

## Role of Reserve Bank of India in Indian Economy

**Harish N**

Lecturer in Economics, Adarsha PU College, 12<sup>th</sup> Cross, 1<sup>st</sup> Block, R.T.Nagar, Bengaluru-560032, Karnataka, India

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### Abstract

The Reserve Bank of India (RBI) was established in the year 1935 in accordance with the Reserve Bank of India Act, 1934. The Reserve Bank of India is the central Bank of India entrusted with the multidimensional role. It performs important monetary functions from issue of currency note to maintenance of monetary stability in the country. Initially the Reserve Bank of India was a private share holder's company which was nationalized in 1949. Its affairs are governed by the Central Board of Directors appointed by the Government of India. Since its inception the Reserve Bank of India had played an important role in the economic development and monetary stability in the country. This paper is an attempt explore into the role, functions, and contribution of RBI in Indian Economy.

**KEYWORDS:** Economy, Finance, Monetary Policy, Central Bank, Price Stability, Economic Growth etc.

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### Introduction

The Reserve Bank of India (RBI) was established in the year 1935 in accordance with the Reserve Bank of India Act, 1934. The Reserve Bank of India is the central Bank of India entrusted with the multidimensional role. It performs important monetary functions from issue of currency note to maintenance of monetary stability in the country. Initially the Reserve Bank of India was a private share holder's company which was nationalized in 1949. Its affairs are governed by the Central Board of Directors appointed by the Government of India. Since its inception the Reserve Bank of India had played an important role in the economic development and monetary stability in the country.

### Evolution of RBI

The Royal Commission on Indian Currency and Finance appointed on August 25, 1925 has suggested the establishment of the Central Bank in India, later the Indian Central Banking Enquiry Committee, 1931 stressed the establishment of the Central Bank in India. The Reserve of Bank was established on April 1, 1935 under the Reserve Bank of India Act, 1934. The main object of Reserve of India is, "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency any credit system of the country to its advantage".

The Reserve Bank of India was established as a private share holder's bank. The Central office of Reserve Bank of India was initially located in Calcutta which was later shifted to Bombay. The Reserve Bank of India issued first of its currency notes in January 1938 in denomination of Rs.5 and Rs.10 and later in the same year denomination of Rs.100, Rs.1000 and Rs.10000 were issued.

**Post Independence** The Reserve Bank of India was nationalized in the year 1949 through the Reserve Bank (Transfer of Public Ownership) Act, 1948 and all shares were transferred to Central Government. The Reserve bank of India is constituted for the management of currency and for carrying the business of banking in accordance with provisions of the Act. It is a body corporate having perpetual succession, common seal and can be sued or sue in its name. The general supervision and direction of the affairs of the Reserve Bank is entrusted with Central Board of Directors.

### **Composition of Central Board**

The Central Board consists of Governor, deputy Governor, Ten Director nominated by the Central Government and two Government official nominated by the Central Government. The deputy Governor and Director are eligible to attend meeting of the Central Board but are not entitled to vote. The Governor and deputy Governor hold office for term of five years and are entitled for a re-appointment. The Directors are appointed for a term of four and hold office during the pleasure of the president. The meeting of the Central Board is convened at least six times in a year.

### **Composition of Local Board**

A local board is formed in each four zones consisting of five members which are appointed by the Central Government. There is Chairperson of the Board who is elected among the member. The members of the Board have a hold office for a term of four years and eligible for reappointment. The Local Board advice on matters referred to it by the Central Board and performs duties delegated to it by the Central Board.

## **1. Objectives and Research Methodology**

### **Objectives of study:**

1. To explore the evolution of Reserve Bank of India (RBI).
2. To analyze the role and functions of RBI.
3. To assess the Monetary Control Methods of RBI. .

### **Research Methodology**

It is always important to be critical of the information presented in sources, especially since the material might have been gathered to address a different problem area. Moreover, many secondary sources do not clearly describe issues such as the purpose of a study, how the data has been gathered, analyzed and interpreted making it difficult for the researcher to assess their usefulness. In order to address this problem I have tried to triangulate the secondary data by using numerous independent sources.

The information about the problem is collected from the Research Journals, Trade Magazines, Annual Reports of Banks and the Internet. For evaluating Role, Functions and Monetary Control Methods of RBI", we have focused on as recent material as possible. In order to get access to the latest developments in this area we have used a number of articles published in academic journals and trade magazines. We have also used secondary information from Internet based discussion forums.

