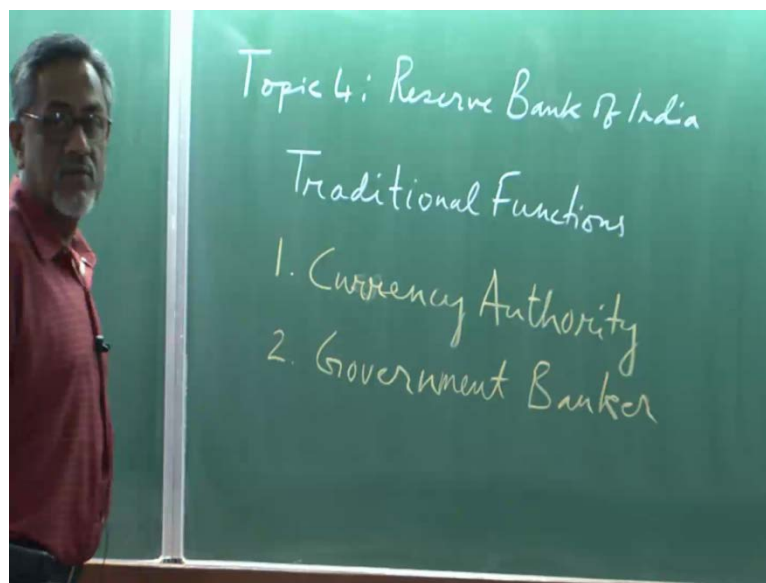


Money and Banking
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Lecture - 26

In topic 4, I should have a different name, because I was ambitious to do something more, I am going to change the title. Can we call it, this is only regulatory institution I would talk about in details.

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I will call that topic 4, Reserve Bank of India, and talk about Reserve Bank of India. Now, Reserve Bank of India, which is a Central Bank of India is not exactly like the Central Bank of other countries, but some functions are same. So, I am going to slowly talk about that and where the difference is come. First of all some question came up long time back in this course, they said Reserve Bank of India is a private institution or a government institution. I always knew it is a government institution, but I got the details that in 1949 or 1947 it was nationalized by the government.

Originally, it was founded as a company and then as a normal bank and then it was nationalized, but some countries have Central Bank not in the government sector, because they do not have a government sector as such. So anyway let us talk about the Central Bank of India, Reserve Bank of India. Earlier I used to call this topic regulatory and promotional institutions, what I found that, there is not lot to talk about or I may

have to expand my notes to include a whole range of promotional institutions. But I found that in case of money market, Central Bank is overwhelming, our Central Bank RBI in terms of regulatory, institution, which regulates the money market, tells you what to do, what not to do and promotes things from a development point of view I will talk about that here in this. So, I found is primarily Reserve Bank of India, so why not call the title Reserve Bank of India not a wage thing like regulatory and promotional institution, but I essentially talk about RBI, so let us talk call this RBI.

Now, RBI was established in first April 1935, many years back definitely not me many of your parents probably were not even born in 1935, many, many years back. RBI was established on first April 1935 with private share holders, very interesting with private share holders. And so just like U S or some other country, the Central Bank of India was founded as a (()) with private share holding a company, but there was an act which was passed by the British government or Reserve Bank of India act 1934.

So, in 1934, the act was passed in 1935 Reserve Bank of India was founded on first of April. Now, it remained with private parties share holding etcetera, but then the Britishers left the country changed and we slowly moved towards the socialist system of 5 year plans, a typical Russian copy. Russians introduced that plan in 1920's 70's 5 year plans, Stalin after the revolution when he came to power he introduced that 5 year plan.

We copied that we have a huge public sector that is also a copy of the Russian model, so the Central Bank naturally after independence, which was in 1947 in 1949 RBI was nationalized. So, we did not remain like U S or other countries where the Central Bank can be in the private sector, which some of you ask the question probably. And then it became the Central Bank it became a Central Bank primarily, I mean it was just not a bank it became a proper Central Bank of India.

So, what do you mean by that, I am going to come to that, before I come to the functions of RBI as a Central Bank, which is comparable with the functions of a Central Bank anywhere else. And functions of RBI as a non typical Central Bank, which in India we have in other countries Central Banks do not do that, so I need to talk about both the traditional functions and the nontraditional functions of our Central Bank.

So, that you know if you study the Central Bank of another country, what you would expect what kind of functions which are under traditional Central Bank functions, and I

need to talk about also the nontraditional functions alright. Now, the Central Bank as a ministry structure as follows like, we have the director, the deputy director, the deans, then the registrars or here various registrars are here. Then registrar function in an university is very different it is like the dean's office, they do not have dean usually in Indian universities, then you have the head of the departments, etcetera.

