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CLASS NOTES
RESERVE BANK OF INDIA

- The central bank of any country is the apex institution in its banking system.
- Its authority to issue currency notes and its role as a government's banker and a bankers' bank impart to it a unique position in the banking structure of a country.
- The Reserve Bank of India (RBI) which is the central bank of this country, performs not only those functions which central banks in developed countries perform but also certain promotional and developmental functions to help the development of the less developed financial markets and institutions.

FUNCTIONS

- The Reserve Bank of India (RBI) is the central bank of India.
- It was established as a shareholders' bank on April 1, 1935. The RBI retained this character for a little less than fourteen year.
- On January 1, 1949 it was nationalised and since lhen it has remained wholly state owned.
- The RBI performs two types of functions: i) traditional functions of a central bank, and ii) developmental and promotional functions.
- The traditional functions are more or less the same which a central bank normally performs in both developed and less developed economies.
- In contrast, the developmental & promotional functions of a central bank operating in less developed countries are determined by the unique requirements of the economy in general & financial markets in particular.
- In India,the inadequacy of agricultural finance & lack of specialised institutions of long-term industrial finance have mainly determined the developmental & promotional functions of the RBI.

TRADITIONAL FUNCTIONS

- The RBI was established on the model of the Bank of England.
- It was, therefore, entrusting with the task of performing all those functions which the Bank of England performing. These functions, which are usually known as traditional functions of a central bank are:
  1) To issue currency notes .
  2) To act as a Banker to the Government
  3) To act as a bankers' bank
  4) To control and supervise banks
  5) To manage and control the foreign exchange
  6) To control credit

ISSUING OF CURRENCY NOTES

- The RBI is the sole authority for issuing currency notes in India. The currency constitutes a significant part of the money supply in India.
- In 1989-90 around 57% of the money supply (considered in the narrow sense, that is, M) was in the form of currency.
- The issue of currency notes, therefore, becomes the principal functions of the RBI.
- All currency notes issued by the RBI are legal tender in India
- The value and volume of banknotes in circulation increased by 3.9 per cent and 7.8 percent, respectively, during 2023-24
- The share of the Rs 500 note in value terms of the total currency in circulation surged to 86.5 per cent as of March 31, 2024
- The increase in the share of the Rs 500 note coincides with the declining share of the Rs 2000 note, which was only 0.2 per cent at the end of FY23.
- The value of total currency in circulation as of March 31, 2024, was Rs 34.8 trillion, up by around Rs 10 trillion in the last five years, from Rs 24.21 trillion in March 2020.

BANKER TO THE GOVT.

- The RBI is a banker to both Central and State governments.
- As a banker it renders a variety of banking services to the government, including acceptance of money deposit, withdrawal of funds by cheques, and collection of payments to Government and transfer of funds.
- The RBI is under statutory obligation to render banker's services to the Central Government.
- The State Governments, however, obtain these services from the RBI by virtue of agreements entered with it.
- The public debt management which is now done by the RBI was earlier the responsibility of the Government.
- Since the RBI operates in gilt- edged market , it has intimate knowledge of it. The RBI can thus provide useful advice to the government on the amounts, terms, conditions and timing of new bonds issue.
- In India, the Treasury Bills now constitute a significant proportion of the public debt of the Central Government.
- The Treasury Bills issued by the RBI as the agent of the government.
- Apart from handling the public debt, the RBI also makes short-term advances to the government – to overcome temporary difficulties of the government arising from shortfalls in their revenue.

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- Finally, the RBI acts as an adviser to the government.
- The RBI, with its experts specialising in various areas, is in a position to advise the government not only on banking and financial matters, but also on issues pertaining to overall economic planning.
- The importance of this function has increased due to the need for integration between the monetary and fiscal policies.

BANKE'S BANK

- Like other central banks, the RBI does not deal with the public or business firms, it is only a bankers' bank.
- The commercial and cooperative banks avail the financial assistance from the RBI in the form of rediscounting of bills as-well as loans and advances against approved securities, for periods not exceeding ninety days.
- The RBI has been entrusted with the task of channelising banking development on sound lines.
- Therefore, while giving advances to banks it has to discriminate between banks on the bases of their financial positions, lending policies and the securities offered.
- The RBI is within its powers to deny financial assistance to any bank wanting to borrow from it without assigning any reason.

