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Origin and Evolution of the Reserve Bank of India

Published On: 06-04-2024

Why is in news? 90 years of the Reserve Bank of India (RBI): Its history, how it navigated times of crisis

The central bank's story of the last 90 years includes ups and downs, but has generally been one of stellar achievement.

Background of RBI:

The Reserve Bank of India (RBI), which was **established o**n **April 1, 1935**, in accordance with the provisions of the **Reserve Bank of India Act, 1934**.

It is responsible for monetary stability, currency management, inflation targeting, regulating the banking system, and setting interest rates.

Hilton Young Commission: RBI was set up based on the **recommendations of the Royal Commission on Indian Currency and Finance**, which was appointed by Lord Reading, then viceroy of India.

Legislation to set up the Reserve Bank of India was enacted in **March 1934**, and the provisions relating to the constitution of the bank, issue of share capital, and establishment of central and local boards **became operative from January 1, 1935.**

The **first Governor of the RBI** was the **Australian Sir Osborne Arkell Smith**, one of the two managing governors of the Imperial Bank of India.

Sir C D Deshmukh was the **first Indian** to become Governor.

Its headquarters was moved from **Calcutta to Mumbai** in 1937.

The bank was **nationalised** (fully owned by government) **in 1949**.

Following Partition, it was agreed that the RBI would cease to be the currency authority for Pakistan, and Indian notes would cease to be legal tender in Pakistan.

The RBI's relationship with the government has been testy at times. But the bank has been steadfast in defending its turf whenever the government has tried to interfere.

Objectives:

To **regulate the issue of Bank notes and keeping of reserves** with a view to securing monetary stability in India and generally to **operate the currency and credit system** of the country to its advantage.

To have a **modern monetary policy framework** to meet the challenge of an increasingly complex economy,

To **maintain price stability** while keeping in mind the objective of growth.

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Structure of RBI:

The Reserve Bank's affairs are governed by a **central board of directors**.

The board is **appointed by the Government of India** in keeping with the Reserve Bank of India Act.

The directors are appointed/nominated for a **period of four years**.

Acts Administered by the RBI: Reserve Bank of India Act, 1934; Public Debt Act, 1944/Government Securities Act, 2006; Government Securities Regulations, 2007; Banking Regulation Act, 1949; Foreign Exchange Management Act, 1999, etc.

Functions of RBI:

Issue of Bank Notes: The Reserve Bank of India has the sole right to issue currency notes except one rupee notes which are issued by the Ministry of Finance.

Banker to Government: As banker to the government the Reserve Bank manages the banking needs of the government. It has to-maintain and operate the government's deposit accounts.

Custodian of Cash Reserves of Commercial Banks: The commercial banks hold deposits in the Reserve Bank and the latter has the custody of the cash reserves of the commercial banks.

Custodian of Country's Foreign Currency Reserves: The Reserve Bank has the custody of the country's reserves of international currency, and this enables the Reserve Bank to deal with crisis connected with adverse balance of payments position.

Lender of Last Resort: The commercial banks approach the Reserve Bank in times of emergency to tide over financial difficulties, and the Reserve bank comes to their rescue though it might charge a higher rate of interest.

Controller of Credit: Since credit money forms the most important part of supply of money. Credit is controlled by the Reserve Bank in accordance with the economic priorities of the government through Repo rate, reverse repo rate.

Contributions of RBI:

Nationalization of banks, 1969:

It was implemented under the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970, to better serve the needs of development of the economy in conformity with national policy objectives.

Priority Sector Lending, 1972:

It provides timely and sufficient credit to key sectors of the economy that might otherwise face difficulties in accessing funds

The reforms of 1991:

It refers to the series of policy changes aimed at opening up the country's economy to the world, with the objective of making it more market-oriented and consumption-driven.

A sharp increase in oil prices in August 1990 led to an acute economic crisis, making the balance of payments situation unmanageable, depleting foreign exchange reserves along with massive capital outflows, and pushing India close to default. The rupee was devalued twice, by 9% and 10%, in three days.

Full convertibility of the rupee on trade account was allowed, giving more flexibility to trade. Banking reforms were announced, the setting of interest rates by lenders was deregulated, and new private bank licences issued between 1991 and 1995.

2008 crisis and after:

India escaped the 2008-09 global financial crisis through a combination of management, structure, and luck. Pre-crisis, the policies of Governor Y V Reddy against capital inflows, especially to the real estate sector, and against rapid foreign bank expansion, were timely.

