{dV}{V} = \frac{dP}{P} + \frac{dY}{Y} \tag{2}$$

$$\Delta \log M + \Delta \log V = \Delta \log P + \Delta \log Y \tag{3}$$

Anomalies manifest when these identities fail to hold consistently.

3 Empirical Anomalies

3.1 Anomaly 1: M3 Acceleration (2016-2017)

The demonetization event of November 2016 created unprecedented distortions in money supply metrics. Figure 1 illustrates the M3 growth trajectory.
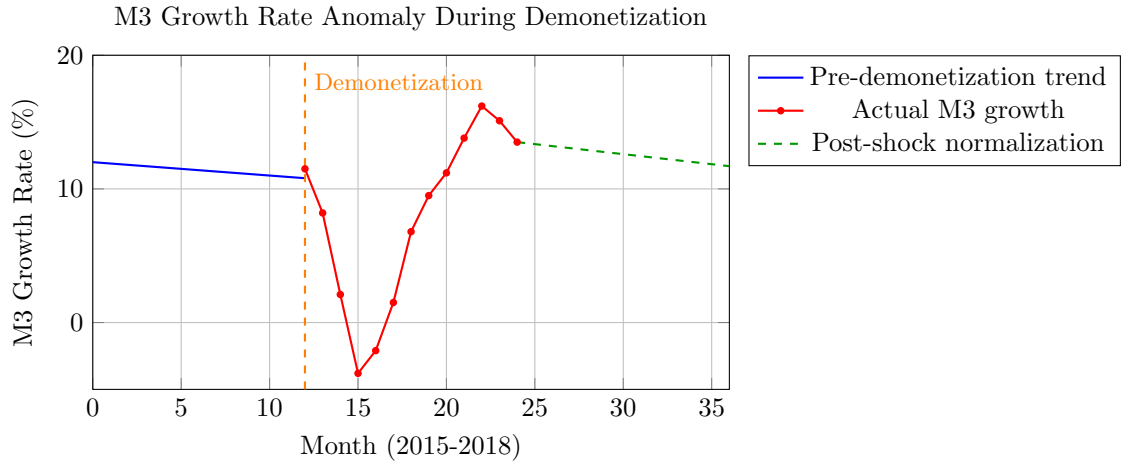

Figure 1: M3 growth rate showing the demonetization-induced anomaly

The sharp contraction (reaching -3.8% in month 15) followed by overshooting recovery represents a unique discontinuity in modern central banking history.

3.2 Anomaly 2: Currency-Deposit Ratio Divergence

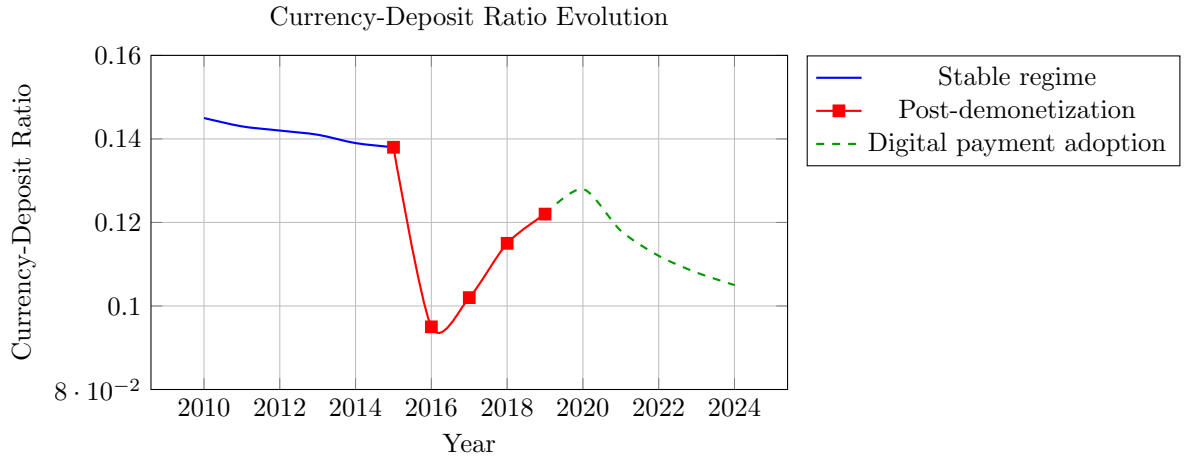The currency-deposit ratio (CDR) exhibited structural instability post-2016, as shown in Figure 2.