RBI is managed by a central board of directors it has in capital letters RBI has a central board of directors. And they have 4 local boards of directors in various cities like Mumbai, Bombay etcetera, 4 local boards of directors, 1 is the central board of directors sitting in Bombay, one are the local 4 boards of directors and a committee of the central board of directors also this is a important committee. Now, usually we do not talk about the local board of directors or the of the committee, central board of directors committee which manages RBI functions.

The central board comprises that is the main thing which usually talk about the central board of directors, where the nominations come from the government also, they self appoint also etcetera. There is the famous governor RBI governor who is the boss top boss right now, there is an ex IIT Kanpur student alumni, who is the governor of RBI. Now, 4 deputy directors there are 40 sorry, 4 deputy governors, they are also on TV from time to time, and 15 directors fifteen directors nominated by the central government.

There are various directors nominated on the, not like IIT Kanpur having one director they have a governor, then 4 deputy governors, then 15 directors which are nominated by the central government. This kind of a structure they have main administrative structure, now having known this is just for the sake of it, some fun to know a RBI structure let us go into the thing we need the economic functions.

So, let us talk about the traditional functions which you will find common across Central Banks of the world, you go to the American Central Bank or the Mexican Central Bank or the British Central Bank or Japanese Central Bank or whatever these functions are common, so they are called traditional functions. So, let us talk about the traditional functions traditional functions the most important traditional function, that any Central Bank would perform is required to do the first and first most important thing is the currency authority is the currency authority.

Now, there has to be an authority either government or some institution, who legalizes takes care of the currency printing, it cannot be in the hands of private companies and they can do whatever they want to do. How much currency to be printed, what will be the features properties of the currency recently, we had a huge problem there were fake currency problem pumped in through Bangladesh, NEPAL etcetera, by other countries. And I have one fake currency, I kept it was supplied to me by our state bank, they denied it later.

I kept it in an envelope as a souvenir, I would not be able to detect it is a fake currency, a shop keeper detected that and told me, Sir, you have fake currency. It must be 500 rupee, so they have to have lots of you know security arrangements for currency. So, this is secured, becomes secured, because your enemy countries are trying to print them and pump into the economy, to de civilize the economy Bangladesh and NEPAL are the usual roots I have heard. So, I come from a state which should be more vigilant, but it requires central government forces, so they keep on blaming each other.

State government says how can we protect the, such a long boundary with Bangladesh and the state government helps us etcetera alright. So, that is an huge problem, so the currency you have already heard this before, RBI is the sole issuer of Indian currency except the 1 rupee note which we do not have any more. And coins because if you take a coin there is no RBI mentioned you will see, only Ashok (()) is there and the amount on the other side.

We call the Ashok (()) side the head when we toss the coin and the amount which is 50 paisa, 1 rupee, 2 rupee, 25 paisa, when I was born there is to be 1 paisa coin, nickel coin, brown colored 1 paisa coin. Is to be there is to be 5 paisa coin there, is to be 10 paisa coin, then 20 paisa coin, then 25 when I joined IIT slowly all that disappear only 25 and 50 paisa coin remained, 25 I do not find anymore much, I see some 50 paisa coins still around.

Except coin and 1 rupee note, if we ever have look at the 1 rupee note, it is very different from any other note, that we see in this country. 500 rupee note, 100 rupee, 50 rupee, whatever it is very different they the issuer is the finance ministry. So, we have split issuer of currency in India, bulk is from RBI, but a part is from the coins primarily 1 rupee note does not exist anymore, it is coming from a the government of India ministry

of finance government of India. Now, all notes and coins in India are legal tender, you understand legal tender it is a feat money legal tender, tender means submission, tender your resignation. I tender my resignation from IIT Kanpur alright or to IIT Kanpur I decided to resign from IIT Kanpur and go work somewhere else. So, the word English language is I tender, I submit my resignation. Now, legal tender means legally you can submit it, during a transaction the other party is bound to accept it. Unless is another country of course, it is not a legal tender, if you leave India and go to NEPAL or Bangladesh or Pakistan or SriLanka or US.

And say legal (()) who cares, whose countries legal tender is this, it is not our countries legal tender. So, it is a legal tender which we call feat money also, and interesting thing is there that, there is a consent of un limited legal tender and limited legal tender. That means, when you submit that in a transaction the other party may refuse beyond an amount, say I am not going to accept so much of that legal tender. So, they can they can say that I do not require, I would not accept a huge amount, suppose I am re paying a loan of 1 lakh rupees which I borrowed from somebody.

