CENTRAL BANK

- The central bank is one of the most useful economic institutions which has been developed to help society to manage its collective financial affairs. Today, central bank is the central arch of the monetary and fiscal framework in every country of the world and its activities are essential for the proper functioning of the economy and indispensable for the fiscal operations of the government.
- A central bank is one which acts as the banker to the governments and the commercial banks, has the monopoly of note issue, operates the currency and credit system of the country and does not perform the ordinary commercial banking function.

RBI INTRODUCTION

- The central bank of the country is the Reserve Bank of India (RBI). It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

RBI INTRODUCTION

- Reserve Bank of India was nationalised in the year 1949. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Boards consist of five members each Central Government appointed for a term of four years to represent territorial and economic interests and the interests of co-operative and indigenous banks.

RBI INTRODUCTION

- The Reserve Bank of India Act, 1934 commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank.

  The Bank was constituted with the following objectives broadly:
- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

- **A Traditional Functions**

  A1. **Monopoly of Note Issue**

A Traditional Functions
A1. **Monopoly of Note Issue**

- In terms of Section 22 of the Reserve Bank of India Act, the RBI has been given the statutory function of note issue on a monopoly basis. The note issue in India was originally based upon "Proportional Reserve System".
- When it became difficult to maintain the reserve proportionately, it was replaced by "Minimum Reserve System ". According to the RBI Amendment Act of 1957, the bank should now maintain a minimum reserve of Rs.200 crore worth of gold coins, gold bullion and foreign securities of which the value of gold coin and bullion should be not less than Rs.115 crore.
- The Government of India issues rupee coins in the denomination of Rs.1, 2, and 5 to public. These coins are required to be circulated to public only through Reserve Bank under Section 38 of the RBI Act. The RBI presently issues notes of denominations Rs.10 and above.

Monopoly of Note Issue

- RBI manages circulation of money through currency chests. Originally RBI issued currency notes of Rs.2 and above. However, due to higher cost of printing small denomination notes these denominations are now issued by Government.

- Currency Chests Currency Chests are receptacles in which stocks of issuable and new notes are stored along with rupee coins. Currency Chests are repositories run by RBI, SBI, subsidiaries of SBI, public sector banks, Government Treasuries and Sub treasuries.
- Currency Chests help in expansion and contraction of currency in the country. The advantages for a bank having currency chest are:

Monopoly of Note Issue

- Currency Chests help in expansion and contraction of currency in the country. The advantages for a bank having currency chest are:
- *(i)* The bank can draw funds whenever it is required for its use and deposit funds when found surplus.
- *(ii)* Exchange old and mutilated notes for new notes and coins
- *(iii)* Enjoy remittance facilities
- The currency chests maintained by public sector and few private sector banks are the property of RBI. The value of currency held in the chest belongs to RBI. There are as many as 4150 currency chests with banks in India.

A2. Banker to the Government

- The RBI acts as banker to the Government under Section 20 of RBI Act.
- Section 21 provides that Government should entrust its money remittance, exchange and banking transactions in India to RBI.
- Under Section 21A RBI has to conduct similar transactions for State Governments also.
- RBI earns no income by conducting those functions but earns commissions for managing the government's public debt. Where RBI has no branch, SBI or its subsidiaries are appointed as agents and sub-agents under Section 45 of the RBI Act. Agency Banks receive commission on all transactions conducted on turnover basis.
- The RBI extends ' ways and means ' advances to Central and State Governments.

Banker to the Government

- It also acts as adviser to Government on economic and financial matters. In brief, as a banker to the Government the RBI renders the following functions:
- (a) Collects taxes and makes payments on behalf of the Government
- (b) Accepts deposits from the Government
- (c) Collects cheques and drafts deposited in the Government accounts.
- (d) Provides short-term loans to the Government
- (e) Provides foreign exchange resources to the Government.

Banker to the Government

- (f) Keep the accounts of various Government Departments.
- *(g)* Maintains currency chests in treasuries at some importance places for the convenience of the government.
- *(h)* Advises governments on their borrowing programmes.
- *(i)* Maintains and operates Central Government's IMF accounts.

A3. Agent and Adviser of the Government

- The RBI acts, as the financial agent and adviser to the Government. It renders the following functions:
- (a) As an agent to the Government, it accepts loans and manages public debts on behalf of the Government.
- (b) It issues Government bonds, treasury bills, etc.
- (c) Acts as the financial adviser to the Government on all important economic and financial matters.

