UNIT 8 RESERVE BANK OF INDIA

Structure

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8.0 OBJECTIVES

After studying this unit, you should be able to:

- describe the functions of the Reserve Bank of India (RBI)
- state the system of note issue in India
- explain the principles followed for issuing the currency notes
- discuss various instruments of credit control adopted by the RBI
- appraise the monetary policy of the RBI.

8.1 INTRODUCTION

In Unit 7 you have learnt about the central bank. As you know, the central bark of any country is the apex institution in its banking system. Its authority to issue currency notes and its role as a government's banker and a bankers' bank impart to it a unique position in the banking structure of a country. The Reserve Bank of India (RBI) which is the central hank of this country, performs not only those functions which central banks in developed countries perform but also certain promotional and developmental functions to help the development of the less developed financial markets and institutions.

In this unit you will study in detail about the functions of RBI, system and principles of note issue by RBI, and the instruments of credit control adopted by RBI. It also critically examines as to how efficiently the RBI has used its monetary control measures to realise the stated objectives of its monetary policy.

8.2 FUNCTIONS OF THE RESERVE BANK OF INDIA

The Reserve Bank of India (RBI) is the central bank of India. It was established as a shareholders' bank on April 1, 1935. The RBI retaind this character for a little less than fourteen years. On January 1, 1949 it was nationalised and since lhen it has remained wholly state owned.

The RBI performs two types of functions: i) traditional functions of a central bank, and ii) developmental and promotional functions. The traditional functions are more or less the same which a central bank normally performs in both developed and less developed economies. In contrast, the developmental and promotional functions of a central bank operating in less developed countries are determined by the unique requirements of the economy in general and financial markets in particular. In India, the inadequacy of agricultural finance and lack of specialised institutions of long-term industrial finance have

mainly determined the developmental and promotional functions of the RBI.

8.2.1 Traditional Functions

The RBI was established on the model of the Bank of England. It was, therefore, entrusted with the task of performing all those functions which the Bank of England had been performing. These functions, which are usually known as traditional functions of a central bank are:

1) To issue currency notes
2) To act as a banker to the Government
3) To act as a bankers' bank
4) To control and supervise banks
5) To manage and control the foreign exchange
6) To control credit

1) **Issue of Currency Notes:** The RBI is the sole authority for issuing currency notes in India. We know that currency constitutes a significant part of the money supply in India. In 1989-90 around 57% of the money supply (considered in the narrow sense, that is, M) was in the form of currency. The issue of currency notes, therefore, becomes one of the principal functions of the RBI. All currency notes issued by the RBI are legal tender in India.

   The Reserve Bank of India Act permits the issue of currency notes in rupees in the denominations of two, five, ten, twenty, fifty, one hundred, five hundred, one thousand, five thousand and ten thousand or such other denominations not exceeding rupees ten thousand as the Central Government may specify. At present notes in denominations of rupees one thousand, five thousand and ten thousand are not issued. One hundred rupee notes are most important as they account for around half the total value of currency notes. The system and the principle of note issue by the RBI will be discussed later in this unit.

2) **Banker to the Government:** The RBI is a banker to both Central and State governments. As a banker it renders a variety of banking services to the government, including acceptance of money deposit, withdrawal of funds by cheques, receipts and collection of payments to Government and transfer of funds. The RBI is under statutory obligation to render banker's services to the Central Government. The State Governments, however, obtain these services from the RBI by virtue of agreements entered with it. The public debt management which is now done by the RBI was earlier the responsibility of the Government. Since the RBI operates in gilt-edged market, it has intimate knowledge of it. The RBI can thus provide useful advice to the government on the amounts, terms, conditions and timing of new bonds issue. In India, the Treasury Bills now constitute a significant proportion of the public debt of the Central Government. The Treasury Bills are issued by the RBI as the agent of the government. Apart from handling the public debt, the RBI also makes short-term advances to the government. These short-term advances are provided to overcome temporary difficulties of the government arising from shortfalls in their revenue.

   Finally, the RBI acts as an adviser to the government. The RBI, with its experts specialising in various areas, is in a position to advise the government not only on banking and financial matters, but also on issues pertaining to overall economic planning. The importance of this function has increased due to the need for integration between the monetary and fiscal policies.