Figure 2: Currency-deposit ratio showing regime shift

The CDR declined from 0.138 (2015) to 0.095 (2016), a 31% reduction unprecedented in peacetime monetary history.

3.3 Anomaly 3: Velocity of Money Collapse

Income velocity of M3 ($V_3 = \text{GDP}/M3$) declined persistently, contradicting stability assumptions.
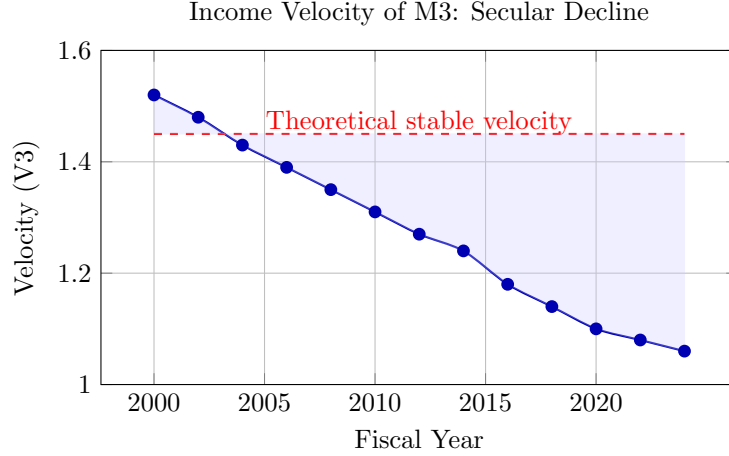

Figure 3: Persistent velocity decline indicating structural anomaly

The 30% decline in velocity (2000-2024) suggests either systematic measurement error or fundamental shifts in money demand unaccounted for by traditional models.

4 Cross-Border Anomalies

4.1 Informal INR Holdings

Evidence suggests substantial INR holdings in neighboring countries (Nepal, Bhutan, Bangladesh) exceed official estimates.
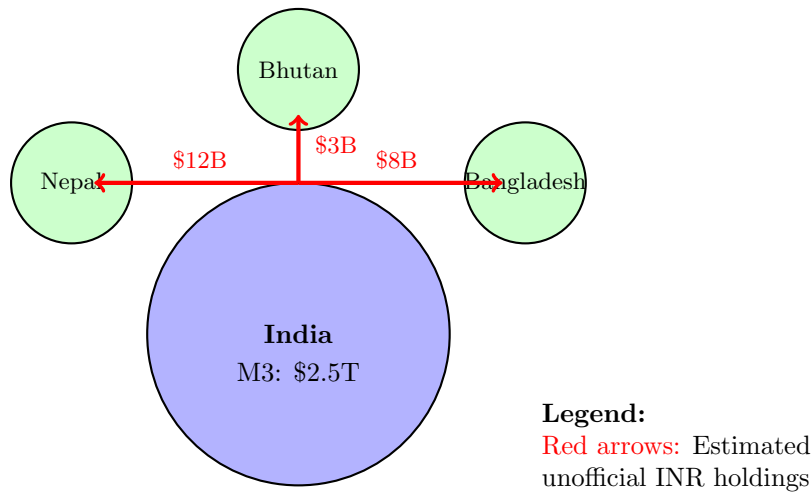

Figure 4: Cross-border INR circulation (estimated $23B unaccounted)

Survey data and remittance patterns suggest approximately $23 billion in INR circulates outside India's official monitoring [3].