A4. Banker to the Banks

- The RBI acts as banker to all scheduled banks. Commercial banks including foreign banks, co-operative banks and RRBs are eligible to be included in the second schedule of RBI Act subject to fulfilling conditions laid down under Section 42 (6) of RBI Act.
- RBI has powers to delete a bank from the second schedule if the bank concerned fails to fulfill the laid down conditions such as erosion in paid up capital below the prescribed limits and the banks' activities became detrimental to the interest of depositors, etc.
- All banks in India, should keep certain percentage of their demand and time liabilities as reserves with the RBI. This is known as Cash Reserve Ratio or CRR. At end November 1999, it is 3 per cent for RRBs and co-operative banks; 9 per cent for commercial banks.

Banker to the Banks

- They also maintain Current Account with RBI for various banking transactions. This centralization of reserves and accounts enables the RBI to achieve the following:
- (a) Regulation of money supply credit.
- (b) Acts as custodian of cash reserves of commercial banks.
- (c) Strengthen the banking system of the country
- (d) Exercises effective control over banks in Liquidity Management.
- (e) Ensures timely financial assistance to the Banks in difficulties.
- (f) Gives directions to the Banks in their lending policies in the public interest.
- (g) Ensures elasticity in the credit structure of the country.
- (h) Quick transfer of funds between member banks.

A5. Acts as National Clearing House

- In India RBI acts as the clearing house for settlement of banking transactions. This function of clearing house enables the other banks to settle their inter bank claims easily. Further it facilitates the settlement economically.
- Where the RBI has no offices of its own, the function of clearing house is carried out in the premises of the State Bank of India. The entire clearing house operations carried on by RBI are computerized. The inter-bank cheque clearing settlement is done twice a day.

A6 Lender of last resort

- The RBI acts as a lender of last resort or emergency fund provider to the other member banks. As such, if the commercial banks are not able to get financial assistance from any other sources, then as a last resort, they can approach the RBI for the necessary financial assistance.
- In such situations, the RBI provides credit facilities to the commercial banks on eligible securities including genuine trade bills which are usually made available at Bank Rate.

A7. Acts as the Controller of Credit

- The RBI controls the credit creation by commercial banks. For this, the RBI uses both quantitative and qualitative methods. The important methods used by RBI are,
- (i) Bank Rate Policy
- (ii) Open Market Operation
- (iii) Variation of Cash Reserve Ratio
- (iv) Fixing Margin Requirements
- (v) Moral Suasion
- *(vi)* Issue of Directives
- *(vii)* Direct Action

Controller of Credit

- By controlling credit, the RBI achieves the following:
- *(a)* Maintains the desired level of circulation of money in the economy.
- *(b)* Maintains the stability in the price level prevailing in the economy.
- (c) Controls the effects of trade cycles
- *(d)* Controls the fluctuations in the foreign exchange rate
- *(e)* Channelizes credit to the productive sectors of the economy

A8. Custodian of Foreign Exchange Reserves

- The RBI acts as the custodian of foreign exchange reserves. Adequate reserves may help maintain foreign exchange rates. In order to minimize the undue fluctuations in the rates it may buy and sell foreign currencies depending upon the situations.
- Its purchase and sale of foreign currencies from the market is done like commercial banks. However, the objective of the RBI will not be profit booking.
- It may buy the foreign currency to build up adequate reserves or to arrest unwarranted rise in the value of rupee which may be due to sudden inflow of foreign currencies into India. It may also buy and sell foreign currencies in international market to switch the portfolio of investments denominated in different international currencies depending upon circumstances and needs.

A9. Exchange Control

- When a country faces Balance of Payment problems usually when its foreign exchange payments exceed foreign exchange receipts it controls the whole gamut of foreign exchange transactions and regulates payment system for its advantage

Exchange Control

- Ever since the beginning of Second World War in 1939 India faced shortage of forex for its development and growth. A Foreign Exchange Regulation Act was originally put in operation from March 1947 and later a new act known as Foreign Exchange Regulation Act (FERA) 1973 was introduced from 1st January 1974.Later FEMA-----
- Under this Act, RBI is empowered to regulate foreign exchange outgo and inflow, for example, we cannot buy everything we need from abroad and pay for it in forex.

A10 Publishes Economic Statistics and Other Information

- The RBI collects statistics on economic and financial matters. It publishes periodically an analytical account of the operations of joint stock and co-operative banks. It presents the genuine financial position of the government and companies.
- The publications like the report on currency and finance, the report on the trend and progress of banking in India, the review of co-operative movement present a critical account and a balanced review of banking developments commercial, economic and financial conditions of the country.

B Supervisory Functions
1. Granting License to Banks

- The Reserve Bank of India performs the following supervisory functions. By these functions it controls and administers the entire financial and banking systems of the country.
- The RBI grants license to the banks, which like to commence their business in India. Licenses are also required to open new branches or closure of branches. With this power
- RBI can ensure avoidance of unnecessary competitions among banks in particular location evenly growth of banks in different regions, adequate banking facility to various regions, etc. This power also helps RBI to weed out undesirable people from starting banking business.