CONTROL & SUPERVISION OF BANKS

- Under the Reserve Bank of India Act 1934 & the Banking Regulation Act, 1949 the RBI has been given extensive powers to control commercial banks.
- The regulatory functions of the RBI relating to commercial banks cover their Licensing, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation.
- For the purpose of control, the RBI conducts inspection of the banks and calls for returns and information from them.
- In case the operations of any bank found unsatisfactory, the RBI may recommend remedial measures to improve the functioning of that bank
- Any company wanting to do banking business in India must obtain a licence from the RBI terms of the provisions of the Banking Regulation Act.
- However, the banks in the public sector commercial banks & rural banks are not required to obtain licence to undertake banking business.
- Control over branch expansion of commercial banks is required for dispersal of banking facilities
- At present the RBI encourages commercial banks to open their branches in rural and semi-urban markets
- Banking Regulation Act has determined the minimum requirements of paid-up capital & reserves, transfer to reserve fund, and maintenance of cash reserve and other liquid assets.
- However, the most important regulatory function of the RBI is the inspection of banks.

FOREIGN EXCHANGE MANAGEMENT & CONTROL

- Foreign exchange management and control involves three main functions: (i) Maintaining the external value of the currency, (ii) Management of external reserves of the country, and (iii) Exchange control.
- Presently the exchange value of the rupees is determined with reference to the daily exchange rate movements of a selected number of currencies of the countries which are India's major trading partners
- The selection of the currency units 'and the weights ta be assigned to them has been left to the discretion of the RBI.
- As a custodian of foreign exchange reserves, the RBI manages the investment and utilisation of these reserves.
- The exchange control is presently governed by the Foreign Exchange Regulation Act, 1973.
- The Act is administered by the RBI in accordance with the general policy laid down by the Central Govt in consultation with the former.

CREDIT CONTROL

- Regulation of credit in accordance with the needs of the economy is perhaps the most significant function of a central bank.
- M.H.De Kock, a leading authority on central banking has observed, " credit control is the function which embraces the most important questions of central banking policy and one through Which practically all other functions are united and made to serve a common purpose."
- De Kock's observation are relevant in the Indian context.
- In this country the objective of economic policy is growth with price stability.
- The monetary policy relying primarily on credit control also aims at realising this objective. Thus the control of credit function of the RBI assumes unique importance.
- In order to regulate the supply of credit, the RBI used both quantitative and qualitative techniques.

DEVELOPMENTAL & PROMOTIONAL FUNCTIONS

- RBI did not perform any developmental functions in pre-independent India
- 4 divisions : – 1) Institutionalisation of Agricultural credit – integration of indigenous bankers with the organised money market – after failure in this RBI encouraged development of cooperative credit in rural areas – also exercised its licensing power in such a manner that commercial banks have now reached rural areas in a big way
  2)To channelise the savings of depositor particularly the small savers, it played an active role in the establishment of the Unit Trust of India (UTI).

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- The UTI presently offers the best investment opportunity to both persons and institutions lacking in investment expertise.
- It ensues steady income, liquidity, low risk and expert management to its investor
- 3) By helping in setting up the National Bank for Agriculture and Rural Development (NABARD), the RBI has filled up a gap in agricultural finance — The NABARD is the apex organisation in agricultural finance – Half of its share capital has been provided by the RBI.
- RBI has contributed greatly to the setting up of a number of development banks in India.
- In fact, the Industrial Development Bank of India (IDBI) was originally established as a subsidiary of the RBI – became autonomous institution in 1976

