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1. INTRODUCTION

The Imperial Bank of India, which emerged as consequence of the amalgamation of three Presidency Banks of Bengal, Bombay and Madras in 1921, assumed certain central banking functions except currency management. The control of currency management continued to be with the Government of India in order to ensure that the central banking entity did not appropriate powers greater than those mandated by the political authority. The Reserve Bank of India Act was placed on the statute book on March 6, 1934. The RBI commenced operations on April 1, 1935 and was nationalized on January 1, 1949. The head office of the Bank is in Mumbai and its executive head is called the Governor.

The objective of establishing the RBI, as stated in the preamble to the RBI Act 1934, was to “regulate the issue of bank notes and the keeping of the 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.” The Bank’s functions as laid down in the statutes were: (a) issue of currency (b) banker to Government; and (c) banker to other banks. Except in the sphere of agriculture, the Bank was not entrusted with any great promotional role and that too on a limited scale.

Central banks occupy a pivotal position in the institutional fabric of an economy. The functions of a modern central bank are vastly
different from what was expected from the early central banks founded in Europe in the 17th century. The evolution of central banking in the Indian context has its own specificity. The RBI, while discharging its statutory responsibilities, has played a crucial role in the national building process, particularly in the development of the financial sector. In fact, institution building constitutes a distinguishing feature of central banking in India.

2. FUNCTIONS OF RBI

The RBI performs all the major functions of a central bank and these are discussed below.

**Sole Currency Authority**: Till March 31, 1935, the task of currency management was undertaken departmentally by the Central Government through the Controller of Currency. Upon its establishment, the RBI took over this function under Section 3 of the RBI Act, 1934. The transition of currency management from the colonial to independent India was reasonably smooth affair. Until its own notes were ready, the RBI issued currency notes of the Government of India. The first issue of notes in the denomination of Rs. 5 and Rs. 10 was made by the RBI in January 1938 while notes in higher denominations (Rs. 100, Rs. 1,00 and Rs. 10,000) were issued later during the year.

In terms of the RBI Act, the affairs of the RBI relating to note issue and general banking business are conducted separately through Issue Department and Banking Department. The Issue Department is

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12 Reserve Bank of India: Functions and Working, Reserve Bank Staff College, Chennai, 2001
responsible for the aggregate value of the currency notes of the RBI in circulation from time to time and maintains the eligible assets for equivalent value. The mechanism of putting currency into circulation and its withdrawal from circulation (expansion and contraction of currency) is undertaken through the Banking Department.

Barring one-rupee notes and coins, RBI is the sole authority for the issue of currency in India. One rupee notes and coins are issued by the Central Government. However, their distribution to the public is the sole responsibility of the RBI. For the issue of notes, the RBI has a separate department, the Department of Issue. All the currency issued by the RBI is its monetary liability and is backed by assets of equal value.

The assets of the Issue Department, against which currency notes are issued under Section 33 of the RBI Act, consist of gold coin and bullion, foreign securities, rupee coin, Government of India rupee securities of any maturity and bills of exchange and promissory notes payable in India which are eligible for purchase by the RBI. The composition of these assets, which determines the currency standard of a country, has changed over the years.

The original Act prescribed a proportional reserve of gold and sterling (later foreign) securities against note issue, whereby, not less than 40 per cent of the total assets was to consist of gold coin and bullion and sterling (later foreign) securities, stipulating further that gold coin and gold bullion were not, at any time, to be less than Rs. 40 crore. The proportional reserve system was substituted by a minimum reserve system in 1956 through the Reserve Bank of India (Amendment) Act, 1956.
The new system required the RBI to hold as assets only a minimum of Rs. 515 crore worth of foreign reserves (Rs. 115 crore of gold and Rs. 400 crore of foreign securities), and the rest in rupee securities. A year after, the requirements were further liberalized with the result that at present the RBI is obliged to hold at least Rs. 115 crore worth of gold as backing against the currency issued while the rest of the backing is in the form of rupee securities. The present system may be termed as managed paper currency standard which gives unlimited powers to the authorities to issue currency backed by rupee securities.

The Central Government is authorized to borrow any amount of money from the RBI by selling its rupee securities to it. This arrangement makes the Central Government the virtual currency authority and the RBI only its agent.

Currency management by the RBI is currently passing through a modernization phase. A number of significant steps have been taken in this sphere which include the following.

1. Building up of the capacity of note printing presses.
2. Reforms in the operations of the Issue Department including in the note distribution network.
3. Introduction of new security features.
4. Shift toward higher denomination notes in circulation.

A. Printing of Currency Notes

The period in the 1990s was marked by a supply constraint as the capacity of the note printing presses fell far short of the demand for fresh notes. It was only in the last year of the decade that adequate capacity was built up with the setting up of two printing presses of the Bharatiya
Reserve Bank Note Mudran Private Ltd (BRBNMPL), a wholly owned subsidiary of the RBI, at Mysore (Karnataka) and Salboni (West Bengal), which became fully operational in 1999 and 2000 respectively. Equipped with modern facilities for printing, process control, accounting and quality check in a secure environment, these are capable of printing notes in all denominations. The combined capacity of the presses is 19.8 billion pieces per year on a 3-shift basis.

B. Clean Note Policy

The operationalastion of the printing presses of BRBNMPL enabled the RBI to embark on the Clean Note Policy in 1999. The objective of the Clean Note Policy is to withdraw non-assumable notes well in time and put fresh notes in circulation in their place. This exercise is dependent on the capacity of the RBI to cope with the need to process and dispose of the notes so withdrawn. While movement of soiled notes from currency chests to Issue Offices could be expedited by several methods, the real issue was the manner in which the processing capacity in the Issue Offices could be augmented so as to match the huge flow of notes from the chests. IN view of the limitation to expansion of capacity manually, it became imperative to supplement the effort of manual processing by mechanical processing. The RBI adopted mechanization of the note processing activity in a big way with installation of 48 Currency Verification and Processing Systems (CVPS) and 27 Shredding and Briquetting System (SBS) in 18 Issue Offices.

The CVPS are high-speed fully automatic machines designed to sort currency notes into fit and unfit categories capable of processing 50,000-60,000 pieces of soiled notes per hour. The fit notes are counted
and banded to make packets of 100 pieces each while the unfit notes pass on automatically to the on-line shredding unit where they are shredded into very small pieces. The shredded pieces are then sucked into the briquetting unit of the SBS where these are converted under high air pressure into compact briquettes and disposed of in an environment-friendly manner.

A beginning has been made in the direction of mechanization of cash handling activity by the commercial banks as well. As a first step for easing the pressure on the distribution channels, coin distribution has been outsoared to private transport operators and the proactive of RBI staff and police personnel accompanying coin remittances has been done away with.