B2. Function of Inspection and Enquiry

- RBI inspects and makes enquiry in respect of various matters covered under Banking Regulations Act and RBI Act. The inspection of commercial banks and financial institutions are conducted in terms of the provisions contained in Banking Regulation Act.
- These refer to their banking operations like loans and advances, deposits, investment functions and other banking services. Under such inspection RBI ensures that the banks and financial institutions carry on their operations in a prudent manner, without taking undue risk but aiming at profit maximization within the existing rules and regulations.
- This type of inspection is carried on periodically once a year or two covering all branches of banks. Banks are obliged to take remedial measures on the lapses / deficiencies pointed out during inspection. In addition RBI also calls for periodical information concerning certain assets and liabilities of the banks to verify that the banks continue to remain in good health.

Function of Inspection and Enquiry

- This type of inspection / verification is known as off- site inspection. The RBI team visiting bank offices to conduct verification of books and records is known as on- site inspection. RBI inspects banks under RBI Act only when there is a threat to close down a bank for mismanagement and there is a need to verify the fulfillment of conditions for the status of 'scheduled bank'.
- RBI presently conducts inspection of commercial banks, Development Financial Institutions like IDBI, NABARD, etc. Urban Co- operative Banks and non banking financial companies like Lease Financing Companies, Loan Companies.

B3. Implementing the Deposit Insurance Scheme

- RBI Implements the Deposit Insurance Scheme for the benefit of bank depositors. This supervisory function has improved the standard of banking in India due to this confidence building exercise. Under this system, deposits up to Rs.1.00 lakh with the bank branch are guaranteed for payment. Deposits with the banking system alone are covered under the scheme.

B4. Periodical Review of the Working of the Commercial Banks

- The RBI periodically reviews the work done by commercial banks. It takes suitable steps to enhance the efficiency of the banks and make various policy changes and implement programmes for the well-being of the nation and for improving the banking system as a whole

B5. Controls the Non-Banking Financial Corporations

- RBI issues necessary directions to the Non-Banking financial corporations and conducts inspections through which it exercises control over such institutions. Deposit taking NBFCs require permission from RBI for their operations.

C Promotional Functions
1 Promotion of Banking Habits

- The RBI institutionalizes saving through the promotion of banking habit and expansion of the banking system territorially and functionally.
- Accordingly RBI has set up Deposit Insurance Corporation in 1962, Unit Trust of India in 1964, the IDBI in 1964, the Agricultural Refinance Corporation in 1963, Industrial Reconstruction Corporation of India in 1972, NABARD in 1982 and the National Housing Bank in 1988, etc.
- It has helped to bring into existence several industrial finance corporations such as Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India for industrialization of the country. Similarly sector specific corporations took care of development in their respective spheres of activity.

C2. Provides Refinance for Export Promotion

- The RBI takes the initiative for widening facilities for the provision of finance for foreign trade particularly of exports.
- The Export Credit and Guarantee Corporation (ECGC) and EXIM Banks render useful functions on this line. To encourage exports the RBI is providing refinance facilities for export credit given by commercial banks. Further the rate of interest on export credits continues to be prescribed by RBI at a lower rate.
- The ECGC provides an insurance cover on Export receivables. EXIM Bank extends long term finance to project exporters and foreign currency credit for promotion of Indian exports.
- many of these institutions were part of Reserve Bank earlier although they are currently functioning as separate financial institutions.

C3. Facilities for Agriculture

- The RBI extends indirect financial facilities to agriculture regularly. Through NABARD it provides short-term and long-term financial facilities to agriculture and allied activities. It established NABARD for the overall administration of agricultural and rural credit. Indian agriculture would have starved of a cheap credit but for the institutionalization of rural credit by RBI.

- The Reserve Bank was extending financial assistance to the rural sector mainly through contributions to the National Rural Credit Funds being operated by NABARD.

C4. Facilities to Small Scale Industries

- The RBI takes active steps to increase the supply of credit to small industries. It gives directives to the commercial banks regarding the extension of credit facilities to small scale industries. It encourages commercial banks to provide guarantee services to SSI sector. Banks advances to SSI sector are classified under priority sector advances.
- SSI sector contributes to a very great extent to employment opportunities and for Indian Exports. Keeping this in view, RBI has directed commercial banks to open specialized SSI bank branches to provide adequate financial and technical assistance to SSI branches.

C5. Helps Co-operative Sector

- RBI extends indirect financing to State Co-operative Banks thereby connects the co-operative sector with the main banking system of the country. The finance is mostly, is routed through NABARD. This way the financial needs of agricultural sector are taken care of by RBI.