

## **FUNCTIONING OF THE RESERVE BANK OF INDIA**

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### **ABSTRACT**

The Reserve Bank of India, which is India's apex financial institution, is responsible for maintaining price stability and ensuring there is no inflation/deflation. For this purpose, the RBI has tools at its disposal. Quantitative tools like repo rate, reverse repo rate, liquidity adjustment facility, marginal standing facility, variable reserve ratios, bank rate, open market operations. Qualitative tools like margin requirements, moral suasion and more. This paper explores the functionality and modalities of how the Reserve Bank of India controls credit and gears economic growth in the country.

**Keywords:** Reserve Bank of India, Finance, Economy, Credit, Monetary Policy

### **Introduction**

The Reserve Bank of India is the topmost institution when it comes to finance in the country. It is also known as Banker's Bank. It was established in April 1935. It falls under the Ministry of Finance. The RBI is a member of the Asian Clearing Union. Its broad aims are to maintain price stability and balance in the economy.

### **Origin Of The Rbi**

In 1773, the Governor of Bengal, Warren Hastings felt that India was in need of a Central Bank. Therefore, he recommended the foundation of a 'General Bank in Bengal and Bihar'. The Report of the Chamberlain Commission in 1913 reiterated the same issue. Professor JM Keynes also proposed a plan but it was not implemented. Finally, in 1921, India's 3 Presidency Banks were merged to form the Imperial Bank of India. Finally, in 1935, the Reserve Bank of India came into existence. It started operating on 1 April, 1935.

### **From Private to State Ownership**

In the beginning, the RBI was a shareholders' bank, which was the international model of central banks in those days. The fully paid-up share capital was Rs. 5 crores which was divided into shares of Rs. 100 each. The share capital system has remained unchanged even today. From time to time, the issue of state ownership was brought to the forefront.

In 1948, an Act was passed and the Government paid adequate compensation to the shareholders, and the government took over the Reserve Bank of India. On January 1, 1949, the Reserve Bank of India started its functioning as a state-owned central banking institution.

## **MONETARY POLICY**

Monetary policy refers to all the instruments or tools that a country's apex financial institution uses in order to promote economic growth which is sustainable, with regard to the sum total of money supply in a nation. The ultimate motive is that the economy stays stable and has a balance. When the RBI wants to discourage consumer spending, it increases the interest rates. Vice Versa, when the central bank wants to encourage more borrowing and spending by consumers, it forces the interest rates to go down.

The main arsenal used is the nation's money supply. It is the RBI's prerogative whether it wants to set high interest rates or low interest rates. This affects all - large businesses to the common man buying a house. All customers are sensitive to rate changes and their purchasing power gets affected by interest rate changes by the Reserve Bank of India. Experts like analysts, economists, shareholders etc. keenly wait for the policy decisions since policy changes have long-lasting impact on the economy. Some other tools at the disposal of the central bank are buying and selling government bonds, regulating foreign exchange rates, and revising the amount of money and deposits that commercial banks are mandated to keep as reserves.

### **What Goes Into Monetary Policy Decisions**

Monetary policy's formulation depends on inputs from various sources like the Gross Domestic Product (GDP) and inflation, growth rates and associated numbers. Other political scenarios like oil embargos, trade tariffs fixed by nations have extensive impact. Information collected through surveys about the concerns of assorted industries' stakeholders and other government institutions are also taken into account.

### **The Mandate**

The monetary authorities are typically given broad policy mandates to realise a stable rise in gross domestic product (GDP), keep unemployment low, and maintain exchange (forex) and inflation rates in an exceedingly predictable range.

## **Difference Between Fiscal Policy & Monetary Policy**

The main goal of Monetary policy is to keep the economy even and balanced. It's imperative to maintain low unemployment, value of currency, and a steady growth rate. Mostly, this is achieved through changes in the interest rates. On the other hand, fiscal policy falls under the purview of the national government. Its goal is to spend tax money in an optimum way to induce economic recovery. The government's buying and spending activities dictate fiscal policy. In a nutshell, the government's decisions in regard to buying and spending is called fiscal policy.

While they both have the same goal, their tools are different. Both have the same purpose - regulation of economic activity over a long-term as well as short-term period. They can encourage the economy's growth and regulate economic activity. Another purpose fiscal policy can achieve is to redistribute wealth and income.

The fundamental goal of monetary and fiscal policy is creating an economic environment where there is stabilised growth and low, in-control inflation. It's important to manoeuvre the economy in such a way that it does not experience an economic boom followed by a subsequent high unemployment period. A stable economic environment is pivotal to householders feeling secure in their saving and expenditure decisions, while the corporate sector can concentrate on its investment decisions and making profits.

As with anything, the challenges to accomplish these goals are plenty. It is the belief of many economists that an economy has natural cycles. Moreover, certain times, no matter how well-intentioned a decision, there have been historical cases when a financial situation was exaggerated and investors in the economy faced disastrous repercussions.

## **Broad Objectives Of Monetary Policy**

- Price stability
- Economic growth
- Under-control Inflation (current limit 2% - 6%)

## **Types Of Monetary Policy**

Monetary policy can be categorised into 2 main categories.