C. Anti-counterfeiting Measures

The security features of banknotes are reviewed and updated from time to time, taking advantage of the research and technology in the field. The approach has been to improve the security features on the existing design so as to combat counterfeiting and to incorporate a mixture of security features on a completely new series of notes. With the advancement of reprographic techniques, traditional security features were deemed inadequate. A new series of notes stylized as the Mahatma Gandhi Series was introduced in 1956. A changed watermark, windowed security thread, latent image and intaglio features for the visually handicapped are amongst the new features. In tune with the international trends in security features, the RBI has now come out with banknotes of 2005 series with machine-readable security features. In view of the greater risk perception in higher denomination banknotes, the banknotes
of Rs. 100, Rs 500 and Rs 1000 have been strengthened with more security features. It is noteworthy that all notes issued in any design by the RBI continue to be legal tender, although, over a period of time, notes in a particular design may not be seen any more because of lack of fresh issues in that design.

D. Computerized Currency Operations

In tandem with the technological innovations, the RBI has taken up the task of putting in place an Integrated Computerized Currency Operations and Management System (ICCOMS) with a view to ushering in greater operational efficiency, improved customer service and providing decision support tools for policy making in the area of currency management. The project involves computerization and networking of the currency chests with the RBI’s Offices to facilitate prompt, efficient and error free reporting and accounting of the currency chest transactions in a secure manner. The system will provide a uniform computing platform across all the Regional Offices for transaction processing, accounting and management information system relating to currency.

E. Coinisation of Lower Denomination Notes

The circulation of currency in India has increased phenomenally, both in volume and value terms. At the time of establishment of the RBI in 1935, the volume of notes in circulation stood approximately at 100 million pieces. As on March 31, 2005, the notes in circulation had risen to 36,985 million pieces (Rs. 3,61,229 crore in value terms). As part of management of the demand for currency, it has been the endeavour of the
The RBI continues to conduct its currency management operations with a view to ensuring the optimal customer service through an adequate supply of good quality and secure notes and coins in the country. Clean notes and intensified anti-counterfeiting measures remain a concurrent objective, alongside continuous up-gradation of the security features.

Banker to the Governments: Before the formation of the RBI, the Imperial Bank of India performed many of the functions as banker to the Government. With the establishment of the RBI, the Imperial Bank ceased to be the banker to the Government, but entered into an agreement with the RBI for providing its services as the sole agent of the RBI in places where it had branch and there was no branch of the Banking Department of the RBI.

As the banker to the Central Government and to the State Governments by virtue of agreements entered into with them, the RBI provides a range of banking services for these Governments such as acceptance of money on government account payment/withdrawals of funds and collection and transfer of funds through different means. Sections 20, 21 and 21A of the RBI Act provide the statutory basis for these functions. The terms and conditions on which the RBI acts as banker to the Central and State Governments are set out in separate agreements, which the RBI entered into with these Governments.

In case the cash balance falls below the minimum level, the RBI intimates the Government concerned about the same and requests it to take measures to meet the situation. It has generally been observed that
the current receipts of Governments fall short of current expenditure
during the earlier part of the financial year, resulting into deficit cash balance To replenish its cash balance, the Central Government borrows from the RBI.

The Central Government enjoys unlimited power to borrow from the RBI. The Short-term borrowing from the RBI is conducted through the seal of ad hoc treasury bills to it. The RBI provides short-term advances to State Governments also, called ways-and-means advances. These advances are for short duration, normally for three months. However, the State Governments are not empowered to borrow any amount they like from the RBI. In other words, there are prescribed limits, imposed by RBI, for the borrowings of individual States. It may be noted that State Governments often cross these limits, i.e. resort to unauthorized overdrafts, adding to monetary indiscipline.

Apart from ways-and-means advances, the RBI also gives loans to State Governments for the development of agriculture. Another function of the RBI as the government’s banker is the management of public debt. The RBI manages all new issues of Government loans, servicing the public debt outstanding, and prepares the market for Government securities. Various measures like the Statutory Liquidity Ratio (SLR) have been taken to ensure success of Government’s borrowing for mobilizing resources for the Five Year plans. Also, the RBI acts as adviser to the Government on such matters as international finance, banking legislation, and resources for Five Year Plans.

**Banker’s Bank and Lender-of-the-last-resort:** Prior to the formation of the RBI, the Imperial Bank of India (established in 1921) functioned to some extent as banker’s bank. Most other banks maintained
balanced with it and could receive accommodation. It also operated
clearing-houses and provided remittance facilities across its branches,
other banks and the public. The predominant banks financing was for
foreign trade, while the share of internal trade was not significant.

The RBI’s responsibility as banker’s bank was essentially two-
fold. First, it acted as a source of reserves to the banking system,
especially for meeting the seasonal requirements apart from serving as
the lender-of-the-resort in times of emergency. The second responsibility
was to ensure that banks were established and run on sound lines, the
emphasis in those years being mainly on the protection of depositors’
interest rather than on credit regulations.

Regulation and supervision of the banking sector was entrusted to
the Banking Department in 1945. However, the RBI did not have much
power until the enactment of the Banking Companies Act in 1949
(renamed as Banking Regulation Act from March 1966). Furthermore,
the RBI could not immediately begin to exercise the powers entrusted to
it by the 1949 legislation due to the post-war banking crisis. Indigenous
banker and moneylenders had a wide scope and choice for their
operations.

Under the Reserve Bank of India Act, 1934 and the Banking
Regulation, Act, 1949, the RBI is vested with extensive powers of
supervision, regulation, and control over commercial and co-operative
banks. The regulatory functions of the RBI pertain to licensing, branch
expansion, and amalgamation of commercial banks. The RBI calls for
returns and other information from the commercial banks and
periodically inspects their working.
The scheduled banks in India are required under law to deposit with the RBI a stipulated ratio (laying between 3 per cent and 15 per cent) or their total liabilities. These are compulsory reserves of banks with the RBI and are not available to them for meeting inter-bank clearing claims. The underlying philosophy of this statutory reserve requirement is that by varying it within limits, the RBI can use it as a weapon of monetary-credit control.

Reserves of the banks with the RBI may be used to meet the temporary cash needs of the commercial banks, Commercial banks are supposed to meet their shortfalls of cash from sources other than the RBI but in acute emergency they can approach the RBI for help and that is why the central bank is also called the lender-of-the-last-resort.

**Controller of Money and Credit**: Like other central banks, the core function of the RBI is to formulate and administer monetary policy to maintain the stability of the rupee. During Pre-Independence period, there was, however, no formal monetary policy formulation other than that of administering the supply and demand for credit in the economy. The Bank Rate [1], reserve requirements and open market operations [2] were the mechanisms for regulating the credit availability. The Bank Rate, as an instrument of control, was not used at all in this period, except once in November 1935 when the rate was reduced from 3.5 per cent to 3.0 per cent. The rate remained unchanged thereafter till November 1951. The RBI, however, employed the instruments of open market operations (OMOs) in a fairly substantial way. Although the RBI was vested with adequate powers to resort to the qualitative instruments, *viz.* selective credit control, no need was felt during the initial stages of its functioning due to the existence of price stability.
An important function of RBI is to control money and credit in the country. The instruments of monetary control operated by the RBI may be classified into two categories (a) quantitative or global or aggregative measures which affect the total amount of money supply and credit and (b) qualitative or selective measures which affect the allocation of bank credit among competing uses and users.