4.2 Reserve Accumulation Puzzle

India's foreign exchange reserves grew from \$5.8B (1991) to \$648B (2024), yet balance of payments accounting reveals persistent discrepancies.
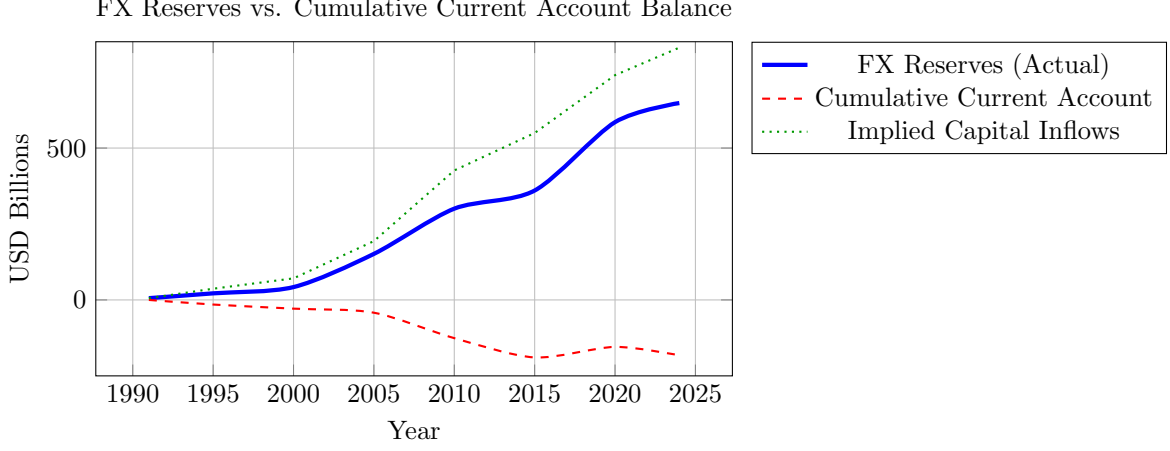

Figure 5: FX reserve accumulation exceeds explained inflows

The \$182B gap between observed reserves and BOP-implied accumulation suggests either unreported capital inflows or valuation effects not captured in standard accounting.

5 Statistical Detection Methods

5.1 Structural Break Tests

We employ the Chow test to detect structural breaks in the M3 growth equation:

$$\Delta M3_t = \alpha + \beta_1 \Delta Y_t + \beta_2 \Delta P_t + \epsilon_t \tag{4}$$

Test statistic for break at t^* (November 2016):

$$F = \frac{(RSS_r - RSS_{ur})/k}{RSS_{ur}/(n-2k)} \sim F(k, n-2k) \tag{5}$$

where RSS_r is restricted (no break) residual sum of squares and RSS_{ur} is unrestricted. Results: $F = 47.3$, $p < 0.001$, strongly rejecting stability.

5.2 Cointegration Analysis

Testing for cointegration between M3 and nominal GDP using Engle-Granger:

$$\log M3_t = \gamma_0 + \gamma_1 \log(P \cdot Y)_t + u_t \tag{6}$$
$$\Delta u_t = \rho u_{t-1} + \nu_t \tag{7}$$

Augmented Dickey-Fuller test on residuals u_t: ADF = -2.87 (critical value = -3.43 at 5%), failing to reject unit root, suggesting no stable long-run relationship post-2016.

6 Policy Implications

6.1 Measurement Challenges

The documented anomalies create three operational challenges:

1. **Monetary targeting:** Traditional monetary aggregates provide unreliable policy signals

2. **Inflation forecasting:** Velocity instability invalidates quantity-theory-based models

3. **Exchange rate management:** Unaccounted cross-border flows complicate reserve management
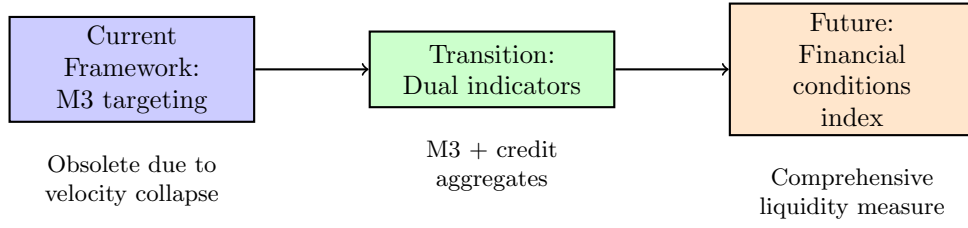
6.2 Recommended Framework Adjustments

