Ref: Samuelson, P. & Nordhaus, W.: Economics, Indian Adaptation, 19th Edition

APPENDIX 24

RESERVE BANK OF INDIA

History

The Reserve Bank of India started operations in 1935. Before that the central banking functions were performed by the Imperial Bank of India (the predecessor of the State Bank of India) and by the central government. The Imperial Bank, though a commercial bank, operated as the banker to the government and as the banker to other banks. The central government looked after the functions of issue of currency and management of foreign exchange. RBI was set up following the recommendations of the Royal Commission on Indian Currency and Finance of 1926.[1]

Structure

The central office where the governor sits and where policies are formulated was at first in Kolkata. It was shifted to Mumbai in 1937. RBI was initially privately owned but since its nationalization in 1949 is wholly owned by the Government of India. The latter also appoints the members of the Central Board of Governors, the top most decision-taking authority. The central board consists of 5 official directors (governor, who is the chief executive and four deputy governors) and 15 non-official directors. One of them represents the central government. Ten others with expertise in different fields such as in economics, law, and business are nominated by the central government. The remaining four members are also nominated by the central government and represent the local boards. There are four local boards in Chennai, Kolkata, Mumbai, and New Delhi and these represent regional and economic interests.

Functions and Objectives

These are summarized in Table 24A-1.

Most of these functions are typical central banking functions. But the developmental role of the RBI is quite a distinctive one. Over the years, RBI has established a number of institutions to pursue specific socio-economic objectives. These include the Unit Trust of India (1964), the first mutual fund in the country; the Industrial Development Bank of India (1964), a development finance institution; the National Bank of Agriculture and Rural Development (NABARD) (1982) for promoting agricultural and rural credit; and the National Housing Bank (1989) for promoting and regulating housing finance. RBI also has special policies for facilitating credit for priority sectors and weaker sections.

MONETARY POLICY INSTRUMENTS IN INDIA

RBI uses all the three main instruments of monetary policy—open market operations, discount rate (called bank rate in India), and reserve requirements. But the extent and the nature of use of these instruments have changed over time particularly after the Economic Reforms since the early 1990s.

Reserve Requirements

In India, banks are required to maintain two types of reserve ratios—Cash Reserve Ratio

[1] Discussion in this appendix is based on materials accessed from the RBI website, www.rbi.org.in, particularly the Brochure issued in 2010 on the occasion of the Platinum Jubilee and the *Report on Currency and Finance*, 2004-05 on the theme of "Evolution of Central Banking in India" and 2005-06 on the theme of "Development of Financial Markets and Role of the Central Bank".

TABLE 24A-1. *Main Functions of the Reserve Bank of India*

Role	Function	Objectives
Monetary Authority	Formulates, implements, and monitors the monetary policy	Maintains price stability and ensures adequate flow of credit to productive sectors
Regulator and supervisor of the financial system	Prescribes broad parameters of banking operations within which the country's banking and financial system functions	Maintains public confidence in the system, protects depositors' interest, and provides cost-effective banking services to the public
Manager of foreign exchange	Manages the Foreign Exchange Management Act, 1999	Facilitates external trade and payment and promotes orderly development and maintenance of foreign exchange market in India
Issuer of currency	Issues and exchanges or destroys currency and coins not fit for circulation	Gives the public adequate quantity of supplies of currency notes and coins and in good quality
Banker to government	Maintains the accounts of the central government and state governments; manages domestic debt of the governments	Facilitates transactions of the government including raising resources from the public
Banker to banks	Maintains banking accounts of all scheduled banks	Facilitates settlement of inter-bank obligations, maintains statutory reserve requirements, acts as lender of last resort
Developmental role	Performs a wide range of promotional functions	Supports national objectives

Source: Reproduced from "About Us" in the RBI website, www.rbi.org.in.