A. Quantitative Credit Controls

These are the following.

**Banks Rate** : As the lender-of-the-last-resort, the RBI helps the commercial banks in temporary need of cash when other sources of raising cash are exhausted. The RBI provides credit to banks by rediscounting eligible bills of exchange and by making advances against eligible securities such as government securities. The lending rate for these advances by the RBI is called the bank rate which is a traditional weapon to control money supply. An increase in the bank rate would discourage commercial banks to borrow from the RBI and a corresponding increase in the lending rate of commercial banks to general public would decrease public borrowings from the banks.

1. **Cash Reserve Ratio (CRR)** : Scheduled banks in India are required statutorily to hold cash reserves, called cash reserve ratio (CRR), with the RBI. Increase/decrease in CRR is used by the RBI as an instrument of monetary control, particularly to mop up excess increases in the supply of money. This power was given to RBI in 1956.

2. **Statutory Liquidity Ratio (SLR)** : Apart from the CRR, banks in India are also subject to statutory liquidity requirement. Under this
requirement, commercial banks along with other financial institutions like life Insurance Corporation of India, the General Insurance Corporation and the Provident Funds are required under law to invest prescribed minimum proportions of their total assets/liabilities in government securities and other approved securities. The underlying philosophy of this provision is to allocate total banks credit between the government and the rest of the economy. The assurance of a certain minimum share of bank credit to the government affects the borrowings of the government from the RBI and hence serves as a tool of quantitative monetary control.

The SLR provision has created captive market for government securities which increases automatically with the growth in the liabilities of the banks. Moreover, it has kept the cost of the debt to the government low in view of the generally low rate of interest on government securities.

Open market operations, considered very effective in developed countries, are not of much importance in India in view of the captive nature of the market for Government bonds. For example, the Treasury bill market is limited largely to the RBI itself and scheduled commercial banks which are required under law to invest a certain minimum proportion of their total liabilities in Government securities. The private dealers in Government securities are few and far between.

3. Moral Suasions : Through moral suasions (discussions, suggestions and advice), the RBI can influence the investment and credit policies of the commercial banks. For example, it can ask the commercial banks to invest a large proportion, than required, of
their assets in Government securities. Similarly, it can advise them regarding the allocation of credit to the private sector.

B. Selective Credit Controls (SCCs)

SCCs, introduced in India in 1956, pertain to regulation of credit for specific purposes. The techniques of SCCs used by the RBI include fixing minimum margins for lending against securities, ceiling on maximum discriminatory rates of interest prescribed for certain kinds of advances. SCCs have been used mainly to prevent the speculative holding of essential commodities like food grains to prevent price rise.

Selective credit controls were abolished in the wake of economic reforms programme initiate in early 1990s.

Controller of Foreign Exchange: The RBI is the custodian of the foreign exchange reserves of India. It manages exchange control and the external value of the rupee. The history of exchange control in India dates back to the outbreak of Second World war in 1939. The exchange control is operated in a manner so that the demand for foreign exchange is contained within the limits of its available supplies. In other words, the available foreign exchange is allocated among competing demands ins such a way as to make its optimum use. The need for this control and planned use arises in view of the general shortage of foreign exchange reserves in most developing countries. All foreign exchange transactions made by the RBI are at the official rates of exchange.

The RBI has delegated considerable powers to the authorized dealers to release foreign exchange for a variety of purposes and has been focusing on the development of the foreign exchange market. In order to deepen the foreign exchange market, a large number of products have
been introduced and the entry of newer players has been allowed. Additional hedging instruments, such as, foreign currency-rupee options have been introduced and authorized dealers have been permitted to use innovative products like cross-currency options, interest rate and currency swaps, caps/collars and forward rate agreements (FRAs) in the international forex market. (See also chapter 14 of this book).

**Source of Economic Information:** The RBI provides, through its publications, useful data and information on various aspects of the economy, particularly monetary and banking activities. Three important and regular publications of the RBI are (a) Reserve Bank of India Bulletin (Monthly), (b) Report on Currency and Finance (Annual) and (c) Handbook of Statistics on India Economy.

**Promotional Role RBI:** Apart from performing the customary functions of a central bank, the RBI has played an important role in building, consolidating, and strengthening the financial infrastructure of India. It has also played an effective role in influencing the allocation of credit in favour of priority sectors. Commercial banking facilities have been extended to small towns and rural areas as a result of the policies of the RBI.

The RBI has paid special attention to the credit needs of the rural (agricultural) sector. Towards this end, the Agricultural Refinance and Development Corporation (ARDC) was set up as wholly-owned subsidiary of the RBI in 1963. The National Bank for Agriculture and Rural Development (NABARD) is another example of the promotional role of the RBI in the agricultural sector. Similarly, the RBI promoted the cause of industrial finance by actively associating itself with such public sector undertakings as erstwhile Industrial Development Banks of India
(DIBI). In the area of credit allocation, RBI has followed the policy of special consideration for priority sectors at confessional rates of interest.

3. **PRE-INDEPENDENCE ACTIVITIES OF RBI**

During most of the pre-Independence period, RBI was a private bank, though formed under a statute and overseen by the then colonial government. The functions of the RBI during this phase were confined essentially to traditional central banking, *i.e.* note issue authority and banker to the Government. During the war and post-war years, its major preoccupation was facilitation of war finance, repatriation of sterling debt and planning and administration of exchange control.

The initial phase of RBI was marked by several war and post-war developments including the separation of Burma (modern Myanmar) in 1937, partition of the country in 1947 and nationalization of the RBI, which altered the area of operations of the RBI. After the separation of Burma, The RBI acted as currency authority of that country till 1942 and as banker to the Burmese Government till March 1947. Upon the partition of the country in 1947, the RBI rendered central banking services to the Dominion of Pakistan until June 1948. In Terms of the Pakistan Monetary System and Reserve Bank (Amendment) Order, 1948, the RBI ceased to function as central bank for Pakistan from July 1, 1948.

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4. POST-INDEPENDENCE ACTIVITIES OF RBI\textsuperscript{14}

**Partition, Disruption and Devaluation**: The partition of the country in 1947 cut across its economic and cultural unity and the growth of centuries of common life to which all the communities had contributed. Whatever might have been the political justification of partition, its economic consequences were disastrous. Regions which had functioned for centuries on a complementary basis were suddenly cut asunder. Economically, India and Pakistan had each, points of advantages and disadvantages. In general, it may be said that while India was much stronger at that time in industrial production and mineral resources, Pakistan had some advantage in agricultural resources, especially foodstuffs. The complementary character of their economies was even deeper than is indicated by this generalization.