### **1. Expansionary**

## **2. Contractionary**

When the focus is on increasing spending by businesses and consumers by making it affordable or inexpensive to borrow, it is an expansionary policy. On the other hand, when it is made expensive to borrow to induce lower spending, it is termed contractionary policy. Depending on the need of the hour, expansionary and contractionary policies bring inflation into the prescribed range, keep unemployment low and maintain the currency's stability internationally.

### **What Is Credit Control**

Credit control is a salient tool, a major weapon in the arsenal of the Reserve Bank of India. It is used to control the demand and supply of money, thus controlling the liquidity in the economy. The Central Bank has the utmost authority over the credit that the commercial banks in a nation grant. These methods are used to bring about "Economic Development with Stability". It means that banks will not only set their sights on controlling inflationary trends in the economy but also focus on stimulating economic growth which will ultimately result in increased national price stability. If the RBI doesn't control and regulate economic activities, there would be social and economic chaos in the country.

### **Need For Credit Control**

Controlling credit in the economy is the most important function of the apex financial institution. The basic needs of credit control in any economy are-

- To invigorate the overall growth of the sectors which are recognized by the government as "prioritized", there are 15 such sectors currently
- To maintain checks and balances over credit channelization so that credit is not undesirably delivered
- To keep deflation and inflation in-control
- To boost the economy by facilitating optimum flow of bank credit
- To develop the economy

### **Methods Of Credit Control**

Methods used by the RBI to control the money supply in the economy are-

- Qualitative methods

- Quantitative methods

During periods of inflation, the Reserve Bank of India tightens its policies to constrict the money supply, whereas during deflation, it permits and guides commercial banks to pump money in the economy.

### **Qualitative Methods**

There are several direct and indirect tools that are used for implementing monetary policy, such as:-

- **REPO RATE:**

Repurchase agreement, or repo rate, also known as the (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF). Repo and reverse repo rates are parts of the liquidity adjustment facility.

- **REVERSE REPO RATE:**

Reverse Repo Rate is the rate at which the central bank, RBI in the case of India, borrows money from the commercial banks of India. It's an instrument used to manipulate the money supply in a nation. If the reverse repo rate is increased, then the money supply is reduced. This is because if it is increased, then the commercial banks are incentivised to deposit their excess funds with the RBI, because they will get high returns; thus reducing their lending capacity which in turn reduces the amount of funds lent to the general public, decreasing money supply in the market. This brings down inflation in the economy.

- **LIQUIDITY ADJUSTMENT FACILITY (LAF):**

It was introduced due to the Narasimham Committee on Banking Sector Reforms (1998). It is basically an instrument which allows commercial banks to borrow money through repurchase agreements, or lend money to the Reserve Bank through reverse repurchase agreements.

- **MARGINAL STANDING FACILITY (MSF):**

This is a facility which allows commercial banks to borrow extra amounts of overnight money from the Reserve Bank of India, by dipping into their Statutory Liquidity Ratio (SLR) portfolio, but only up to a limit and at a penal rate of interest. This provides a safety net against unanticipated liquidity shocks to the banking system. It is an option for

emergency situations.

- **CORRIDOR:**

The corridor for daily movement is determined by the MSF rate and reverse repo rate. An interest rate corridor, also called a policy corridor, is a term for the range within which the operating target of the monetary policy - a short term interest rate manoeuvres around the policy rate announced by the central bank. Usually, it is mandatory that a corridor have a discount rate or standing lending facility at the upper limit and an uncollateralized deposit facility at the lower limit. The word standing facility refers to a facility to access funds at a specified rate from the Central Bank (or deposit funds with Central Bank) on a standing basis which means all throughout the year.

- **BANK RATE:**

Bank rate is the term used for the rate at which the central bank buys or sells (rediscounts) bills or other papers of commercial usage. It is mentioned under Section 49 of the Reserve Bank of India Act, 1934. It changes as and when the Marginal Standing Facility rate fluctuates. It is also known as discount rate. If the bank rate falls, it leads to other rates of interest being reduced too. This leads to credit becoming affordable as its cost has fallen. If the bank rate rises, it proves to be anti-inflationary since the total availability of money is reduced.

- **VARIABLE RESERVE RATIOS:**

Variable Reserve Ratios are deposits that the commercial banks are required to keep in the form of cash to ensure liquidity for the credit which they create. The Reserve Bank of India has the power to change the reserve requirements of commercial banks. There are 2 reserve ratios, Statutory Liquidity Ratio and Cash Reserve Ratio.

- **CASH RESERVE RATIO (CRR):**

Cash Reserve Ratio is the amount of money that banks have to maintain with the central bank as deposits. This leads to less supply of credit in the economy, thus bringing inflation under control. There is an inverse relation between deposit multiplier and CRR. This is the RBI's method of controlling the excess liquidity in the economy. It should not be less than 4% of the total NDTL, which is the Net Demand and Time Liabilities.