3) **Bankers' Bank:** Like other central banks, the RBI does not deal with the public or business firms, it is only a bankers' bank. The commercial and cooperative banks avail the financial assistance from the RBI in the form of rediscounting of bills as well as loans and advances against approved securities, for periods not exceeding ninety days. The RBI has been entrusted with the task of channelising banking development on sound lines. Therefore, while giving advances to banks it has to discriminate between banks on the bases of their financial positions, lending policies and the securities offered. The RBI is within its powers to deny financial assistance to any bank wanting to borrow from it without assigning any reason.

4) **Control and Supervision of Banks:** Under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 the RBI has been given extensive powers to control

commercial banks. The regulatory functions of the RBI relating to commercial banks cover their licensing, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. For the purpose of control, the RBI conducts inspection of the banks and calls for returns and information from them. In case the operations of any bank are bound unsatisfactory, the RBI may recommend remedial measures to improve the functioning of that bank.

Any company wanting to do banking business in India must obtain a licence from the RBI in terms of the provisions sf the Banking Regulation Act. However, the banks in the public sector and the regional rural banks are not required to obtain licence to undertake banking business. Control over branch expansion of commercial banks is required for dispersal of banking facilities. A6 present the RBI encourages commercial banks to open their branches in rural and semi-urban ma..

In order to ensure that commercial banks are organised and operated on sound financial lines, the Banking Regulation Act has determined the minimum requirements of paid-up capital and reserves, transfer to reserve fund, and maintenance of cash reserve and other liquid assets. However, the most important supervisory function of the RBI is the inspection of banks. It safeguards the interests of the depositors and helps in developing banking system in conformity with the banking laws and regulations.

5) **Foreign Exchange Management and Control:** Foreign exchange management and control involves three main functions: (i) maintaining the external value of the currency, (ii) management of external reserves of the country, and (iii) exchange control. The RBI, being the central bank of the country, is required to perform all these functions. Presently the exchange value of the rupee is determined with reference to the daily exchange rate movements of a selected number of currencies of the countries which are India's major trading partners. The selection of the currency units and the weights to be assigned to them has been left to the discretion of the RBI. As a custodian of foreign exchange reserves, the RBI manages the investment and utilisation of these reserves. The exchange control is presently governed by the Foreign Exchange Regulation Act, 1973. The Act is administered by the RBI in accordance with the general policy laid down by the Central Government in consultation with the former.

6) **Credit Control:** Regulation of credit in accordance with the needs of the economy is perhaps the most significant function of a central bank. M.H.De Kock, a leading authority on central banking has observed, *"it (credit control) is the function which embraces the most important questions of central banking policy and one through which practically all other functions are united and made to serve a common purpose."* De Kock's observations are no doubt relevant in the Indian context. In this country the objective of economic policy is growth with price stability. The monetary policy relying primarily on credit control also aims at realising this objective. Thus the control of credit function of the RBI assumes unique importance. In order to regulate the supply of credit, the RBI used both quantitative and qualitative techniques which are discussed later in this unit.

8.2.2 Developmental and Promotional Functions

In the pre-Independence days the RBI did not perform any developmental functions. But after the country got Independence the RBI has begun performing a number of developmental and promotional functions. Broadly these may be classified under four heads. First, it has largely institutionalised agricultural credit. With this in view, it first hied to integrate indigenous bankers with the organised money market. Having failed in this attempt, it not only encouraged development of cooperative credit in rural areas but also exercised its licensing power in such a manner that commercial banks have now reached rural areas in a big way. Secondly, in order to channelise the savings of depositors particularly the small savers, it played an active role in the establishment of the Unit Trust of India (UTI). The UTI presently offers the best investment opportunity to both persons and institutions lacking in investment expertise. It ensures steady income, liquidity, low risk and expert management to its investors. Thirdly, by helping in setting up the National Bank for Agriculture and Rural Development (NABARD), the RBI has filled the gap in agricultural finance. The NABARD is the apex organisation in agricultural finance. Half of its share capita?has been provided by the RBI. Finally, the RBI has contributed greatly to the setting up of a number of development banks in India. In fact, the Industrial Development Bank of India (IDBI) was originallv established as a subsidiary of the RBI. However, in 1976 it

became an autonomous institution.

Check Your Progress A

1) List the main functions of the Reserve Bank of India.