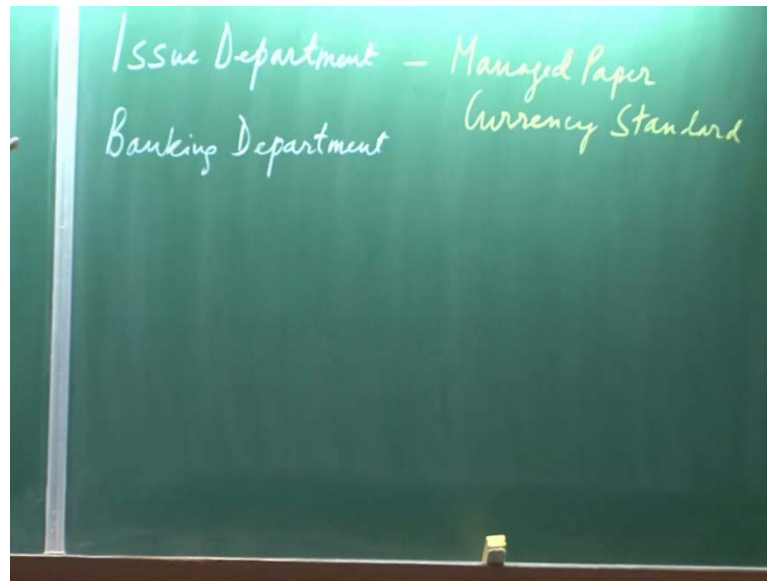
Bank can say at the time of repayment of loan, bank can say I am not going to access so much of that particular currency now what is that unlimited and limited legal tender. Well, I do not know whether it changes sometimes it changes RBI's small rules change, and it is very difficult to give track. When I prepare the notes a few years ago I was opening up books and RBI site and all those things I found 50 paisa coin and below 50 paisa coin are have limited legal tender.

That means somebody can refuse to accept so much of 50 paisa (()) in 50 paisa coin (()), he can say I refuse it beyond an amount whatever amount he chooses. So, that is limited legal tender a limited amount they can accept, and unlimited legal tender is anything else. So, he can imagine according to law I have taken 1 lakh loan I can return it the 1 paisa coin, 1 rupee coin currency, because it is unlimited legal tender by law RBI has made it.

See that is also quite a head ache for somebody to accept that, I gave you some money you are returning it 1 rupee coin. I say there is an understand usually we do not accept it we do not do it, but by law that is unlimited legal tender alright. Now, the question is if you come to RBI, the topic is RBI Reserve Bank of India look at the structure within

RBI, how this money is handled, this is very interesting. I would make reference to two important departments in RBI, 1 is the issue department I have not show you some data also. Issue department and the other one is the banking department, there are two departments of RBI which are interesting, which do does deal with a lot of things that we have to talk about in this course.

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Issue department and banking department, issue department and banking department the currency that I am talking about currency authority, that I am the authority to issue currency not only manufacture them, but put them also RBI does it. There are role of two departments here comes, the issue department issues currency under law they must be backed by assets of equal value comprising of gold coins, gold bullion, foreign currencies and government of India securities gold coin, gold bullion, gold bars etcetera chunk of gold bullion foreign currencies and government of India securities.

So, when the issue department issues currency 10 rupee note, 100 rupee note, 500 rupee note whatever 1000 rupee note, they have to be backed like an asset and liability of two sides of a balance sheet. If currencies are a liability which is of the RBI, because the issue it and you open a currency as I told you in class. You will say that this is backed by or guaranteed by the central government, and RBI governor etcetera then that is the liability. So, it should be backed on the asset side equal value of gold, gold bullion, foreign currencies and government of India securities, that is why deficit financing can

be handled or is an instrument or a function which is a legal function that can be carried out an activity carried out by the RBI or the Central Bank of any country.

What is deficit financing deficit financing is RBI does not have governments money RBI does not have it is own money in the Walt, but government wants cash it is in trouble. It can simply issue or which is called selling of treasury bills which is called government of India securities to RBI, an RBI by law or Central Bank by law legally will have to exchange that for hot currency. And where is the hot currency coming from the currency would come simply from manufacturing them, which you and me cannot do with respect to our transaction with a bank.

In a transaction with a bank, I cannot tell the bank here is my security and give me cash (()) a government can go to RBI and say here is the securities, I need cash give me cash. They say we do not have cash government would simply say, I come back tomorrow print them print them that is the busy financing in some ways printing, extra money which does not exist, from here it drops.