(CRR) and Statutory Liquidity Ratio (SLR). CRR is the share of net demand and time liabilities that banks must maintain as cash balance with RBI. Currently, it is 6%. SLR is the share of net demand and time liabilities that banks must maintain in safe and liquid assets such as government securities, cash, and gold. CRR has been one of the most active instruments of monetary policy in India. But SLR has traditionally been more a fiscal policy instrument than a monetary policy instrument in India. After remaining constant at 20% during the 1950s and the early 1960s, SLR was increased to 25% in September 1964. Since then, it was raised occasionally and systematically and reached the level of 38.5% by September 1990. The high SLR created a captive market for government securities and facilitated low-cost government borrowings. Unlike at present, the interest rates were administered and the rates were kept low, unrelated to market demand and supply conditions. After Economic Reforms, SLR was gradually reduced and reached 25% by October 1997. It has remained at that level except for a short period between November 2008 and October 2009, when following the global crisis, it was brought down to 24%. CRR continues to be the more active monetary policy instrument as noted below.

Bank Rate

Changes in the bank rate operate as a monetary policy instrument primarily through its impact on other interest rates, for example, the bank lending rate. It does so not only by directly influencing the cost of credit. It also acts as a signaling device. Before reforms, the use of bank rate was blunted because interest rates were administered. After reforms, the use of bank rate was activated for a while. But it is not currently an active monetary policy instrument.

The bank rate has remained unchanged at 6% since April 2003.

Open Market Operations

Open market operations (OMO) too was not an active instrument before reforms. For OMO to be effective as a monetary policy instrument, what is required is an active government securities market so that the central bank can buy or sell securities and thereby influence both the liquidity and the price of securities and hence the rate of interest. But the interest rate was administered as mentioned above and did not vary depending on demand and supply conditions. The high SLR also did not give the banks much flexibility to buy and sell government securities. Another crucial factor was the system of automatic funding of government deficits through ad-hoc Treasury Bills. Government's receipts and expenditure do not exactly match, and hence, in its account with RBI at the end of any day, there will be either a negative or a positive balance. In case of a negative balance, as is customary, RBI provides financial accommodation to the government. Earlier this was done through issue of Treasury Bills, i.e., short-term government securities. But there was no limit to such ad-hoc issues and the rate of interest was also kept low and fixed at 4.6%.

Among the steps taken since the early 1990s as a part of Economic Reforms are:

- Abolition of administered interest rate system: banks are free to fix the lending and deposit rates subject to some conditions.
- Abolition of the system of automatic monetization of Centre's fiscal deficit since April, 1997: a system of ways and means advances (WMA) to the central government, subject to limits at market-related rates, was put in place instead to meet mismatches in cash flows.
- Market for government securities:
  - Abolition of administered interest rate system in government securities: an auction system was started for the central government's market borrowings in June 1992.
  - Introduction of primary dealership in March 1995.
  - Introduction of a variety of instruments, such as floating rate bonds, Treasury bill of different maturities. FIIs were permitted to invest in government securities from July 1997.
  - Introduction of retail trading in stock exchanges from January 2003.

As a result of all these changes and with the development of an active government securities market and market-determined interest rates, RBI can and does use OMO as a monetary policy instrument.

Liquidity Adjustment Facility (LAF)

Apart from outright purchase/sale of government securities, RBI has started the system of repurchase arrangements from June 2000. Under LAF, RBI sets two rates—the repo rate and the reverse repo rate. Repo/Reverse repo is a repurchase agreement in which two parties agree to sell and repurchase a security on an agreed date at a predetermined price. When banks sell government securities to RBI to get funds, repo rate is applicable. When banks buy securities from RBI to park surplus funds, reverse repo rate is applicable. LAF has developed as a very important instrument. It makes possible daily injection of liquidity (through repo) or absorption of liquidity (through reverse repo) using government securities as collateral. The repo/reverse repo rates fixed by the RBI also set limits to variations of other short-term money market interest rates. A change in these rates acts as a signaling device for movement in other segments of financial markets and the real economy.