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2) State which of the following statements are True and which are False.
   i) The Reserve Bank of India is the central bank of India.
   ii) Right from the day the RBI was set up, it has been a public sector organisation.
   iii) The RBI has the sole right to issue currency notes in India.
   iv) The currency notes issued by the RBI are legal tender throughout the world.
   v) The RBI is a banker to both Central and State Governments.
   vi) The Treasury Bills are sold by the RBI for raising its working capital.
   vii) The RBI is a bankers' bank.
   viii) All commercial banks, including those owned by the Government, need a licence from the RBI to do banking business.
   ix) The exchange control in India is managed by the Central government independently.
   x) The developmental and promotional functions which the RBI has performed are the same as the, Bank of England has performed in the UK

8.3 NOTE ISSUE

As explained earlier in this unit, note issue is one of the basic functions of the RBI. The RBI has the monopoly power to issue currency notes. In this section we shall discuss the system and the principle of note issue.

8.3.1 System of Note Issue

In terms of the Reserve Bank of India Act, the RBI conducts note issue through two separate departments: 1) the Issue Department, and 2) the Banking Department. The Issue Department is liable for all the currency notes put into circulation from time to time. The Issue Department is required lo maintain eligible assets for equivalent value. In terms of the Reserve Bank of India Act, the assets of the Issue Department against which currency notes can be issued consist of gold, foreign securities, rupee coins, Government of India rupee securities and bills of exchange, and promissory notes payable in India which are eligible for purchase by the RRI. In practice, the distinction between the Issue Department and the Banking Department does not have much ecohomic significance because the assets of the two Departments keep on shifting frequently. However, the Issue Department does not hold some of the assets of the Banking Department. The assets which are not eligible for being held by the Issue Department are State Government securities and coins.

The responsibilities of the Issue Department include arranging the printing of notes from the currency printing presses of the Government of India, distribution of currency notes among the public and withdrawal ofnon-usable notes. On the other hand, the functions of putting the currency into circulation and its withdrawal from circulation is performed by the Banking Department. An illustration will help you to understand this clearly. Suppose, a commercial bank wants to withdraw Rs. 5 crores from its deposit with the RBI, the transaction will be handled by the Banking Department. The bank concerned will get currency in the denominations required by it and its account with the RBI will be debited for the amount withdrawn by it. For meeting this kind of demands the Banking Department holds stock of currency. Whenever it feels that its stock of currency is not sufficient, it replenishes it from the Issue Department against transfer of eligible assets. The commercial banks also make deposits with the RBI on a regular basis. Suppose, a particular bank tenders cash to the RBI to be deposited in its account, this cash will be received by the Banking Department and will be held as stock of currency. As a result of this receipt of cash, if there is surplus holding of currency in the Banking Department, the excess cash, will be transferred to the Issue Department in exchange for the assets of equal value. For exchanging currency notes of one denomination for another or for coins and vice versa, the

Issue Department deals with the public directly. As a related function of note issue, the RBI provides currency to the central and state governments to facilitate their transactions. From this point of view the RBI has made elaborate arrangements like maintaining offices of the Issue Department in a number of cities. At other centres the currency requirements are met through currency chests maintained by the RBI with the State Bank of India and its associated banks, other nationalised banks, and the Government Treasuries and sub-treasuries. The agency of the RBI, namely the State Bank of India or any other nationalised bank or the Treasury at which the chest is provided, can withdraw cash therefrom according to its requirements. It is also required to deposit into the chest any cash in excess of its immediate needs, as these funds can be withdrawn later when a need arises.

8.3.2 Principle of Note Issue

At the time of establishment of the RBI, gold standard (that is, a monetary system in which the currency of the country was directly or indirectly convertible into gold) was still prevailing at the international level.

Therefore, in India the principle of linking gold and foreign reserves to note issue was followed by adopting proportional reserve system. Under this system the RBI was required to maintain a reserve of gold and foreign securities (until January 1, 1949 sterling securities), not less than 40% of the total assets. However, at any time gold reserve was not to fall below Rs. 40 crore in value. The proportional reserve system requirement could be suspended with the previous sanction of the central government. Nonetheless the RBI was required to pay a tax on the shortfall in the statutorily required gold and foreign securities reserve. This system of note issue worked well for about two decades as it put a check on money supply in the economy and therefore, keeping an effective control on commodity and factor prices.