It was not possible to reach an agreement on all matters before August 15, 1947 when the two dominions came into existence and took over the Government of their respective territories. A number of important points were accordingly left over for further consideration by the two Dominions and, in the absence of an agreement between them, an Arbitral Tribunal was set up. Among the important issues on which it had not been possible to reach an agreement included, allocation of debt between the two Dominions, the method of discharging the pensioner

\textsuperscript{14} Reserve Bank of India: Functions and Working, Reserve Bank Staff College, Chennai, 2001.
liability, the valuation of the Railways, the division of the assets of the RBI and the division of the movable stores held by the Army.

Soon after Independence, there was rapid depletion of the sterling balances which caused some anxiety to the Government of India. These balances represented the entire foreign exchange reserves of the country and it was of the utmost importance that they were not frittered away on the import of unessential and luxury articles. The view of the Government of India was that these reserves should not be used to finance deficits in the balance of payments on what was called normal current account. The aim was to meet normal day-to-day requirements from abroad through the earning of current exports and draw upon these accumulated reserves, broadly speaking, only for the purpose of purchasing capital goods, the import of which was necessary for developing the agricultural and industrial productivity of the country.

With this aim in view, Government of India decided to follow a more restrictive import policy from the second half of the calendar year 1947. Broadly speaking, that policy consisted of dividing imports into three categories: free, restricted and prohibited. Imports of food, capital goods, the raw materials of industry and certain essential consumer goods were free and no exchange restrictions were placed upon their import. Consumer goods which were not absolutely essential were licensed on a quota basis, while others which in the context of the economy of India were regarded as totally unessential and luxury imports were altogether prohibited. Together with the restrictions on imports, certain restrictions on remittances abroad, in particular on the transference of Indian capital were also introduced.
Another matter which was causing concern to the Government was the emergence of a substantial adverse balance in India’s external payments. India’s balance of trade had in the past always been substantially in her four, the surplus of exports over imports being used by her to (a) meet the interest and amortization charges on her sterling debt, (b) pay the pensions and leave salaries of British officers and (c) make other invisible payments such as the remittance of the profits of foreign investments in India.

During the war years, India’s balance of trade became even more favorable than before, due not only to restrictions on their imports on account of war time conditions but to the large payments which accrued to her on account of supplies and services to the allied nations and the Defense Expenditure Plan. The result of India’s earning, both visible and invisible, being vastly in excess of her expenditure, was the rapid accumulation of sterling balances. Part of these balance was used to purchase the Indian railways and to repatriate compulsorily almost the whole of the Indian railways and to repatriate compulsorily almost the whole of the Indian sterling debt, part was used through Indian national acquiring British investments in India. All these measures served greatly to lessen the annual drain on India while the interest earned on the sterling balances added in some measures to income.

India had always displayed an interest in the arrangement commonly known as the Empire Dollar Pool. The arrangement was that the countries of the sterling area hold all their foreign exchange reserves in sterling, selling currencies which they did not need to the Banks of England, and buying from the Bank of England currencies which were in short supply. As a consequence, there was always in the custody of the
Bank of England, a pool of foreign exchange from which members of the sterling area could buy for sterling, the currencies which they needed.

The external financial position of the country soon after Independence was marked by the following trends.

1. Sharp decline in the sterling balances held by the RBI.
2. Growing difficulty in the financing of imports from the hard currency areas.
3. Emergence of Pakistan as foreign country for currency purposes with the separation of its currency from that of India.

The reduction in sterling balances was due mainly to the large imports of food but there were also substantial imports of other goods in satisfaction of the pent up demand of the war years. There were several other reasons. The first was the payment to the United Kingdom Government in accordance with the agreement reached with them of Rs. 284 crore for the purchase of annuities for financing the payment of sterling pensions and the acquisition of the Defense installations and stores left behind in India by the United Kingdom at the end of the war. The second was the payment to the State Bank of Pakistan of Pakistan’s share of these balances following the separation its currency from that of India.

Nationalization of RBI (In 1949)\textsuperscript{15}: Upon the nationalization of the RBI in 1949 in terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 and the enactment of the Banking Regulation Act, 1949, regulation and supervision of banks received the focus. On the initiative of the RBI, the Government appointed the Rural Banking

\textsuperscript{15} Reserve Bank of India, Functions and Working of RBI, Fourth Edition (1983)
Enquiry Committee in 1949 to consider important policy issues relating to the extension of banking facilities in the country.

The enactment of the Banking Companies Act, 1949 gave special authority to the RBI to supervise the operations of commercial banks so as to ensure their establishment and working on sound lines. By 1951, it had become a well-established practice for the commercial banks and cooperative banks to turn to the RBI for accommodation. As such, the RBI was in a position to pursue a credit policy that was both expansionary and regulatory, broadly in accordance with the investment priorities indicated in the Plans. In 1956, the RBI was vested with power to vary, within broad limits, the statutory reserve, which the commercial banks were required to maintain with it. The RBI also made efforts for credit planning, guiding the commercial banks with regard to the aggregate quantum of credit creation, season-wise and its sector-wise distribution and employing device of incentives and penalties in the rate structure. Furthermore, the RBI also instituted the mechanism for providing temporary accommodation to the banks for meeting their seasonal demand requirements of reserves through the seasonal fluctuations in credit expansion and narrowing. For this purpose, the RBI had instituted the Bill Market Scheme as early as in January 1952, enabling the banks to borrow from the RBI against the security of their advances converted into issuance bills.

Five Year Plans and the RBI: With the launching of five-year plans, the RBI’s functions became more diversified in terms of Plan financing and establishment of specialized institutions to promote savings and investment in the Indian economy and meet the credit requirements.
of the priority sectors. In this context, the RBI took over a number of crucial developmental and promotional roles. The First Five Year Plan (1951-56) emphasized the role of monetary and credit policy as an important instrument for maintaining price stability and for regulation of investment and business activity. Accordingly, the RBI was expected to play its role in promoting economic development by aligning the banking system to the needs of a planned economy. The fundamental task before the RBI was to put in place an appropriate institutional framework for mobilization of potential savings through the promotion of financial intermediaries and creation of a broad spectrum of financial assets and effective investment of these resources for economic development.

By this time the RBI had acquired enough experience and expertise in discharging the traditional central banking functions. It had obtained fairly adequate control over the money market. Thus, organizationally, the RBI was well-equipped to play its due role to promote the country’s economic growth.