Market Stabilisation Scheme (MSS)

This is another instrument of monetary management. This was introduced in 2004. When capital flows in from abroad and liquidity tends to go up, RBI can and does absorb additional liquidity by selling government securities. This cannot be done if in the first place RBI does not have adequate stock of securities. Under MSS, RBI is permitted to issue treasury bills and dated government securities for the purpose of such sterilization exercises. In the market, these are indistinguishable from those issued by the government. The proceeds are maintained in a separate government account with RBI.

Movements of CRR, Repo Rate and Monetary Policy

CRR and the repo rate represent the most visible signs of operation of monetary policy in India. Let us consider three recent episodes in India: (i) the phase of rising inflation between late 2007 and late 2008; (ii) the fall in the inflation rate and the recession following the global economic crisis in mid-September 2008, and (iii) rising inflation again since October 2009.

As can be seen from Figure 24A-1, the rate of WPI inflation (year-on-year) increased sharply from 3.1% in October 2007 to 12.8% in August 2008 during the first period. This was also the period when RBI increased both the repo rate and the CRR from around 7% to 9% (with reverse repo rate, however, remaining steady at 6%). In the second period since September 2008 as the prices started falling and as demand deficiency threatened India following the global financial crisis and global recession, RBI was quick to respond by adjusting these rates downwards. In stages, the CRR was reduced to 5% by January 2009 and the repo rate to 4.75% by April 2009. (SLR was also reduced from 25% to 24% and the reverse repo rate from 6% to 3.25%.) In the third period since October 2009 when the inflation rate again became positive and was rising, RBI exited from "expansionary monetary policy."[2] This started in October 2009 by restoring the SLR to the pre-crisis level of 24% and by terminating some sector-specific liquidity facilities. It was followed by increases in CRR and repo rate to 6% and 5.25% respectively by April 2010.

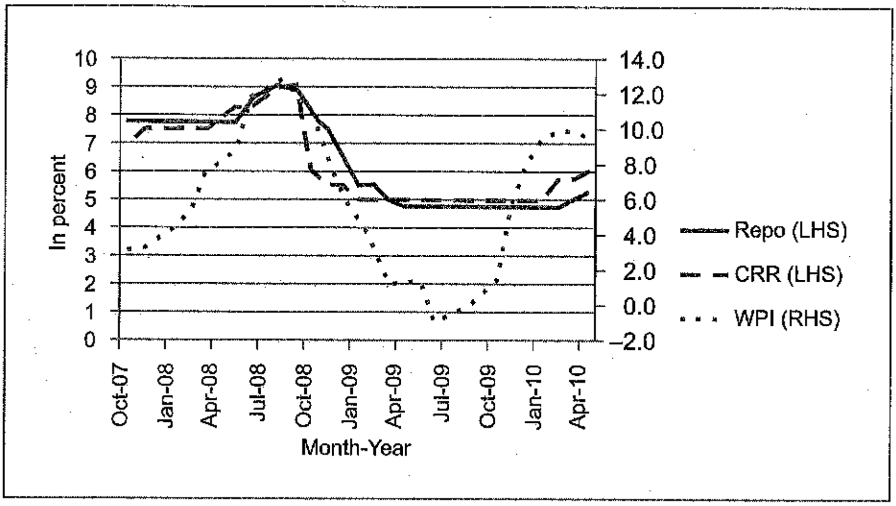

FIGURE 24A-1. Movements of CRR, Repo Rate, and WPI

Source: Centre for Monitoring Indian Economy (CMIE), *Business Beacon* databse and Reserve Bank of India, *Handbook of Statistics on Indian Economy*. Repo rate and cash reserve ratio (CRR) are measured in the left-hand scale (LHS) and year-on-year WPI inflation rate in the right-hand scale (RHS).

[2] *Reserve Bank of India Monetary Policy Statement 2010-11 by Dr D Subbarao, Governor,* (p. 9), accessed from www.rbi.org.in.