However, in 1956 with the adoption of the Second Five Year Plan a big push was to be given to development effon. Moreover, the process of monetisation became faster. Under such circumstances the demand for money was expected to increase which under the constraints of the proportional reserve system could not be easily met. Further, it was felt that blocking of foreign exchange in reserve to back issue of currency notes served no useful purpose; rather they serve greater purpose if used to cover unavoidahle deficits in the balance of payments. The system of note issue was, therefore, made more flexible in 1956. **The proportional reserve system was replaced by the minimum reserve system. This implies that the note issuing authority is under an obligation to maintain only a certain minimum of gold and foreign exchange reserve; the rest to be kept in the Form of other eligible securities.** In terms of the Reserve Bank of India (Amendment) Act, 1956 the minimum reserve prescribed was Rs. 400 crore in foreign securities and Rs. 115 crore in gold, adding upto Rs. 515 crore. In 1957 the provisions governing the minimum amount of reserve backing note issue were modified and the minimum requirement of the gold nnd foreign exchange reserve was fixed at Rs. 200 crore, of which the minimum value of gold was to be Rs. 115 crore. The Second Amendment Act of 1957 also empowered the RBI to dispense with reserve in foreign securities with the prior sanction of the Central Government. However, gold reserve of Rs. 115 crore is to be kept all the time. This system of note issue is no doubt flexible, but it does not provide for any check on inflationary tendencies.

Check Your Progress B

1) State the two methods of note issue which have been adopted in this country from the time the RBI was set up in 1935.

   i) ....

   ii) ....

2) State which of the following statements are True and which are False:
   i) The RBI conducts its note issue through the Issue Department and the Banking Department.
   ii) The Banking Department is liable for all the currency notes put into circulation.
   iii) The issue of currency notes is backed by the eligible assets.
   iv) The function of putting the currency into actual circulation is performed by the Issue Department.

v) For exchanging currency notes with coins or noles of one denomination for another, the Issue Department deals with the public directly.
vi) When the RBI was set up, the minimum reserve system of note issue was adopted.
vii) When proportional reserve system of note issue was adopted in this country, the, amount of reserve held in gold and foreign securities had to be at least 40% of the total assets.
viii) The proportional reserve system put a check on inflationary expansion of currency notes.
ix) The minimum reserve system of note issue follows the principle of flexibility in currency issue.
x) Presently the minimum gold reserve backing the note issue in India has to be of not less than Rs. 515 crore.

8.4 CONTROL OF CREDIT

As discussed earlier in this unit, control of credit is one of the most important functions of the Reserve Bank of India. In fact, through the RBI's credit control the government attempts to influence overall economic activity and the price level. In this section we shall first discuss the objectives of the monetary policy of the RBI as they provide its framework for credit control. Thereafter, the instruments of general credit control and direct credit regulation shall be discussed.

8.4.1 Objectives of Monetary Policy

Monetary policy refers to use of different instruments under the control of the central bank to regulate the supply of money and credit with the aim of achieving optimum levels of output and employment, price stability, balance of payments equilibrium or any other objectives decided by the State. At present the main objective of monetary policy in India is believed to be the promotion of economic growth coupled with high level of employment and price stability. It has induced economic growth by facilitating adequate volume of credit to industry, trade and agriculture. This obviously necessitated the RBI to follow policies that lead to expansion of credit.

But such a policy could lead to inflation. Therefore, the RBI has been following a cautious policy in credit expansion. To keep inflationary pressures under control, it has to restrain credit expansion and prevent flow of credit to socially undesirable activities like speculation and hoarding. Thus, the RBI's function has been to ensure adequate availability of credit to sustain the tempo of development without adversely affecting the internal price stability. This policy is often characterised as the **policy of controlled expansion.**

8.4.2 Techniques of General Credit Control

As discussed in the previous unit, the techniques of credit control are of two types: i) general or quantitative, and ii) selective or qualitative. The techniques of credit control in the first category are the bank rate, open market operations and reserve requirements. All these three methods affect loanable funds of the commercial banks, and thereby influence the volume of credit and thus total money supply. In the case of qualitative or selective credit control (which will be discussed later in this unit), the impact is on the direction of credit rather than its amount. Following are the general or quantitative techniques of credit control.

1) **Bank Rate: The bank rate is that rate of interest at which the central bank makes advances to commercial banks.** The central bank provides financial accommodation to banks against approved securities or purchases or rediscounts of eligible bills of exchange and other commercial papers. The purpose of making changes in bank rate is to vary the cost of securing funds from the central bank. If bank rate changes, it brings about changes in the structure of market interest rates, which in turn influences the level of economic activity. In an inflationary situation when policy of reducing money supply is to be pursued, the bank rate is raised with the hope that unwarranted investment activity will be checked. On the other hand, in the recessionary situation the bank rate is raised with the expectation that it will induce investment activity thereby providing impetus to overall economic activity.