Which Milton Friedman used to call helicopter money, like you wake up in the morning a helicopter drop dropped a bag full of currency in your back here, Milton Friedman have you heard of Milton Friedman he was the Chicago economist the Nobellorient. And he used to call that helicopter money, that is this is as if helicopter has dropped it from sky it is dropped in your back here and you open and my goodness I have, so much currency.

That is deficit is possible simply because of this simple rule that exists, that provided you have gold, gold bullion, foreign currencies and government of India securities, you can issue currency any amount, they have to be backed by that value current value alright. This system of issuing currency by the issue department is known as managed paper currency standard, is called managed paper currency standard.

This issue department thing, that I just mentioned is called the managed paper currency standard managed paper currency standard alright managed paper currency standard issue department issues currency using a system called managed paper currency standard. Where, this is like a balance sheet it has the liability side shows currency issued total amount backed by on the asset side, they have to show disasters. What are the four

items, they can use gold, gold bullion, foreign exchange and government of India securities.

Now, after they have issued them; that means, they have legally declared, this is the currency or we are ready to put into the economy, issue departments job is over it is very interesting. This is now goes that currency goes to the or instruction goes to the banking department, then the banking department is the one who puts the currency in circulation. Now, how is the currency put into circulation, it may be depends, how the currency is put into circulation.

If the government of India is borrowing, it gives it to government of India and government of India starts spending goes into circulation. If banks asked for it by handing over foreign reserves, then it goes to the banks it depends various routes are there like exit points from RBI, like a drain and the fresh currency goes into the system alright. This is how it goes, but this job is done very interesting by the banking department, when you does not do any accounting it has been taken care of by the issue department.

And banking department simply have to do the manual part, the mechanical part. So, when government of India wants to borrow some currency, what happens is it does not go to the issue department, it goes to the banking department. They request banking department knocks on the issue department and says this is the amount they want. Issue department checks what it has, takes care of it the legal part of it whether enough government of India securities have come the amount they want or foreign exchange has come or gold or gold bullion has come, against which they are going to change it convert it into Indian currency, hands over does that work is over.

So, banking neighbors is like APA personal assistant to the issue department, who has the main job. Similarly, when RBI monetary policy division decides, now we are going to go for open market sale of securities. Why because our monetary policy is going to be a tight monetary policy, because by selling securities by RBI if sells securities, even me and banks etcetera, buy them. The money is squeezed out from the system, into banks locker RBI's locker is called a contractionary or tight money policy, open market sale of securities.

Who does it, issue department does not this is done by the banking department, so banking department has the whole lot of very important functions to carry out. Not only to pump in fresh currency, but also when a open market operations come which is a standard monetary policy instrument in most countries alright, it does it. Now, how it does it is different, it starts act it starts acting like an under writer announces, the sales of securities amount, it can give the job to the primary dealers.

These days who were appointed by the RBI, to do the under writing job it sends out the notices to various buyers or securities like banks, non banks, companies, etcetera public at large. And then the job is done, but it is the banking department head ache, monetary policy is monetary policy is executed by the banking, issue department main head ache is to the currency minting, so the mint is under their control where is manufactured etcetera. So, I will show you some data about issue department balance sheet I have, but I will not do it now I will do it later.

Data would distract you from the conceptual part, so I do the conceptual part the way I am doing proceeding with this course and then I come to the data at the end. Next a very important, second most important function, currency authority then government banker government banker, very interesting, what do you are saying is what you are saying is that who is your bank, who is your banker? The commercial banks, a company also as the banker is the commercial bank, but government does not usually consider commercial banks to be it is banker.

Both the state government and the central government in India in a federal structure like ours, both the central government and the state governments do not consider commercial banks to be their banker. They may do some business with SBI, which has literally become although it is a commercial bank, it has become like a right hand of RBI, it has reached it has acquired that status.

It may do some business with state bank, I really do not know because it have never in part of a finance ministry or something where you know what goes on. But what I found was very interesting, when I went to Delhi once for an union public service commission work, UPSC which conducts the IAS exams and selects people for planning commission etcetera. I went because they often invite faculty etcetera from here, and there for some job.

I went there, and I said he asked me would you like to take this some fee and my travel expenses in cash, I said no give me a cheque, god knows why I said cheque I had no interaction by experience with government. It is a government body UPSC, and the cheque came very interesting in Delhi UPSC writes a Cheque in favor of a bank which I never heard it existed some of you may know.