The RBI’s role in Plan financing evolved in the form of deficit financing. In January 1955, through the exchange of letters with the Central Government, the RBI agreed to replenish the latter’s balances whenever they fell short of Rs. 50 crore at the end of any week. This agreement in effect gave a go-ahead to an enabling provision in the RBI Act [Section 17(5)], which authorized the RBI to provide to the Central and State Government advances repayable not later than three months. These advances were matched by the issue of ad hoc treasury bills issued by the Central Government to the RBI, which were held in the Issue Department. While it was customary for a central banks to extend temporary short-term advances to the government to cover mismatches
between the logger’s receipts and expenditure, the practice made routine since 1955 gave the Central Government and unlimited right to borrow from the RBI.

Over time, the proactive of replenishing the Government’s balances by creation of ad hoc Treasury Bills attained a permanent character and an alternative source of financing government expenditure. Similarly, the State Governments also began drawing unauthorized overdraft from the RBI. As such, the RBI became a source of cheap credit not only for the Central Government, but also indirectly for the State Governments. Plan financing also necessitated heavy drawls in foreign exchange reserves held by the RBI, which in turn called for appropriate legal measures to arm the RBI to facilitate as well as counter the ill effects thereof.

The substitution of the proportional reserve system by a minimum of foreign exchange reserve system under the Reserve Bank of India (Amendment) Act, 1956 provided a more elastic method of note issue to meet the growing currency requirements. The period since 1960 also marked the beginning of the regulation of interest rates (lending as well as deposits) of commercial banks by the RBI.

**RBI as Institution Builder**\(^\text{17}\): After Independence, a major task thrust upon the RBI was to put in place the necessary institutional mechanism to complement the planning efforts. This was crucial especially in the context of the weak financial system with an underdeveloped and evolving commercial banking set up. Organised credit institutions had a negligible presence in rural India. In this

backdrop, building up a sound and adequate institutional structure of rural banking and credit was paramount.

**D. Deposit Insurance Corporation (DIC)**[^18]: A wholly-owned subsidiary of the RBI, it commenced operations in 1962. A number of important developments concerning deposit insurance took place during 1967-81. The DIC Act was amended in 1968 to extend the insurance scheme to deposits with cooperative banks. This phase witnessed strong growth and consolidation of the deposit insurance fund consequent upon the expansion of bank deposits and progressive increase in the coverage of insured deposits.

The RBI promoted a public limited company named Credit Guarantee Corporation (CGC) in 1971. The main thrust of the credit guarantee schemes introduced by CGC was to encourage the commercial banks to meet the credit needs of the hitherto neglected sectors, particularly the weaker sections of the society engaged in non-industrial activities.

The two organizations—the DIC and the CGC—were merged in 1978, leading to formation of the Deposit Insurance and Credit Guarantee Corporation of India (DICGC) with the twin objectives of giving protection to small bank depositors and providing guarantee cover to credit facilities extended to certain categories of small borrowers belonging to the weaker sections of society.

B. Specialized Financial Institutions\textsuperscript{19}: In the absence of a well-developed capital market, the RBI played a proactive role in setting up a number of specialized financial institutions at the national and regional level to widen the facilities for term finance to industry and for institutionalization of savings. The examples are: the Industrial Development Bank of India (IDBI) in 1964 and the Unit Trust of India (UTI) in 1964.

C. National Bank for Agriculture and Rural Development (NABARD)\textsuperscript{20}: To supplement the institutional build-up, the RBI also assumed special responsibilities for augmenting the flow of rural credit. The formulation of agricultural credit policy beginning 1951 was a major landmark in the RBI’s responsibilities for agricultural credit. The RBI organized a comprehensive All India Rural Credit Survey under the direction of a Committee (Chairman: A.D. Gorwala) appointed in 1951. The recommendations of the Committee set the pace and directions for the subsequent years not only for the RBI’s agricultural credit policy but also for the related policies of Central and State Government.

The Committee’s recommendations led to (a) the nationalization of the Imperial Bank of India and the banks associated with the former princely states, (b) restructuring of the short-term co-operative credit structure and (c) reorganization of the institutions specializing in long-term lending for agricultural development. The Agricultural Credit Department was established mainly with the objective of coordinating the RBI’s operation with those of other institutions engaged in agricultural

\textsuperscript{19} Financial Institutions and Markets by-L M Bhole, (3\textsuperscript{rd} Edition) 1999 Tea McGraw-hill publishing company limited, New Delhi
\textsuperscript{20} NABARD @ Google.com
lending. The RBI Act was amended in 1955 to enable it to create two fund: National Agricultural Credit (long-Term-Operations) Fund and the National Agricultural Credit (Stabilization) Fund. The RBI set up the Agricultural Refinance Corporation in 1963 for extending medium and long-term finance to agriculture. With the establishment of the national Bank for Agriculture and Rural Development (NABARD) on July 12, 1982, the focus of the RBI in regard to rural credit has been more on-coordination. This role of the RBI expanded after 1982 with the formation of the Rural Planning and Credit Department.

**Export Import Bank of India (EXIM Bank)**

It was established in January 1982, to which the export finance functions of the IDBI were transferred. The EXIM Bank was also made eligible to loans and advances from the National Industrial Credit (Long-Term Operations) Fund operated by the RBI.

Apart from the initiatives to build-up an institutional base, the RBI made the provision of annual allocation from profit a fund called the National Industrial Credit (Long-Term Operations) Fund for use for development banking. The RBI also administered, as the agent of the Central Government, Various credit guarantee schemes for the small-scale industries (SSI) sector, which were designed to provide protection to banks and other institutions lending to such small scale units.

The establishment of the banking and other specialized institution had significant implications for the working of the RBI in that it widened the spectrum of the financial sector and heightened the supervisory role of the RBI.

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21 EXIM Bank of India @ Google.com
Nationalization of Banks in 1969 and 1980\textsuperscript{22} : The need for nationalization was felt in the context of the major lacuna that many rural and urban areas remained inadequate in banking after two decades of Independence. Also, the large industries and big and established business were fond to be receiving a major portion of the credit facilities, which was detrimental to the interests of the preferred sector such as agriculture, small scale industries and exports. Accordingly, a National Credit Council (NCC) was set up in December 1967 to assess the demand for bank credit from the various sectors of the economy, determine the priorities for the grant of loans and advances commensurate with the availability of resources and the requirements of priority sectors and to coordinate lending and investment policies of various institutional agencies to ensure the efficient use of the overall resources.

The Government of India nationalized 14 major Indian scheduled banks having deposits of Rs. 50 crore and above through the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969. The objectives of bank nationalization went far beyond the objective of social control. The objective of the takeover as illustrated in the preamble of the Act was “to control the heights of the economy and to meet progressively, and serve better, the needs of development of the economy in conformity with national policy and objectives”. In essence, the nationalization of banks aimed at accelerating the pace of expansion of commercial banks branches in rural areas and augmenting the flow of bank credit to agriculture and to the weaker sections of the society.

\textsuperscript{22} Bhasim, Niti, Banking and Financial Market, 1947 to 2007, New Delhi, New Century Publication.
Nationalisation of 14 private commercial banks in July 1969 greatly influenced the functions of the RBI in the subsequent years.