   However, the effectiveness of bank rate is rather limited in India. The changes in the

bank rate have very little operative significance. They merely indicate the changes in the direction of the credit policy of the RBI. It is for this reason that changes in the bank rate are almost always accompanied by some other techniques of credit control. Making his observations on the efficacy of the bank rate in India, H.V.R. Iyengar, a former Governor of the RBI, has remarked, *"in a planned economy which has a large public sector of investment and where government have a battery of powers of direct regulation of investment, the efficiency of bank rate changes is far less clear than it is in industrially advanced countries with a free economy."*

2) **Open Market Operations:** Open market operations are a technique of credit control by means of which the central bank changes the liquidity position of banks by operating directly in the market. Open market operations involve purchase and sale of government securities, foreign exchange, gold, bills of exchange and company shares by the central bank. However, in India open market operations are generally confined to the buying and selling of government securities, including Treasury Bills.

   Open market operations have two aspects. The first is the buying of securities. When the central bank purchases securities from banks, the latter's cash reserves increase and this improves their capacity to create credit. The other aspect is die selling of securities to the commercial banks which results in the decline of their cash reserves. As a consequence the banks' credit creation capacity is reduced.

   In India, the government securities market is narrow which is constraint on open market operations. A sizeable proportion of the government securities is held by some leading financial institutions and the volume of transactions in them is limited. Further on account of the virtual absence of a treasury bill market, open market operations of the RBI are entirely in government bonds. Given the narrow government securities' market, any attempt by the RBI to conduct large scale operations would unduly disturb security prices.

3) **Reserve Requirements:** The Central bank can change the reserve requirements and can thereby affect the credit creating capacity of the commercial banks. It is a direct and effective instrument of credit control. In India, 'the RBI regulates the liquidity of the banking system by two complementary methods: 1) cash reserve ratio, and 2) statutory liquidity ratio. The commercial banks are statutorily required lo maintain a cash reserve with the RBI equal to a certain percentage of deposits. This cash reserve ratio is prescribed by the RBI and can be in the range of 3 to 15 per cent of the deposits. **Whenever the RBI wants to put a check ow the expansion of credit, it raises the cash reserve ratio. Conversely, when credit expansion is to be induced, the cash reserve ratio is lowered.**

The effectiveness of changes in cash reserve ratio is limited by the tenaency of the commercial banks to offset their impact by liquidating their government security holdings. Therefore, along with a change in cash reserve ratio, a change in statutory liquidity ratio also becomes necessary. In India, until 1962 the commercial banks were required to maintain a liquidity ratio of 20% against their deposit liabilities. Cash in hand, cash with the RBI and other banks, gold and unencumbered approved securities constituted liquid assets. The statutory provision until 1962 enabled commercial banks to liquidate some government securities whenever cash reserve ratio was raised. Hence their capacity to create credit remained intact. The Banking Regulation Act was thus mended to plug this loophole. Now liquid assets are to be maintained exclusive of the cash balance maintained in terms of statutorily determined cash reserve ratio. The statutory liquidity ratio is also determined by the RBI.

8.4.3 Direct Credit Regulation

The regulation of credit by means other than control of bank reserves or the cost of credit is known as direct credit regulation or qualitative credit control. The widely used qualitative techniques of credit control are; (1) selective credit control, and (ii) moral suasion.

The quantitative or general techniques of credit control operate effectively in well organised money markets but are not very effective in countries where money markets are less developed. Qualitative techniques are more suitable for less developed money markets as these techniques help in regulating tlie distribution or direction of bank resources to

particular sectors of the economy in accordance with broad national priorities. In fact, qualitative credit control measures are considered complementary to general credit control and their effectiveness increases greatly when these are used together with general credit control.

1) **Selective Credit Regulation: The RBI** exercises selective credit control under the provisions of the Banking Regulation Act. The main techniques of selective control in India are: i) margin requirements for lending against selected commodities, ii) ceilings on levels of credit, and iii) charging of minimum rate of interest on advances against specified commodities. The first two techniques control the amount of credit, while the' thii technique operates through its impact on the cost of credit. These instruments of credit control are operated by the RBI in such a manner that they meet particular situations or achieve the desired direction of flow of credit. The margin against a particular commodity is determined keeping in view the socially and economically legitimate requirements of bank credit to that sector. Ceiling limits are fixed in order to restrict the capacity of the lending bank to grant credit against controlled commodities. The rate of interest mechanism is used to achieve policy objective of increasing or decreasing the credit flows to particular sectors. It is in fact through this technique that credit is made available to certain preferred sectors on concessional interest rates.

