Working of Indian Economy

Let me start with an interesting example. In our economy we have three important people:

- RBI (Reserve Bank of India), similar to Grandfather.
- Commercial Banks, similar to Father.
- General Public, similar to Son.

Now if father wants the money, he will take it from grandfather.

Similarly, if son wants the money, he will take it from father.

Coming back to the point. Let's start with very basic questions.

What is the role of RBI?

RBI is the central bank of our country. It has the sole power to mint money of denomination higher than one rupee notes and coins.

RBI has the total control over the money supply in our economy.

In simple words, RBI has a switch to on and off the inflation and growth factor.

RBI as said before is the grandfather. Hence if the commercial banks need money, then RBI helps them by lending the money.

It also charges interest on such lending which is known as 'repo rate'.

The money so minted is given as a loan from RBI (grandfather) to Commercial banks (father).

What do commercial banks do of such money?

Commercial banks as the name suggests are commercial in nature. Which means they are profit oriented.

They will lend the money to general public (son) for various purposes.

Hence if a random start-up wants to have money for the business, it will approach bank for the money.

In other words, banks help general public for promoting their business.

What do the businessman do after taking loan?

The businessman will invest the money in the business and thereby earn profit.

Also he will have to spend money for running his business on various factors. These are known as factors of production:

- Land (rent)
- Labour (wages)
- Capital (interest)
- Entrepreneur (profit)

Now you see that the cycle of money is completed this way:

Money minted by RBI — Commercial banks —Businessmen—and the same businessmen will put their earned profit as a saving in banks.

Thus completing the money cycle.

How does RBI control growth?

Remember that RBI is the grandfather? Not just he is a grandfather, infact this grandfather is a strict person.

When RBI wants to increase growth, the following will happen:

- RBI will mint more money.
- More money means more loan to Commercial banks.
- More loan to commercial banks means more loan to general public.
- Giving more money in the hands of public will cause increase in their purchasing power.
- More purchasing power means more demand for goods and business will flourish.
- But, Increase in demand of goods will cause rise in prices of the goods hence causing inflation.

How does RBI control inflation?

It will simply reverse the above procedure.

- It will mint less money
- Less money means less amount to banks.
- Hence less money for general public.
- Hence lesser demand for goods and lesser the prices.

Note: **You will now observe that growth and inflation go hand in hand.**

If the economy grows, so will the inflation.

Hence expecting RBI to grow the economy without letting the prices increase is like wanting to eat a lot of ice-cream without wanting to catch a cold.

RBI is unfortunately not ajay devgan to ride both the horses simultaneously. You get one, you sacrifice another.

What is the role of government then?

Well, the government also plays a special role of say grandmother here.

Finance ministry is responsible for the economy too.

The money earned by public is given back to the government in the form of taxes.

If the inflation rises, the grandmother will come to rescue too.

- Finance minister will increase the income tax.
- More income tax, means less money to spend in the hands of public.
- Less money will result into less demand and lesser prices of goods.

Note: These taxes are further used by the government on various infrastructural and developmental projects. Sometimes there may be differences between RBI and government as there can be between grandfather and grandmother.