With nationalization, the ownership of the banks was vested with the Central Government, while the operational aspects of banks continued to be the look out of the RBI. This paved the way to a centralized control and direction over the banking system. While the main objective of nationalization was that credit should be available to a wider range of people than before, the major task of the RBI was to ensure the compliance to its policies by the nationalized banks. This called for significant changes in the institutional arrangements and more stringent control and supervision of the banking system.

In terms of outcome, this phase of nationalization greatly succeeded in the mobilizing private savings through the banks. The savings so mobilized were used for supporting public borrowing as well as for meeting hitherto neglected genuine credit needs. This success led to the nationalization of six more private commercial banks in 1980 through the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1980. With the second phase nationalization, the public sector banks accounted for over 90 per cent of the total deposits of all scheduled commercial banks. While the RBI had not been a party to the bank nationalization in 1969, the initiative for the second phase of nationalization in 1980 came from the RBI, the reason being the need to supervise private banks to ensure their compliance with social control norms, given the fact that several small private banks had grown to respectable size and it was not easy to control their activities in practice.
Sukhamoy Chakravaty Committee and Monetary Policy

Initiatives during the 1980s\textsuperscript{23} : Policy makers in India were greatly concerned with the inflation rate during the 1970s. The large deficits of Government and its financing by the RBI leading to a significant rise in money supply relative to output prompted a new look for evolving a broader approach in assessing the size and growth of overall money supply. The Committee to Review the Working of the Monetary System (Chairman : Sukhamoy Chkravarty) suggested that the monetary authority should embark on monetary targeting in a more formal and secured manner. The level of the monetary target needs to be determined on the basis of desired growth in output and the tolerable level of inflation.

The Chakravarty Committee suggested targeting the broad measure of money supply (M3) with feedback. The Committee outlined a systematic operating procedure, in particular the planning of the monetary and credit budget. The monetary budget was estimated using the core parameters of real growth the and inflation and was followed with a consistency check with the estimated movements in the sources of money supply, \textit{viz.} net domestic credit (net RBI credit to Government and the commercial sector), Net Foreign Assets (NFA) and Net Non-Monetary Liabilities (NNML) of the RBI. While movements in NFA and NNML are determined on the basis of past trends, the RBI credit to the Government and the commercial sector was projected in a manner consistent with the overall size of the stymied monetary budget.

\begin{footnotesize}
\textsuperscript{23} Monetary Policy, Internal Debt and Autonom of the Central Bank, Macroeconomics and Monetary Policy-Issues for a Reforming Economy, Montek S. Ahluwalia, Y.V. Reddy and S. S. Tarapore, 2002
\end{footnotesize}
The Committee also suggested an independent assessment of the seasonal demand for credit and recommended RBI support in the form of refinance for the shortfall, if any. Formulation of monetary policy thus became a formal mechanism of the restructured monetary policy programme. The RBI evolved a formal framework of monetary policy programme. The RBI evolved a formal framework monetary policy by the mid-1980s with M3 as a nominal anchor to be targeted, broadly based on the recommendations of the Chakravarty Committee.

The Working Group on Money Market (Chairman: N. Vaghul), which examined the recommendations of the Chakravarty Committee regarding the development of the money market, submitted its report in January 1987. Following the report, a number of money market instruments were introduced: 182-day Treasury Bills, inter-bank participation certificates (IBPSc), certificates of deposits (CDs) and commercial pagers (CPs). The Discount and Finance House of India (DFHI) was set up in 1988 for promoting a secondary market in various money market instruments.

The process of expansion in the banking network in terms of geographical coverage and heightened controls affected the quality of banks assets and strained their profitability. In response to these development’s a number of measures were undertaken in the mid-1980s for consolidation and diversification and, to some extend, deregulation of the financial sector. Certain initiatives were also taken to impart greater operation flexibility to banks. These included permitting the banks to enter into the business of equipment leasing and mutual funds, dosing away with the requirement of prior authorization under the CAS and
rationalization of bank deposit and lending rates rising coupon rates on
government securities.

**Post Reforms and Responsibilities of RBI** 24: The process of
liberalization and globalization of the Indian economy initiated since
1991 added serial new dimensions to the responsibilities of the RBI.
Along with financial sector reforms, the monetary policy framework has
been fine-tuned and the conventional central banking functions including
those of currency management and payment and settlement systems have
been revamped in tandem with the global trends and domestic
expediency.

**Financial Sector Reforms:** During the 1980s, the financial
markets were highly segmented and controlled and the interest rates in
the government securities market and the credit market were tightly
regulated. The banning sector remained dominated by public sector banks
with a significant quantum of non-performing assets. Credit was
extended to the Government by mandating the maintenance of a
minimum Statutory Liquidity Ratio (SLR) whereby the commercial
banks set aside substantial portions of their liabilities to investment in
government securities at below market interest rates. The state of the
development of financial markets turned out to be yet another major
constraint. Removal of the institutional technological and legal obstacles
for the healthy growth of financial markets for effective transmission of
the policy signals formed a major agenda for the reform of the financial
sector since mid-1991.

Increasing globalization of the Indian economy necessitated
integration of domestic markets with international financial markets for

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full realization of the benefits of globalization. Financial sector reforms were initiated in India in 1992 with a view to improving the efficiency in the process of financial intermediation, enhancing the effectiveness in the conduct of monetary policy and creating conditions for integration of the domestic financial sector with the global system. The first phase of reforms, guided by the recommendations of the Committee on Financial System (Narasimham Committee I), aimed at enhancing the operational flexibility and functional autonomy of the financial sector with a view to fostering efficiency, productivity and profitability. The second phase, based on the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II), focused on strengthening the foundations of the banking system and bringing about structural improvements.

A. Banking Sector: The first phase of reforms in the financial sector focused on deregulation of the banking industry including permitting the entry of new private sector banks. Simultaneously, measures were undertaken to strengthen the institutional framework in banking, non-banking financial companies, financial companies, financial institutions and the capital markets through prudential norms, capital adequacy stipulations, improvements in payments and settlement systems and strengthening of the supervisory framework. Institutional measures also included setting up of the Board for Financial Supervision for strengthening the RBI’s supervisory mechanisms, recapitalization of banks and improvements in debt recovery.

The second phase of reforms focused on the banking sector with an emphasis on the prudential norms. Prudential norms have been
introduced gradually to meet international standards. Action has been initiated increase the capital adequacy ratio; assign risk weights to open position in fore and gold. The required level of capital adequacy after implementing the recommendations of the Narrasimham Committee II warranted a substantial infusion of capital into the banking system. Similarly, internationally accepted norms of income recognition have been introduced.

B. **Development Finance Institutions:** Measures aimed at fostering competition and establishing prudential regulation and supervision have also been introduced for the non-bank financial intermediaries. The non-banking financial companies (NBFCs), especially those involved in public deposit taking activities, the Development Finance Institutions (DFIs), specialized term-lending institutions, urban cooperative banks all have been brought under the regulation of the RBI. With the aim of regulatory convergence for entities involved in similar activities, prudential regulation and supervision norms have also been introduced for DFIs, NBFCs and cooperative banks.