## **2. Functions of Reserve bank of India**

Functions of may be summarized as given below:

### **Banker to Government**

The Reserve Bank of India accepts and makes payment on behalf of Central Government. It carries out its exchange, remittance, management of public debt and other banking function of the Central Government. The Central Government entrusts its money, remittance, exchange and banking transactions in India with the Reserve Bank of India. It deals in repo or reverse repo.

### **Right to Issue Bank note**

The Reserve Bank of India has the sole right to issue bank notes in India. The bank notes are legal tender guaranteed by the Central Government. The issue of bank note is conducted by a separate department called issue department. The Central Government on the recommendation of Central Board specifies denomination of bank notes including discontinuance of bank notes. The Central Government approves design, form and material of Bank notes on consideration of recommendations of the Central Board.

### **Formulates Banking policy**

The Reserve is empowered to formulate banking policy in the interest of the public or depositors banking policy in relation to advances and provide direction on the purpose of the advances, margins to be maintained in a secured advances, the maximum amount of advance may be made, the rate of interest, terms and conditions for advances or guarantees may be given.

### **Licensing Authority**

The Reserve Bank of India is empowered to grant license to commence banking business in India, including the power to cancel a license granted to a banking company. A petition was filed under Article 226 of the Constitution, challenging the constitutional validity of section 22 of the Banking Companies Act, 1949. Section 22 empowers, Reserve Bank of India to grant license to Banks and banks which were already in existence on the commencement of the Act have to apply for license before the expiry of six months from commence. The petitioner contended that the section 22 of the Banking Regulating Act, 1949 is in restraint of trade and business hence unconstitutional. The writ was dismissed and the High Court declared section 22 of the Banking Regulating Act, 1949 as constitutionally valid and cherished the role of Reserve Bank of India in the economic development of the country. The Madras High Court meticulously said, "The Reserve Bank of India was established with a view to fostering the banking business and not for impeding the growth of such business. The powers vested in it under Section 22 are not one invested with a mere officer of the Bank. The standards for the exercise of the power have been laid down in Section 22 itself. The Reserve Bank is a non-political body concerned with the finances of the country. When a power is given to such a body under a statute which prescribes the regulations of a Banking Company, it can be assumed that such power would be exercised so that genuine: banking concerns could be allowed to function as a bank, while institutions masquerading as banks or those run on unsound lines or which would affect the interests of the public could be weeded out."

### **Banker's Bank**

The banks listed in second schedule and non schedule banks shall maintain a cash reserve ratio with the Reserve bank of India with a view to securing the monetary stability in the country. It provides loans and advances in foreign currency to scheduled Banks and to other financial institution. It purchases, sells or discount any bill of exchange or promissory note or makes a loan or advances to schedule bank.

### **Depositor Awareness and Education**

The Reserve Bank of India has constituted a fund called "Depositor Education and Awareness Fund." The fund is utilized for the promotion of depositors' interest and other purposes in the interest of the depositor.

### **Regulation and Management of Foreign Exchange**

The Reserve Bank of India is empowered to regulate, prohibit, and restrict dealing in foreign exchange. It issues license to banks and other institution to act as the authorized agency in the foreign exchange market.

The functions of the Reserve Bank today can be categorized as follows:

- Monetary and Credit policy
- Foreign exchange management
- Currency management
- Banker to banks & Lender of the last resort
- Banker to the Central and State Governments
- Central clearing house of payment and settlement systems
- Performing developmental and promotional functions.

### **3. Monetary Policy of the RBI:**

RBI works as the monetary authority of India and there by operates the monetary policy. Reserve Bank of India announces Monetary Policy every year in the Month of April. This is followed by three quarterly Reviews in July, October and January. But, RBI at its discretion can announce the measures at any point of time. The Annual Monetary Policy is made up of two parts viz. Part A: macroeconomic and monetary developments; Part B: Actions taken and fresh policy measures. Monetary policy of the RBI deals with almost all other vital topics such as financial stability, financial markets, interest rates, credit delivery, regulatory norms, financial inclusion and institutional developments etc.

Objectives of the monetary policy: Monetary policy refers to an umbrella of operations used for the control of money supply in the economy with broad objective to maintain economic and financial stability; and ensure adequate financial resources for the purpose of development. These objectives of the monetary policy in India have gone through a process of gradual evolution and can be further expanded to maintaining price stability, adequate flow of credit to productive sectors, promotion of productive investments & trade, promotion of exports and economic growth. The following are the principal objectives of monetary policy:

- i. **Full Employment:** Full employment has been ranked among the foremost objectives of monetary policy. It is an important goal not only because

unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect.