It is not SBI it is not the banks, you know it is called bank of Maharashtra, I first time I came to know bank of I never lived in Maharashtra, I never lived in Bombay I never heard of that bank I never saw that bank in Calcutta. It is called bank of Maharashtra UPSC in Delhi writing, a cheque not UPSC in Bombay and then god knows where the bank of Maharashtra office was it took a month for the cheque to clear anyway, it is another story.

So, government departments may have various banking transactions, but government property state governments and central government, their bank is Central Bank. So, what do they do RBI as a banker to the government, it does the usual banking operations commercial, banking operations like open an account accept deposit is remit funds, draft, bankers cheque etcetera provide checking facilities. It does all those functions that you find a commercial bank doing for the public, Central Bank of India functions like that for the government, deposit accept (()) checking facilities (()) whatever alright.

But, the interest thing that is the usual alright, something new that a as a bank if you call my it is my bank they are supposed to do those commercial banking activities. But, the most important part here is as a bank required to the government which a commercial bank being a bank to a public like you and me to a personal individual does not do. Is that, this banker to the government the Central Bank carries out or performs a view few very special functions for the government, which come under traditional functions of a Central Bank.

Nothing, uncommon about it every country does it, every country Central Bank do it, so what is their special functions which are not offered by a commercial bank to you and me if we open an account number one. They have created something called ways and means advances which is a method that they use, these days to fund or finance temporary government deficits. So, as a government banker, it deals with ways and Means

Advances, WMA it is called ways and Means Advances the ad of treasury bill is over they have 91 day bill 182 day 364 day.

In addition to that they also have 3 months advance etcetera, like a loan when state governments or central governments need cash called ways and means advances. They have created that once they wind up the ad of treasury bills which was becoming notorious because ad dock government was using misusing that facility all the time. But, they have replaced it by something else very interesting called Ways and Means Advances, this is managed by as a banker.

If you have at family at home the salary you earned suddenly got exhausted on 20th or 24th of the month, you have 6 more days to wait or 7 more days to wait before your salary comes. You cannot go to the bank and say give me ways and means advances to tied over my deposit at home, but government can do that government may be have to wait for two months for tax revenue to come in. There is short of cash, they do not want to sell treasury bills, just for these two months because the treasury bill is 90 days minimum 91 day or something.

So, what they can do they can ask ways and means advances, and this is done by the RBI as a banker it is very interesting. So, government has extra power when it enjoys the facilities offered by a bank like the Central Bank, but just remember these temporary advances like ways and means advances which are giving to the state government are often subject to certain conditions. Ways and Means Advances to the central government is often an open door policy, any amount a much more free.

But, ways and means advances to the state governments is sometimes a bit restrictive RBI differentiates in their treatment of state governments we service central government. Give me one example, the state governments are subject to certain qualifications by note says advances can be without any collateral, so state government can take a loan 2 months 3 months loan without giving any assets. For security deposit or showing some collateral security, like I am trying to build my own company I show my father's property as a collateral and take loans against it from a bank cash.

Advances can be without collateral which is great news like a central government which does often, advances can be made against the pledge of GOIS securities, but in government of India securities. So, state governments holding government of India's

securities and show that to get advances in the past they invested there, now they show it as a collateral as a security valuable to RBI to get some temporary loans.

They can do that there are often special advances when say there is a natural calamity in Assam going on, Assam government can ask for special advances, because there is a whole lot of extra expenses now alright. The state is in terrible shape right now, the other day they had a satellite picture of how much of the state is covered with water, it is unbelievable large portion 50 percent nearly covered you know with flood water.

So, special advances can be given to state governments, but there case has to be made then only RBI agrees to give the special advances and also there are interest rates various kinds of interest rates etcetera, often it is determined by the bank rate. That is charge on this advances these are not interest freed loan, these are with interest, but what kind of an interest, they would ask also change from time to time often the guide line is the bank rate.

I am coming to bank rate what is bank rate bank rate is a interest rate of the Central Bank, essentially commercial banks have interest rates two types you know deposit rate and a lending rate. They can be structure or deposit rates savings account (()) fixed deposit account (()) broadly two groups and lending rates. Central Bank usually has one interest rate called bank rate, but when it comes to ways and means advances, this sometimes charge different interest rates, but they are in proportion in relation to the bank rate that does happen.

Now, before I go to the other part or ways and means advances and functions of Central Bank as a banker to the government. And government I am using in a singular word, but government has two types of governments in India, for instance the central government and the state governments. Look I am not talking about the municipalities, I am not talking about local government RBI usually does not have any interaction with local governments or Panchayat's. These are also part of the government structure, governance structure we have in India I am only talking about state governments and central government alright. What I would do I would close it today.