C. **Capital Market:** The Indian Capital market was opened up for foreign institutional investors (FIIs) in 1992. The Indian corporative sector has been allowed to tap international capital markets through American depository receipts (ADRs), global depository receipts (GDRFs), foreign currency convertible bonds (FCCBs) and External Commercial Borrowings (ECBs). Similarly, overseas corporate bodies (OCBs) and non-resident Indians (NRIs) have been allowed to invest in Indian companies. FIIs have been permitted in all types of securities including Government securities
and they enjoy full capital convertibility. Mutual funds have been allowed to open offshore funds to invest in equities abroad.

D. Debt Market: The management of public debt and operations of government securities market are governed by the Public Debt Act, 1944. The procedures prescribed are archaic and some of the provisions have ceased to be of relevance in the present context. A new legislation titled the Government Securities Act to repeal and replace the Public Debt Act was approved by the Union Cabinet and is awaiting Parliament clearance. However, since the Public Debt Act, 1944, is applicable for marketable loans raised by the RBI on behalf of both the Central and State Governments, the proposal requires consent of all State Governments. Upon the enactment of the new legislation, the RBI would have substantive powers to design and introduce an instrument of transfer suited to the electronic environment.

Interest rates on Government paper have been made market-related and the maturity periods changed to reflect market preferences. Since April 1992, the Central Government borrowing programme has been conducted largely through auctions enabling market-based price discovery. As a result of the institutions of market-related interest rates on Government borrowing, Open market operations (OMOs), hitherto ineffective, gained considerable momentum. There has been a gradual shift in emphasis from direct to indirect instruments of policy, i.e. OMOs and repose have been actively used to influence the level of reserves available with banks.

Several important reforms have been undertaken in the sphere of government securities market. The RBI entered into a historic agreement
with the Government of India in September 1994 for gradual phasing out of ad hoc treasury bills. Accordingly, the *ad hoc* treasury bills were discontinued with effect from April 1, 1997.

**External Sector Reforms:** Until 1991, the policy of maintaining foreign exchange reserves was essentially based on the traditional approach, i.e. to maintain an appropriate level of import cover defined in terms of number of months of imports equivalent to reserve. It may be recalled that the import cover of reserves fell dangerously to three weeks of imports by the end of December 1990.

A. **High Level Committee on Balance of Payments (Chairman: C. Rangarajan), 1993**: The Rangarajan Committee made the following recommendations pertaining to India’s external sector.

1. Introduction of a market-determined exchange rate regime within limits.
2. Liberalisation of current account transactions leading to current account convertibility.
3. Compositional shift in capital flows away from debt to non-debt creating flows.
5. Discouraging volatile elements of flows from non-resident Indians.
6. Full freedom for outflows associated with inflows (i.e. principal, interest, dividend, profit and sale proceeds) and gradual liberalization of other outflows.
The developments in the subsequent years generally followed these recommendations. The Liberalised Exchange Rate Management System (LERMS) involving a dual exchange rate mechanism was instituted in March 1992 along with other measures of liberalization in the areas of trade industry and foreign investment. The dual exchange rate system was essentially a transitional phase, culminating in the unified exchange rate system effective from March 1, 1993. This brought about the area of market-determined exchange rate regime of the rupee. It also marked an important step in the progress towards current account convertibility, which was finally achieved in August 1994 when India accepted Article VIII of the Articles of Agreement of the International Monetary Fund.

As a follow-up measure for the development of the foreign exchange market in India, an Expert Group (Chairman : O.P. Sodhani) was appointed November 1994, which submitted its report in June 1995. This Group made several recommendations to develop, deepen and widen the forex market, ensure risk management, foster efficiency in the market by removing restrictions, introducing new products and tightening internal controls. Many of the subsequent actions were based on this Report.

The Rangarajan Committee recommended that the target for foreign exchange reserves be fixed in such a way that they are generally in a position to accommodate imports of three months. Furthermore, a change in the traditional approach to reserve management was warranted and the emphasis on import cover had to be supplemented with the objective of smoothening out the volatility in the exchange rate.

According to the Committee, the following factors need to be taken into account in determining the desirable level of reserves.
1. The need to ensure a reasonable level of confidence in the international financial and trading communities about the capacity of the country to honour its obligations and maintain trade and financial flows.

2. The need to take care of the seasonal factors in any balance of payments transition with reference to the possible uncertainties in the monsoon conditions of India.

3. The amount of foreign currency reserves required to counter speculative tendencies or anticipatory actions amongst players in the foreign exchange market and

4. The capacity to maintain the reserves so that the cost of carrying liquidity is minimal.

C. Foreign Exchange Reserves : Cost and Utilization Considerations: The unprecedented accumulation of foreign exchange reserves in recent years has generated a debate regarding the cost of holding the reserves. In this connection, the RBI has maintained’ “While the cost of reserves is secondary to properly meeting the overall objective behind holding reserves, it is important to note that in India, in the last few years, almost the whole addition to reserves has been made without increasing the overall level of external debt, which has hovered around US$ 100 billion during the previous five years. The increase in reserves largely reflects higher remittances, quicker repatriation of export proceeds and non-debt flows.”

India’s foreign exchange reserves comprising foreign currency assets, gold and Special Drawing Right (SDRs) have increased significantly since 1991-92. It may be recalled that during the crisis
period in 1990-91, the foreign currency assets had dipped below US$ 1.0 billion, covering barely two weeks of imports. The subsequent reform period has coincided with a record accretion, especially since 1993. The reserves almost doubled during the period 2000-2003, rising from US$ 38.0 billion at end-March 200 to US$ 75.4 billion at end-March 2003. As on April 7, 2006, the reserves stood at US$ 154.1 billion, with India being the sixth largest holder of reserves in the world.

The strength of the foreign exchange reserves has, *inter alia*, led the International Monetary Fund (IMF) to designate India as a creditor country under its Financial Transaction Plan (FTP). Strong foreign exchange reserves and low interest rates in the domestic markets have enabled the Government to prepay certain foreign currency loans amounting to US$ 5.2 billion during 2003 thorough outright purchase of foreign exchange from the RBI. These foreign debts were substituted with domestic debt by the issue of Government securities on private placement basis to the RBI.

These transactions did not have any fiscal or monetary impact, as it was a substitution of external sovereign debt with domestic sovereign debt placed with the RBI. Corporation bodies have also taken advantage of low international interest rates in prepaying at part of their external commercial borrowings (ECBs).