2) **Moral Suasion: Moral suasion refers to the advice given by the central bank to commercial banks in respect of their lending and other operations with the expectation that it will be accepted and the latter will operate accordingly.** Moral suasion may be quantitative in content, that is, the quantum of credit that a bank may grant may be fixed. It can also be qualitative, that is, banks may be advised not to give credit against certain commodities as their prices may be subject to speculative tendencies. In India, the RBI has found the technique of moral suasion quite useful. Since the nationalisation of major commercial banks, effectiveness of moral suasion has increased. An added reason for the effectiveness of moral suasion in India is that it is backed by the RBI's vast powers of direct regulation.

Check Your Progress C

1) State the three quantitative techniques of credit control operated by the RBI.

   i) ....

   ii) ....

   iii) ....

2) List the three methods of selective credit control operated by the RBI.

   i) ....

   ii) ....

   iii) ....

3) State which of the following statements are True and which are False.
   i) Monetary policy refers to the policy of the central bank with regard to issue of currency notes.
   ii) The RBI's monetary policy is often characterised as the policy of controlled expansion.
   iii) Bank rate is the rate of interest charged by the central bank from the commercial banks on advances given to them.
   iv) Bank rate policy is relatively ineffective technique of credit control in India.
   v) Open market operations refer to buying and selling of government securities by the central bank in the open market.
   vi) Open market operations are quite effective in India.
   vii) Cash reserve ratio and statutory liquidity ratio when used by the RBI can prove to be effective for credit regulations..
   viii) Since the money market in India is less developed, selective credit controls have no relevance in this country.
   ix) 'Backed by the vast powers of direct regulation, the RBI has found the technique of moral suasion quite useful.

8.5 APPRAISAL OF THE MONETARY POLICY OF THE RBI

In developed countries the monetary policy generally aims at full employment with price stability. In developing countries, however, its objective is optimisation of growth with a high level of employment and price stability. In a country like India where all the time there has been a stress on accelerating the rate of growth, there has to be a continuous expansion of money supply and credit to meet the legitimate credit needs of industry, agriculture and trade. Therefore, the RBI's approach cannot be one of credit restriction. The RBI's responsibility under the circumstances is only to prevent availability of credit for unproductive and speculative purposes. **The RBI has, thus, rightly claimed that its monetary policy is one of controlled expansion.**

We have earlier discussed in this unit that the RBI possesses extensive powers of credit control, both quantitative and qualitative in nature. We shall now consider in this section as to how effectively the RBI has used these instruments of monetary control during the four decades of development planning. We are restricting our discussion to this period only because prior to 1951, the RBI did not have any specific monetary policy.

The era of development planning began in 1951. This was the period when most countries world over were pursuing the cheap money policy implying that the bank rate was kept low. In 1951, however, under the impact of the Korean War, inflationary pressures had built up and thus the RBI raised its bank rate from 3% to 3.5%. The rate of increase in money supply (M3) during the First Five Year Plan was as low as 3.4% per annum. But this was not sufficient to meet the increased demand for money arising from expansion in output and growing monetisation of the economy. Hence, the wholesale prices registered a decline of 2.7% per annum. Situation changed substantially during the Second Plan period. With increased emphasis on industrialisation and attempt to give a big push to the economy the demand for credit increased rapidly. The annual increase in the money supply (M3) thus was 8.2% during 1956-61. In order to moderate the growth of money supply, the RBI not only raised the bank rate to 4% in May 1957 but also resorted to selective credit controls. The price level, however, rose at an annual rate of 6.3%.

During the Third Plan period, as against a modest performance on the production front resulting in a mere 2.3% annual increase in national income, M3 increased at 9.1% per annum. This gave rise to inflationary pressures which the RBI tried to contain by raising bank rate to 4.5% in January 1963 to 5% in October 1964 and further to 6% in Mitrch 1965. For four years from 1960 to 1964 the RBI operated quota-cum-slab system for providing refinance and in 1964 adopted a system of differential rates. Both these instruments aimed at credit restraints. In September 1964 the statutory liquidity ratio was raised from 20 to 25%. These measures should have been effective had the output position been satisfactory. But this was not to be, Due to failures on the supply front expansion in the supply of money in spite of adoption of credit control measures proved to be quite inflationary. In 1967-68 however when supply position improved due to encouraging performance on the production front the inflationary pressures eased and the bank rate was lowered from 6% to 5%.