- ii. **Price Stability:** One of the policy objectives of monetary policy is to stabilize the price level. Both economists and laymen favour this policy because fluctuations in prices bring uncertainty and instability to the economy.
- iii. **Economic Growth:** One of the most important objectives of monetary policy in recent years has been the rapid economic growth of an economy. Economic growth is defined as “the process whereby the real per capita income of a country increases over a long period of time.”
- iv. **Balance of Payments:** Another objective of monetary policy since the 1950s has been to maintain equilibrium in the balance of payments.

**Instruments of Monetary Policy:** The instruments of monetary policy are tools or devices which are used by the monetary authority in order to attain some predetermined objectives. There are two types of instruments of the monetary policy as shown below.

#### **(A) Quantitative Instruments or General Tools**

The Quantitative Instruments are also known as the General Tools of monetary policy. These tools are related to the Quantity or Volume of the money. The Quantitative Tools of credit control are also called as General Tools for credit control. They are designed to regulate or control the total volume of bank credit in the economy. These tools are indirect in nature and are employed for influencing the quantity of credit in the country. The general tool of credit control comprises of following instruments.

##### **i. Bank Rate Policy (BRP)**

The Bank Rate Policy (BRP) is a very important technique used in the monetary policy for influencing the volume or the quantity of the credit in a country. The bank rate refers to rate at which the central bank (i.e. RBI) rediscounts bills and prepares of commercial banks or provides advance to commercial banks against approved securities. It is "the standard rate at which the bank is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the RBI Act". The Bank Rate affects the actual availability and the cost of the credit. Any change in the bank rate necessarily brings out a resultant change in the cost of credit available to commercial banks. If the RBI increases the bank rate than it reduce the volume of commercial banks borrowing from the RBI. It deters banks from further credit expansion as it becomes a more costly affair. Even with increased bank rate the actual interest rates for a short term lending go up checking the credit expansion. On the other hand, if the RBI reduces the bank rate, borrowing for commercial banks will be easy and cheaper. This will boost the credit creation. Thus any change in the bank rate is normally associated with the resulting changes in the lending rate and in the market rate of interest. However, the efficiency of the bank rate as a tool of monetary policy depends on existing banking network, interest elasticity of investment demand, size and strength of the money market, international flow of funds, etc.

## **ii. Open Market Operation (OMO)**

The open market operation refers to the purchase and/or sale of short term and long term securities by the RBI in the open market. This is very effective and popular instrument of the monetary policy. The OMO is used to wipe out shortage of money in the money market, to influence the term and structure of the interest rate and to stabilize the market for government securities, etc. It is important to understand the working of the OMO. If the RBI sells securities in an open market, commercial banks and private individuals buy it. This reduces the existing money supply as money gets transferred from commercial banks to the RBI. Contrary to this when the RBI buys the securities from commercial banks in the open market, commercial banks sell it and get back the money they had invested in them. Obviously the stock of money in the economy increases. This way when the RBI enters in the OMO transactions, the actual stock of money gets changed. Normally during the inflation period in order to reduce the purchasing power, the RBI sells securities and during the recession or depression phase she buys securities and makes more money available in the economy through the banking system. Thus under OMO there is continuous buying and selling of securities taking place leading to changes in the availability of credit in an economy.

However there are certain limitations that affect OMO viz; underdeveloped securities market, excess reserves with commercial banks, indebtedness of commercial banks, etc.

## **iii. Variation in the Reserve Ratios (VRR)**

The Commercial Banks have to keep a certain proportion of their total assets in the form of Cash Reserves. Some part of these cash reserves are their total assets in the form of cash. Apart of these cash reserves are also to be kept with the RBI for the purpose of maintaining liquidity and controlling credit in an economy. These reserve ratios are named as Cash Reserve Ratio (CRR) and a Statutory Liquidity Ratio (SLR). The CRR refers to some percentage of commercial bank's net demand and time liabilities which commercial banks have to maintain with the central bank and SLR refers to some percent of reserves to be maintained in the form of gold or foreign securities. In India the CRR by law remains in between 3-15 percent while the SLR remains in between 25-40 percent of bank reserves. Any change in the VRR (i.e. CRR + SLR) brings out a change in commercial banks reserves positions. Thus by varying VRR commercial banks lending capacity can be affected. Changes in the VRR helps in bringing changes in the cash reserves of commercial banks and thus it can affect the banks credit creation multiplier. RBI increases VRR during the inflation to reduce the purchasing power and credit creation. But during the recession or depression it lowers the VRR making more cash reserves available for credit expansion.