NOTE ISSUES

- The RBI has the monopoly power to issue currency notes.
- RBI conducts note issue through two separate departments: 1) the Issue Department, and 2) the Banking Department,
- The Issue Department is liable for all the currency notes put into circulation from time to time.
- The Issue Department is required to maintain eligible assets for equivalent value.
- In terms of the Reserve Bank of India Act, the assets of the issue Department against which currency notes can be issued consist of gold, foreign securities, rupee coins, Government of India rupees securities and bills of exchange, and promissory notes payable in India which are eligible for purchase by the RRI.(Rate of Return on Investment)
- In practice, the distinction between the Issue Department and the Banking Department does not have much economic significance because the assets of the two Departments keep on shifting frequently.
- However, the Issue Department does not hold some of the assets of the Banking Department.
- The assets which are not eligible for being held by the Issue Department are State Government securities & coins.
- The responsibilities of the Issue Department include arranging the printing of notes from the currency printing presses of the Government of India, distribution of currency notes among the public and withdrawal of non- usable notes.
- On the other hand, the functions of putting the currency into circulation and its withdrawal from circulation is performed by the Banking Department.
- Suppose, a commercial bank wants to withdraw Rs. 5 crores from its deposit with the RBI, the transaction will be handled by the Banking Department.
- The bank concerned will get the currency in the denominations required by it and its account with the RBI will be debited for the amount withdrawn by it.
- For meeting this kind of demands the Banking Department holds stock of currency.
- Whenever it feels that its stock of currency is not sufficient, it replenishes it from the Issue Department against transfer of eligible assets.
- The commercial banks also make deposits with the RBI on a regular basis
- Suppose, a particular bank tenders cash to the RBI to be deposited in its account, this cash will be received by the Banking Department and will be held as stock of currency.
- As a result of this receipt of cash, if there is surplus holding of currency in the Banking Department,. the excess cash ,will be transferred to the Issue Department in' exchange for the assets of equal value
- For exchanging currency notes of one denomination for another or for coins and vice versa, Issue department deals with the public directly
- RBI provides currency to the central and state governments facilitate their transactions
- RBI has made elaborate arrangements like maintaining offices of the Issue department in a number of cities.
- At other centres the currency requirements are met through currency chests maintained by the RBI with the State Bank of India and its associated banks, other nationalised banks & the Government Treasuries and sub- treasuries.
- The agency of the RBI, namely the State Bank of India or any other nationalised bank or the Treasury at which the chest is provided, can withdraw cash therefrom according to its requirements.
- It is also required to deposit into the chest any cash in excess of its immediate needs, as these funds can be withdrawn later when a need arises.

PRINCIPLE OF NOTE ISSUES

- At the time of establishment of the RBI, gold standard (i.e. monetary system in which the currency of the country was directly or indirectly convertible into gold) was still prevailing at the international level
- Therefore, in India the principle of linking gold and foreign reserves to note issue was followed by adopting proportional reserve system.
- Under this system the RBI was required to maintain a reserve of gold and foreign securities (until January 1, 1949 sterling securities), not less than 40% of the total assets.
- However, at any time gold reserve was not to fall below Rs. 40 crore in value.
- The proportional reserve system requirement could be suspended with the previous sanction the central government

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- Nonetheless the RBI was required to pay a tax on the shortfall in the statutorily required gold and foreign securities reserve.
- This system of note issue worked well for about two decades as it put a check on money supply in the economy and therefore, keeping an effective control on commodity and factor prices.
- However, in 1956 with the adoption of the Second Five Year Plan a big push was to the development
- Moreover, the process of monetisation became faster. Under such circumstances the demand for money was expected to increase which under the constraints of the proportional reserve system could not be easily met.
- The system of note issue was, therefore, made more flexible in 1956.
- The proportional reserve system was replaced by the minimum reserve system.
- This implies that the note issuing authority is under an obligation to maintain only a certain minimum of gold and foreign exchange reserve; the rest to be kept in the Form of other eligible securities.
- In terms of the Reserve Bank of India(Amendment) Act, 1956 the minimum reserve prescribed was Rs. 400 crore in foreign securities and Rs. 115 crore in gold, adding upto Rs. 515 crore.
- In 1957 the provisions governing the minimum amount of reserve backing note issues were modified and the minimum requirement of the gold & foreign exchange reserve was fixed at Rs. 200 crore, of which the minimum value of gold was to be Rs. 115 crore.
- The Second Amendment Act of 1957 also empowered thc RBI to dispense with reserve in foreign securities with the prior sanction of the Central Government.
- However, gold reserve of Rs. 115 crore is to be kept all the time.
- This system of note issue is no doubt flexible, but it does not provide for any check on inflationary tendencies.