During the period of Fourth Five Year Plan failures on the production front coupled with an increase in expenditure on defence and evacuee relief operations increased inflationary pressures. In this period the supply of money should not have been allowed to increase at a high rate. However, the annual rate of increase in M3 was 16.2% which certainly contributed to a lot of inflationary pressure. The RBI nonetheless tried different measures of monetary control. The net liquidity ratio was raised from 30% in April 1970 to 34% in January 1971 and further to 37% in 1973. The bank rate was raised in May 1973 from 6% to 7%. The cash reserve ratio was raised from 3% to 5% and further to 7% in September 1973. All these measures however failed to contain inflationary pressures and the wholesale prices rose by 20.2% in 1973-74. During the Fifth Five Year Plan period, while the national income increased at an annual rate of 5.3%, the supply of M3 increased at the rate of 17.9%. This did not ease inflationary pressures. Hence the RBI not only raised bank rate from 7% to 9%, the government also adopted certain fiscal measures. These measures arrested inflationary pressures to some extent and made the RBI a bit complacent about inflationary situation. As a result, the grip of the monetary policy was loosened. The cash

reserve ratio was reduced from 7% to 5% in June 1974 and further to 4% in December 1974. These were unwarranted concessions. The year 1979-80 was a drought year. In this year in spite of the fact that the national income declined by 5.5%, the supply of M3 was allowed to rise by 17.3%. As a consequence the wholesale prices rose by 17.2%.

The Sixth Plan period showed complacency on the part of monetary authorities. In this period in spite of 5.3% per annum increase in the national income the wholesale prices rose at the rate of 9.3%. This happened due to an annual increase of 16.9% in M3. The raising of bank rate to 10% in July 1981, fixation of cash reserve ratio and statutory liquidity ratio at 9% and 35% respectively in 1984 had little impact on inflationary situation.

During the Seventh Plan period the supply of money (M3) and national income rose at the rates of 17.6% and 5.4% per annum respectively. The wholesale prices during this period rose at the rate of 7% per annum. This indicates that the RBI did not move carefully on the money supply front. During the Seventh Plan period the cash reserve ratio was raised a number of times and was finally fixed at 11% effective from July 30, 1988. The statutory liquidity ratio was also revised upward a number of times and fixed at 38% in April 1987. These along with selective credit control measures proved ineffective to stabilise the general price level. In 1990-91 the inflationary situation had gone out of control, as the wholesale prices rose at about 12%. The RBI in this period did little to arrest price rise. Only the statutory liquidity ratio was raised to 38.5% in September 1990.

To sum up, the monetary policy of the RBI has been rather *weak*. All the time there seems to be some hesitation in operating drastic measures of monetary control. May be dilemma of the RBI in pursuing effective measures emanates from the risk of a decline in growth rate as a result of adoption of drastic credit control measures.

Check Your Progress D

1) State the monetary policy of the RBI in one sentence.

....

....

2) State whether the following statements are True or False.
   i) In India the entire emphasis of monetary policy cannot be on credit restriction.
   ii) During the first sixteen years of its existence, the RBI like many other central banks pursued cheap money policy.
   iii) During the First Plan period, increase in the supply of money was in two digits which led to inflationary pressures.
   iv) The annual increase in M3 was 8.2% during the Second Plan period.
   v) During the Third Plan period an annual increase of 9.1% in M3 was not excessive because in this period the performance of the economy on production front was excellent.
   vi) Various measures which the RBI adopted to check inflation during the Fourth Plan period proved to be effective.
   vii) During the Fifth Plan period the annual rate of increase in M3 was as high as 17.9%.
   viii) The monetary policy of the RBI was not entirely irrational when it allowed 17.3% increase in M3 in 1979-80.
   ix) The monetary authorities in India were somewhat complacent to inflationary pressures during the Sixth Plan period.
   x) Various measures of credit control adopted by the RBI during the Seventh Plan period proved to be quite effective as prices remained stable in this period.

8.6 LET US SUM UP

The Reserve Bank of India (RBI) was set up as the Central Bank of India on 1st April 1935. Though originally set up as a shareholders' bank, it was nationalised in 1949.

The RBI performs both traditional and developmental-cum-promotional functions of a central bank. The traditional functions of the RBI are: i) to issue currency notes, ii) to act as a banker to the government, iii) to act as a bankers' bank, iv) to control and supervise banks, v) to manage and control foreign exchange, and vi) to control credit.