- **STATUTORY LIQUIDITY RATIO (SLR):**

Statutory Liquidity Ratio is the share of deposits that a bank has to keep in the form of cash, gold or other securities, before offering credit to customers. This ensures liquidity, and is so that the banks do not run out of liquid funds in case depositors want to withdraw a large amount of their funds in an emergency situation. This puts a cap on the credit creation capabilities of commercial banks. Both CRR and SLR are fixed by the RBI itself.

- **OPEN MARKET OPERATIONS (OMOs):**

Open Market Operations refers to the sale and purchase of government securities in the open market. The purpose is to inject or absorb liquidity in the economy. These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively. On one hand, they are able to make budgetary requirements available in the economy while on the other hand, they are also able to siphon off the excess funds in times of inflation.

- **MARKET STABILISATION SCHEME (MSS):**

The Market Stabilization Scheme (MSS) was brought into effect in April 2004. During 2002-2004, there were huge capital inflows into India which resulted in an appreciation of the rupee (because demand for the Indian rupee increased). Appreciation of the rupee, or an increase in the value of currency in relation to another currency is not necessarily a positive occurrence since it makes exports more costly. Therefore, the RBI intervened and started buying US Dollars with Indian Rupees so that the supply of rupee increased and it became devalued. Another term for withdrawal of liquidity is sterilisation.

### **Qualitative Methods**

- **MARGIN REQUIREMENTS:**

Margin requirement is the value difference between the loan advanced by commercial banks and the security offered by the borrower. Commercial banks do not advance loans equal to the full amount of security because of depreciation of assets and other factors. Margins against securities are determined by the RBI. The flow of credit becomes influenced by a change in margin requirements. An increase in the margin requirement results in a contraction in the borrowing value of the security and in the same way, a decrease in the margin requirement results in an increase in the borrowing value of the security.

- **CREDIT RATIONING:**

Credit rationing is the limiting which is done by the Central Bank so that there is a ceiling on the maximum amount of loans that can be advanced.

- **REGULATION OF CONSUMER CREDIT:**

Consumer credit is regulated for various reasons, for instance, to stabilise the economy by liberalising loan conditions to stabilise the economy.

- **MORAL SUASION:**

Moral suasion is the persuasion and pressures applied by the RBI to make the commercial banks comply with its credit policies. It is basically a method of coercion, functioning on the principle of moral responsibility that all banks should undertake for the greater good of the economy.

- **PUBLIC ANNOUNCEMENTS:**

The Reserve Bank makes public announcements and publicises its goals so as to make commercial banks aware of its goals for the fiscal period. RBI also publishes data and information which will have an effect on banks.

### **Effectiveness**

Effectiveness of credit control in an economy depends upon many factors. First, a well-organised money market. Second, circulation of a large proportion of money in the well-organised money market. In the end, the money and capital markets should be elastic in nature. Extensiveness widens the scope of credit control and elasticity lends it adjustability to the changed conditions. Economic conditions are such, in developing economies, as to limit the effectiveness of the credit control measures.

### **Steps to improve monetary transmission:**

It is the prerogative of both the Indian government and the RBI to undertake plans and steps to accelerate the effectiveness of monetary policy. Bringing down interest rates on small saving accounts is a goal of the government. The government aims to bring down the interest rates on small saving accounts. Linking the small saving rates to the bank rate could serve as a permanent solution. Inflation is not being able to be brought under control due to:-



1. Financial deficits
2. Issues on the supply side, such as crude oil prices, issues in agricultural marketing, etc.
3. Borrowers still depend on moneylenders, who are not under RBI's control, leading to financial exclusion and exploitation
4. Non-monetised economy in certain rural areas

**Current Scenario:**

The Monetary Policy Committee meeting held on August 6, 2021 decided to:

- Keep the repo rate unchanged at 4%
- The reverse repo rate at 3.35%
- The MSF and the Bank Rate at 4.25%
- It was decided that the accommodative stance be continued due to the effect of the pandemic and lockdown on the economy
- Keep inflation under control going forward

All decisions are congruent with the goal of keeping inflation within the range of 2 percent to 6 percent.

**Conclusion**

The Monetary Policy's goals are to ensure price stability and adequate flow of credit to the productive sectors of the economy. An economy's problems include inflation, boom, unemployment, etc. Changes in the money supply affect interest rates as well as spending in sectors such as business investment, housing and foreign trade. The Monetary Policy Committee has taken a number of steps to enhance the effectiveness of monetary policy. These include improvement in the payments and settlement systems, dissemination of knowledge, diversification of investor base, reduction in non-performing assets, introduction of guidelines and reduction in the overall transaction costs. Efficient and effective Monetary Policy can help correct the economic ills of the economy such as inflation and deflation.

This is crucial to the growth of a nation since economic progress forms the backbone of development in any country. This research project has aimed to sufficiently explain how the

Monetary Authority of a country, in the case of India, RBI aims to maintain equilibrium in the economy. The paper covers the origin and history of RBI, Monetary Policy and its Tools, Monetary Policy Committee of India, the current economic scenario as of August 2021 in India and a case study.

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