## **(B) Qualitative Instruments or Selective Tools**

The Qualitative Instruments are also known as the Selective Tools of monetary policy. These tools are not directed towards the quality of credit or the use of the credit. They are used for discriminating between different uses of credit. It can be discrimination favoring export over import or essential over non-essential credit supply. This method can have influence over the lender and borrower of the credit. The Selective Tools of credit control comprises of following instruments.

### **i. Fixing Margin Requirements**

The margin refers to the "proportion of the loan amount which is not financed by the bank". Or in other words, it is that part of a loan which a borrower has to raise in order to get finance for his purpose. A change in a margin implies a change in the loan size. This method is used to encourage credit supply for the needy sector and discourage it for other non-necessary sectors. This can be done by increasing margin for the non-necessary sectors and by reducing it for other needy sectors. Example:- If the RBI feels that more credit supply should be allocated to agriculture sector, then it will reduce the margin and even 85-90 percent loan can be given.

### **ii. Consumer Credit Regulation**

Under this method, consumer credit supply is regulated through hire-purchase and installment sale of consumer goods. Under this method the down payment, installment amount, loan duration, etc is fixed in advance. This can help in checking the credit use and then inflation in a country.

### **iii. Publicity**

This is yet another method of selective credit control. Through it Central Bank (RBI) publishes various reports stating what is good and what is bad in the system. This published information can help commercial banks to direct credit supply in the desired sectors. Through its weekly and monthly bulletins, the information is made public and banks can use it for attaining goals of monetary policy.

### **iv. Credit Rationing**

Central Bank fixes credit amount to be granted. Credit is rationed by limiting the amount available for each commercial bank. This method controls even bill rediscounting. For certain purpose, upper limit of credit can be fixed and banks are told to stick to this limit. This can help in lowering banks credit expouresure to unwanted sectors.

### **v. Moral Suasion**

It implies to pressure exerted by the RBI on the Indian banking system without any strict action for compliance of the rules. It is a suggestion to banks. It helps in restraining credit during inflationary periods. Commercial banks are informed about the expectations of the central bank through a monetary policy. Under moral suasion central banks can issue directives, guidelines and suggestions for commercial banks regarding reducing credit supply for speculative purposes.

### **vi. Control through Directives**

Under this method the central bank issue frequent directives to commercial banks. These directives guide commercial banks in framing their lending policy. Through a directive the central bank can influence credit structures, supply of credit to certain limit for a specific purpose. The RBI issues directives to commercial banks for not lending loans to speculative sector such as securities, etc beyond a certain limit.

### **vii. Direct Action**

Under this method the RBI can impose an action against a bank. If certain banks are not adhering to the RBI's directives, the RBI may refuse to rediscount their bills and securities. Secondly, RBI may refuse credit supply to those banks whose borrowings are in excess to their capital. Central bank can penalize a bank by changing some rates. At last it can even put a ban on a particular bank if it does not follow its directives and work against the objectives of the monetary policy.

### **4. Conclusion**

The Reserve Bank of India was established with a view to fostering the banking business and not for impeding the growth of such business. The powers vested in it under Section 22 are not one invested with a mere officer of the Bank. The standards for the exercise of the power have been laid down in Section 22 itself. The Reserve Bank is a non-political body concerned with the finances of the country. When a power is given to such a body under a statute which prescribes the regulations of a Banking Company, it can be assumed that such power would be exercised so that genuine banking concerns could be allowed to function as a bank, while institutions masquerading as banks or those run on unsound lines or which would affect the interests of the public could be weeded out.

The Reserve Bank's developmental role includes ensuring credit to productive sectors of the economy, creating institutions to build financial infrastructure, and expanding access to affordable financial services. It also plays an active role in encouraging efficient customer service throughout the banking industry, as well as extension of banking service to all, through the thrust on financial inclusion.

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These are various selective instruments of the monetary policy. However the success of these tools is limited by the availability of alternative sources of credit in economy, working of the Non-Banking Financial Institutions (NBFIs), profit motive of commercial banks and undemocratic nature off these tools. But a right mix of both the general and selective tools of monetary policy can give the desired results.

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