As to the perspective of use of reserves, it may be noted that most of the accretion in reserves in the recent period has been through net purchases by the RBI in the domestic foreign exchange market for which an equivalent amount of domestic currency has been released to the domestic entities concerned which could decide on their use either for investment, deposits or as liquid assets. To the extent that this counterpart
local currency is used by recipient entities for further investment in economy, the impact on industrial demand and growth would be favorable.

Addition to reserves in the last few years in India largely reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows while the overall level of external debt has remained virtually unchanged.

Committee on Capital Account Convertibility (Chariman : SS. Tarapore), 1997 25: As a part of India’s external economic policy, capital account convertibility (CAC) has remained a controversial issue for quite sometime.

The Report of the Committee submitted in May 1977, provided the framework for liberalization of capital account transactions in India and served as the basis for undertaking further liberalization during the relate 1990s.

The Committee highlighted the benefits of a more open capital account but at the same time cautioned that CAC [6] could pose tremendous pressures on the financial system. It laid down a three-year road-map ending 1999-2000 for CAC based on the following three pre-conditions.

1. Fiscal consolidation.
2. Strengthening of financial system.
3. Low rate of inflation.

The Committee recommended a phased implementation of CAC in India to be completed by the year 1999-2000 and prescribed the macroeconomic framework for implementing full convertibility in terms of the preconditions for greater liberalization. The Committee had suggested that implementation of the measures in each of the three phases should be based on a continuous monitoring of certain precondition and attendant variables identified from the lessons of the international experiences and related to the specifics of the India situation.

These pre-conditions are yet to be achieved on sound footing and therefore the Government is in no hurry to introduce CAC on full-fledged basis.

A significant feature was that the Committee did not recommend unlimited opening up of capital account but preferred a phased liberalization of controls on outflows and inflows over a three year period. Even at the end of the three-year period, capital account was not to be fully open and some flows, especially debt would continue to be managed. An obvious corollary of this approach was that the mere attainment of preconditions may not be enough for implementing full liberalization of the capital account. The approach towards full convertibility must be consistent with the overall policy framework that is assigned to the objective of growth and stability.

It is noteworthy that convertibility of capital for non-residents in India is allowed subject to certain administrative procedures. It is only the residents (both individuals and companies) who are subject to capital controls. However, as part of the liberalization programme, Government
has been relaxing these controls. Thus, residents are allowed to invest abroad through mutual fund route subject to prescribed procedures.

Gradually, capital account has also been liberalized for cretin purposes. For example, in the 1002-2002 budget, the Finance Minister allowed Indian companies to invest abroad up to US$ 50 million on an annual basis through the automatic route without being subject to the three year profitability condition. The gradual liberalization of restrictions on various external transactions has resulted in widening and deepening of the foreign exchange market.

**Deregulation of Interest Rates:** The process of simplification in the administered interest rate structure begin in September 1990 with the reduction in the number of slabs for which lending rates were prescribed. In a major move, the minimum lending rate was abolished and the lending rates were freed in October 1994 for credit limits of over Rs. 2 lakh. As a consequence of deregulation and simplification of interest rates, banks now enjoy ample flexibility in deciding their deposit and lending rates. At present, except for the prescribed ceilings for the interest rates on export credit and small loans up to Rs. 2 lakh, all other lending rates have been deregulated. On the deposits side, only savings deposit rates and NRI deposit rates are prescribed by the RBI. As per the current practice, banks set their lending rates with reference to a pre-announced benchmark prime lending rate (BPLR) by taking into account the risk premia and/or term premia. The BPLR is decided by taking into account various factors, such as actual cost of funds, operating expenses, minimum margin to cover the regulatory requirements of provisioning/capital charge and profit margin. The BPLR also serves as the ceiling rate for small loans up to Rs. 2 lakh.
**Short-term Liquidity Management** : Short-term liquidity management is aided by conduct of repos on a regular basis. Repos/reverse repos denote injection/absorption of liquidity by the RBI.

Liquidity Adjustment Facility (LAF) has emerged as the principal operating instrument of monetary policy, enabling the RBI to modulate short-term liquidity under varied financial market conditions. The LAF operates through daily repo and reverse repo auctions that set a corridor for the short-term interest rates consistent with the policy objectives. In order to fine-tune the management of liquidity and in response to suggestions from market participants, the RBI has introduced from November 28, 2005 a second liquidity adjustment facility (SLAF). Thus, at present repos and reverse repos are being conducted twice a day. Although there is no formal targeting of overnight interest rates, the LAF has enabled the RBI to de-emphasise targeting of bank reserves and focus increasingly on interest rates. This also has helped reducing the CRR without engendering liquidity pressure.

The Market Stabilization Scheme (MSS) was introduced in April 2004 to provide the RBI with an additional instrument of liquidity management and to relieve the LAF from the burden of sterilization operations. The MSS is an arrangement between the Government of India and the RBI to mop up the excess liquidity generated on account of the accretion of the foreign exchange assets of the Bank to neutralize the monetary impact of capital flows. Under the scheme, the RBI issues treasury bills/dated Government securities by way of auction and the cost of sterilization is borne by the Government.

**Payment and Settlement Systems** : Payment and settlement systems feature prominently as the backbone of economic activity in any
modern society. With the gathering pace of globalization and advances in technology, the importance of safe, sound, secure and efficient payment and settlement systems is recognized by the banks, the world over. It is in this context that the Core Principles for Systemically Important Payment Systems of the Banks for International Settlements (BIS) assumes significance.

Recognizing the importance of payment and settlement systems, the RBI had taken upon itself the task of setting up a safe, efficient and robust payment and settlement system for the country for more than a decade now. Since clearing operations were at the heart of efficient payment and settlement system’s thrust areaways on such systems. One of the key driving factors in the reforms aimed at improving the existing systems was technology. With the technological developments, which have had a significant impact on the banking sector, the pace in reforms was accelerated with the fillip provided by technology for use by modern payment and settlement systems. The efforts of the RBI have been to ensure full compliance to the core principles of BIS and one of the moves aimed at reducing risks has been the introduction of the Real Time Gross Settlement (RTGS) system. The system, in its present form, would take care of all inter-bank transactions and other features would be added on soon. Banks have risen to the occasion in ushering in a system, which uses the latest technology and relies, to a large extent on network-based information flows.

In view of the positive response of the financial sector to the initiatives of the RBI and the banning sector also coming of age, the RBI has now taken the policy perspective of migrating away from the actual management of retail payment and settlement systems. Thus, for a few
years now, the task of setting up new MICR based cherub processing centers has been delegated to the commercial banks. This approach has yielded good results and the RBI now envisions the normal processing functions to be managed and operated by professional organizations, which could be constituted through participation from banks. This would be applicable to the clearing houses as well, which will perform the clearing activities, but the settlement function will continue to rest with the RBI. With this, the RBI will continue to have regulatory oversight over such functions without actually acting as the service provider. The exception to this would be the RTGS which is retained by central banks the world over. The RTGS, which provides for funds transfer across participants in electronic mode with reduced risk, will be operated by the RBI.