In India, the main objective of the economic policy being growth with stability, the policies of RBI are also directed to realise this objective. Among the developmental and promotional functions, setting up of specialised institutions of industrial and agricultural finance have received particular attention of the RBI.

Of the various functions perfoimed by the RBI, the function of note issue is very important. The RBI conducts note issue through its Issue Department and Banking Department. Whenever there is demand for currency, the Banking Department offers eligible assets to the Issue Department and obtains currency. The assets against which currency can be issued are gold, foreign securities, rupee coin and bills of exchange and promissory notes payable in India. Presently, gold and foreign securities reserve against the issue of currency cannot be less than Rs. 200 crore, of which gold reserve in any case must not be less than Rs. 115 crore.

During the planning period, the RBI's attempt has been to ensure adequate supply of money and credit needed to sustain tempo of economic growth without generating unnecessary inflationarypressures. This approach is often known as the policy of "controlled expansion". The RBI can use all the instruments of credit control, hoth quantitative and qualitative. However, in India due to lack of adequate development of bill and the securities markets the bank rate policy and open market operations are not very effective. The RBI therefore relies more on changes in cash reserve ratio and statutory liquidity ratio. Selective credit controls are more suitable in India as they regulate the distribution and direction of hank resources to particular sectors of the economy. The RBI has also founcl that since it enjoys extensive powers of direct regulation moral suasion proves quite effective.

The RBI has all the possible weapons of monetary regulation in it; arsenal, yet its actual monetary control has been weak. The supply of money (M3) over the past two decades has increased at a rate exceeding 15 per cent per annum, while the national income rose at the rate of 4.1 per cent per annum. This has resulted in inflationary pressures. The measures adopted by the RBI to combat them have been found lacking.

8.7 KEYWORDS

Bank Rate: That rate of interest at which the central bank makes advances to commercial banks or rediscounts their hills.

Cash Reserve **Ratio:** Ratio of cash reserve to bank's aggregate deposits,

Currency Chests: Receptacles in which issuable notes are stored.

Exchange Control: Control of the monetary authority over all transactions involving foreign exchange.

Margin Requirement: A portion of the value of the security charged to the bank, which is required to be paid by the borrower out of his own resources.

Minimum Reserve System of Note Issue: A system of note issue requiring that a certain minimum amount of reserve backing of note issue should be in the Form of gold and foreign securities.

Money Supply (M3): Supply of currency plus all deposits with banks.

Moral **Suasion:** An instrument of central bank's pressure upon the lending activities of commercial banks through exhortations that they follow certain restrictive practices.

Open Market Operations: Purchase or sale of eligible securities by the central bank in the open market.

Proportional Reserve **System** of Note **Issue:** A system of note issue requiring that a certain percentage of reserve backing the note issue should be in the form of gold and foreign securities.

Selective Credit **Control:** Such credit control that it regulates the distribution or direction of bank resources to particular sectors.

Statutory Liquidity Ratio: The ratio of liquid assets to total demand and time liabilities determined statutorily.

8.8 ANSWERS TO CHECK YOUR PROGRESS

A 2) i) True ii) False iii) True iv) False v) True vi) False
vii) True viii) False ix) False x) False

B 1) i) The Proportional Reserve System
ii) The Minimum Reserve System

2) i) True ii) False iii) True iv) False v) True vi) False
vii) True viii) True ix) True x) False

C 1) i) Bank Rate Policy
ii) Open Market Operations
iii) Reserve Ratio Changes

2) i) Margin Requirements Changes
ii) Ceilings on Levels of Credit
iii) Charging of Minimum Rate of Interest on Certain Advances

3) i) False ii) True iii) True iv) True v) True vi) False
vii) True viii) False ix) True

D 1) The monetary policy of the RBI can be characterised as the policy of controlled expansion.

2) i) True ii) True iii) False iv) True v) False vi) False vii) True
viii) False ix) True x) False

8.9 TERMINAL QUESTIONS

1) Discuss the various functions of the Reserve Bank of India.
2) Explain the system of note issue in India.
3) Explain the methods of credit control adopted by the Reserve Bank of India. Discuss their relative importance also.
4) Why is the Reserve Bank's monetary policy often characterised as the policy of controlled expansion? Critically evaluate the monetary policy of the Reserve Bank of India during the four decades of developmental planning.

Note: These questions will help you to understand the unit better. Try to write. answers for them. But do not submit your answers to the University for assessment. These are for your practice only.