Post-crisis, management was excellent, and appropriately measured.

Under Subbarao, the RBI opted for a **liberal accommodative policy** to salvage economic growth.

Raghuram Rajan announced plans to **internationalise the rupee**, float inflation bonds linked to the consumer price index, steps to boost exports and increase inflows, and plans to review the monetary policy process, and gave banks freedom to open branches without having to approach the RBI for licences.

TReDS, 2014:

It is an electronic platform where MSMEs can sell their receivables at a competitive rate to financiers, including banks and non- banking financial companies (NBFCs), through an auction mechanism.

Unified Payment Interface (UPI), 2016:

It was launched by the National Payments Corporation of India (NPCI) to provide seamless and instant experience to users across India.

Inflation Targeting Framework, 2016:

Under this framework, the RBI set a target for inflation and adjusted monetary policy instruments to achieve it, the banking regulator has set an **inflation target of 4%, with a tolerance band of +/- 2%.**

Demonetisation of 2016:

On November 8, 2016, the government announced the demonetisation of Rs 500 and Rs 1000 notes of the Mahatma Gandhi Series. It also announced the issuance of new Rs 500 and Rs 2000 notes in exchange for the demonetised notes.

The **sudden withdrawal of notes** created a liquidity shortage in the country. It also roiled the economy — demand fell, businesses faced a crisis, and GDP growth declined close to 1.5 per cent.

Managing the situation was one of the biggest challenges faced by RBI. At stake was the credibility of the bank and Governor Patel.

MPC, asset quality review:

The Monetary Policy Committee (MPC) which **decides on interest rates** started during the early phase of Patel's tenure; he chaired the first meeting of the MPC on October 3 and 4, 2016.

The RBI has utilised the **Insolvency and Bankruptcy Code (IBC)** to **address the huge debt pile of some of the biggest defaulters**; it has drawn up two lists of 40 corporates with debt of around Rs 4 lakh crore which are in various stages of resolution in National Company Law Tribunals.

Covid-19 pandemic:

As demand crashed, there were production cuts and job losses, and growth declined. Shaktikanta Das, the current Governor, and his team opted for an **accommodative monetary policy**.

Repo rate, the main policy rate, was brought down to 4% to kickstart growth. However, the liberal policy led to a spike in inflation, forcing the RBI to raise rates by 250 basis points to 6.5% now.

However, **the pandemic aided the RBI in boosting digitisation of payments**. The launch of UPI revolutionised payments in the banking system.

Enhanced Public Confidence in the Banking Sector:

The Reserve Bank has taken appropriate measures to enhance public confidence in the banking systems. It strictly supervises the working of the Scheduled Commercial banks so as to avoid their failures.

The Deposit Insurance and Credit Guarantee System has also been introduced to protect the interests of the depositors. It has proved an important factor in promoting depositors' confidence in banks.

Challenges of RBI:

Global financial crises: RBI has had to navigate through various global financial crises, such as the Asian financial crisis (late 1990s) and the global financial crisis of 2008 which posed challenges to India's financial stability and required coordinated policy responses from the RBI and other authorities.

Domestic disruptions: During demonetization in 2016 certain currency notes were invalidated overnight which presented significant logistical and economic challenges.

COVID-19 pandemic: RBI implemented various measures to support the economy, such as liquidity injections, regulatory relaxations, and interest rate cuts, to mitigate the economic impact of the pandemic.

Bad loans: Non-Performing Assets (NPAs) or bad loans have been a persistent challenge for the Indian banking sector, RBI has implemented measures to address this issue, including asset quality reviews, prompt corrective action frameworks, and resolution mechanisms like the Insolvency and Bankruptcy Code (IBC).

Inflation management: India has experienced periods of high inflation, RBI implemented monetary policy measures to manage inflation.

Crypto regulations: Despite a Supreme Court ruling overturning the RBI's ban on cryptocurrency trading, regulatory clarity on crypto remains ambiguous

Conclusion:

RBI transcends its role as a central bank to become a beacon of excellence and innovation.

It serves as a guardian of stability and resilience in the face of global uncertainties, leveraging advanced risk management tools and fostering a culture of prudence and foresight.

Together, guided by a shared vision of prosperity and progress, RBI can unleash its full potential as a driving force for creating a "Viksit Bharat".