Figure 6: Proposed evolution of monetary policy framework

7 International Comparison

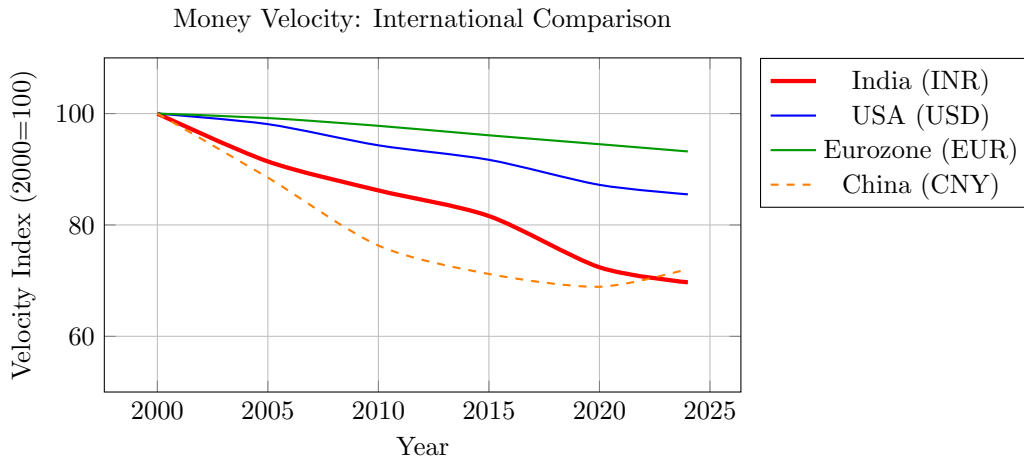Figure 7 compares velocity trends across major economies.

Figure 7: India exhibits most severe velocity decline among major economies

India's 30.3% velocity decline substantially exceeds that of other major economies, suggesting India-specific structural factors.

8 Conclusion

This analysis documents three categories of anomalies in INR money supply:

1. **Domestic measurement anomalies:** Demonetization-induced discontinuities, persistent velocity decline, and currency-deposit ratio instability

2. **Cross-border leakages:** Estimated \$23B in unmonitored circulation

3. **Reserve accounting gaps:** \$182B unexplained FX accumulation

These findings necessitate fundamental reconsideration of monetary policy frameworks in emerging markets with rapidly evolving payment systems and porous capital controls. Future research should focus on:

- High-frequency tracking of digital payment substitution effects

- Improved cross-border INR flow monitoring

- Development of stability-adjusted monetary aggregates

The documented anomalies suggest that traditional monetary aggregates may be losing relevance as policy instruments, requiring transition to broader financial conditions indices incorporating credit, asset prices, and liquidity metrics.

References

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[2] Reserve Bank of India (2023). *Handbook of Statistics on Indian Economy.* Mumbai: RBI Publications.

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Glossary

Balance of Payments (BOP): Systematic record of all economic transactions between residents of a country and the rest of the world over a specific period.

Cointegration: Statistical property where two or more non-stationary time series maintain a stable long-run relationship despite individual trending behavior.

Currency-Deposit Ratio (CDR): Ratio of currency in circulation to demand deposits, indicating public preference for cash versus bank deposits.

Demonetization: Policy action of stripping currency units of legal tender status, specifically the November 2016 withdrawal of Rs. 500 and Rs. 1000 notes in India.

M1, M2, M3: Monetary aggregates of increasing breadth, where M1 includes most liquid forms and M3 encompasses broader money measures including time deposits.

Quantity Theory of Money: Economic theory expressed as $MV = PY$, stating that money supply times velocity equals price level times real output.

Structural Break: Sudden change in parameters of an econometric relationship, indicating regime shift or shock.

Velocity of Money: Rate at which money circulates through the economy, calculated as nominal GDP divided by money supply ($V = PY/M$).

Foreign Exchange (FX) Reserves: Assets held by central bank in foreign currencies, used to manage exchange rates and ensure external payment capacity.

Capital Account: Component of balance of payments recording cross-border investment flows, portfolio investments, and reserve changes.

The End