CONTROL OF CREDIT

OBJECTIVES OF MONETARY POLICY

- Monetary policy refers to use of different instruments under the control of the central bank to regulate the supply of money and credit with the aim of achieving optimum levels of output and employment, price stability, balance of payments equilibrium or any other objectives decided by the State.
- At present the main objective of monetary policy in India is believed to be the promotion of economic growth coupled with high level of employment and price stability.
- This obviously necessitated the RBI to follow policies that lead to expansion of credit.
- But such a policy could lead to inflation. Therefore, the RBI has been following a cautious policy in credit expansion.
- To keep inflationary pressures under control, it has to restrain credit expansion and prevent flow of credit to socially undesirable activities like speculation and hoarding.
- Thus, the RBI's function has been to ensure adequate availability of credit to sustain the tempo of development without adversely affecting the internal price stability.
- This policy is often characterised as the policy of controlled expansion

TECHNIQUES OF GENERAL CREDIT CONTROL

- Two types: — i) general or quantitative, and ii) selective or qualitative.
- The techniques of credit control in the first category are —-the bank rate, open market operations and reserve requirements.
- All these three methods affect loanable funds of the commercial banks, and thereby influence the volume of credit and thus total money supply.
- In the case of qualitative or selective credit control, the impact is on the direction of credit rather than its amount.

GENERAL OR QUANTITATIVE TECHNIQUE OF CREDIT CONTROL

- Bank Rate : — The bank rate is that rate of interest at which the central bank makes advances to commercial banks – against approved securities – If bank rate changes, it brings about changes in the structure of market interest rates, which in turn influences the level of economic activity.
- In an inflationary situation when policy of reducing money supply is to be pursued, the bank rate is raised with the hope that unwarranted investment activity will be checked
- In the recessionary situation the bank rate is reduced with the expectation that it will induce investment activity thereby providing impetus to overall economic activity.
- However, the effectiveness of bank rate is rather limited in India
- It is for this reason that changes in the bank rates, accompanied by some other techniques of credit control.

OPEN MARKET OPERATIONS

- A technique of credit control by means of which the central bank changes the liquidity position of banks by operating directly in the market.
- Open market operations involve purchase and sale of government securities, foreign exchange, gold, bills of exchange and company shares by the central bank.
- However, in India open market operations are generally confined to the buying and selling of government securities,including 'Treasury Bills.
- Open market operations have two aspects : –

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1) When the central bank purchases securities from banks, the Bank's cash reserves increase and this improves their capacity to create credit.
2)The other aspect is the selling of securities to the commercial banks which results in the decline of their cash reserves. As consequence the banks' credit creation capacity is reduced.

- In India, the government securities market is narrow which constraints on open market operations.
- A sizeable proportion of the government securities is held by some leading financial institutions and the volume of transactions in them is limited.
- Further on account of the virtual absence of a treasury bill market, open market operations of the RBI are entirely in government bonds.

RESERVE REQUIREMENT

- The Central bank can change the reserve requirements can thereby affect the credit creating capacity of the commercial banks.
- It is a direct and effective instrument of credit control.
- In India, 'the RBI regulates the liquidity of the banking system by two complementary methods: 1) cash reserve ratio, and 2) statutory liquidity ratio.
- The commercial banks are statutorily required lo maintain a cash reserve with the RBI equal to a certain percentage of deposits.
- This cash reserve ratio is prescribed by the RBI and can be in the range of 3 to 15 percent of the deposits.
- Whenever the RBI wants to put a check on the expansion of credit, it raises the cash reserve ratio.
- Conversely,when credit expansion is to be induced, the cash reserve ratio is lowered.
- The effectiveness of changes in cash reserve ratio is limited by the tendency of the commercial banks to offset their impact by liquidating their government security holdings.
- Therefore , along with a change in cash reserve ratio, ;a change in statutory liquidity ratio also becomes necessary.

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