Reserve Bank of India
Its functions and tools

Department of Communicative English & Media Studies
Second Year/Fourth Semester (2019-21)
Indian Polity and Economy (Paper CC409)

RBI, to keep the monetary policy on track

- Set up in 1935 under the Reserve Bank of India Act, 1934
- The basic function is stated in its Preamble:

"…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 and the credit of the country to its advantage".

Position in the economy

- Any modern economy is governed through two sets of policies – Fiscal and Monetary
- While Fiscal policy manages the government’s revenues and expenditures, the Monetary policy is concerned with managing the money supply in the economy
- Fiscal policy in India is decided by the Union Ministry of Finance; Monetary policy is decided by the country’s **central bank**. In India, that role is played by the Reserve Bank of India
- Both have to work in tandem to steer the economy on a path of growth and development

Key functions

- The RBI carries out a number of crucial functions. The major ones are:

1. Issuing currency notes
2. Controlling money supply
3. Act as a bank to the government
4. Act as the custodian of foreign exchange
5. Play a banker to the banking system
6. Plays a supervisory role to the financial system

Currency notes

- The RBI issues currency notes of all denominations, except one-rupee notes & coins and smaller coins
- One-rupee notes & coins and smaller coins are issued by the Government of India. In fact, the RBI also issues these on behalf of the Government of India
- At present, notes of denominations 2, 5, 10, 20, 50, 100, 500 and 2, 000 are issued by the central bank

Controlling money supply

- The RBI controls quantity of money in the economy at any given point of time, keeping two things in mind – need of growth and rate of inflation
- The central bank achieves this with the help of various tools:

1. Repo Rate (RR)
2. Reverse Repo Rate (RRR)
3. Bank Rate (BR)
4. Cash Reserve Ratio (CRR)
5. Statutory Liquidity Ratio (SLR)

RR/RRR

- There are two types of open market operations of the RBI to control money supply – **outright** operation and **repurchase** or repo operations
- Repo Rate and Reverse Repo Rate are the means of carrying out the repurchase agreement operations.
- On the government's behalf, the RBI purchases or sells bonds which are also called securities. In **outright operations**, the RBI buys securities, injecting money in the economy or sells securities sucking up the money permanently. There is no repurchase or resell provision

RR/RRR

- In the **repurchase agreement**, the RBI buys securities to lend money to banks. The rate at which the RBI lends is called the **Repo Rate**. This agreement has specification about the date and price of the resale of securities. If the Repo Rate is decreased, banks can borrow more and, therefore, lend more, increasing money supply in the economy
- At times, banks buy securities from the RBI to park their surplus funds. The rate at which the RBI returns the money on the agreed date in lieu of the securities is called the **Reverse Repo Rate**. Repo Rate is always higher than Reverse Repo Rate

BR

- The RBI can influence money supply also by changing the rate at which it provides loans to the commercial banks. This rate is called **Bank Rate**. By increasing the Bank Rate, loans taken by the banks become expensive. This reduces the reserves of the banks and hence decreases the money supply in the economy. A fall in the Bank Rate increases the money supply
- Reserves are deposits of the banks which they maintain with the RBI. These deposits are kept partly in cash and partly in financial instruments like bonds and treasury bills or securities (government bonds)

CRR and SLR

- The RBI also controls the money supply through quantitative methods with the help of CRR and SLR
- **Cash Reserve Ratio** is the minimum percentage of deposits with commercial banks that they have to deposit in cash in the current account held with the RBI
- **Statutory Liquidity Ratio** is the reserve which banks have to maintain with the RBI in liquid form like gold and securities in the short-run
- An increase in CRR or SLR will leave less money in the hands of banks, limiting their capacity to give loans and vice-versa

Banker to the government

- The RBI also renders a crucial function of acting as an agent/ agency of the central and state governments.
- It makes payments, receives taxes and deposits, etc, on behalf of the governments.
- Maintains government accounts and gives financial advice to the governments
- Maintains foreign exchange (**forex**) on behalf of the government. It prepares forex rate policy vis-à-vis the Re. Domestic fiscal and monetary policies are crucial factors in maintaining external value of Re. The RBI has a key role in this

Supervisory/Advisory role

- Grants licences to banks and controls opening of new branches; carries out inspections of banks
- The RBI has the right to issue directives to non-banking financial institutions because they are not influenced by the overall monetary policy
- Refinace companies like NABARD, IDBI, SIDBI, etc, also function under the guidance of the RBI
- It also paves way for ease of lending into a particular sector to ensure it comes out of a slump