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# **ORIGIN AND DEVELOPMENT OF RESERVE** **BANK OF INDIA AND ITS FUNCTION**

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## **Abstract:**

The RBI was established on April 1-1935 under RBI Act 1934 on the recommendation of the JHON HILTON Commission 1926 called the Royal Commission on Indian Currency and Finance. RBI headquarters are in Mumbai. RBI has played an important role in the economic development and financial control in the country. RBI issues currency notes to maintain financial stability in the country. Banking structure in India can be divided into two groups: scheduled banks and non-scheduled banks. Scheduled banks are further divided into two types: co-operative banks and commercial banks. This paper explains the role of commercial banks on private banks. RBI was merely introduced as a lender and the borrower, and facilitates recovery.<sup>1</sup>

The Reserve Bank of India or RBI is India's central bank and regulatory body responsible for regulating the banking system in the country. It operates under the Ministry of Finance.<sup>2</sup>

The Reserve Bank of India is the central Bank of India entrusted with the multidimensional role. It performs important monetary functions from issue of currency note to maintenance of monetary stability in the country. Initially the Reserve Bank of India was a private share holder's company which was nationalized in 1949. Its affairs are governed by the Central Board of Directors appointed by the Government of India. Since its inception the Reserve Bank of India has played an important role in the economic development and monetary stability in the country. This paper is an attempt to explore into the role, functions, and contribution of RBI in Indian Economy.<sup>3</sup>

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<sup>1</sup> [https://www.researchgate.net/publication/351599838\\_Role\\_of\\_Reserve\\_Bank\\_in\\_Indian\\_Banking\\_System](https://www.researchgate.net/publication/351599838_Role_of_Reserve_Bank_in_Indian_Banking_System)

<sup>2</sup> <https://pwonlyias.com/reserve-bank-of-india-rbi/>

<sup>3</sup> issn 2278-3660 volume 7, number 1 (2017)

## Introduction:

India is one of the fastest growing economies in the world, with a population over 1.2 Billion, has become the hub for global investment. There are various factors that influence and control Indian economy, one such being, The RBI, one of the oldest institution behind the success of our economy. The RBI is the backbone of Indian economy and because of it, growth in Exports, FOREX, Capital Markets and other sectors of the economy are all happening. It plays an important role in strengthening, developing and diversifying the country's economic and financial structure. It is the apex bank in the Indian Banking System.

The Reserve Bank of India (RBI) is India's Central banking institution, which controls the monetary policy of the Indian rupee. The Reserve Bank of India was established on April 1, 1935, in accordance with the provisions of the Reserve Bank of India Act, 1934. Though originally privately owned, since nationalisation in 1949, the Reserve Bank is fully owned by the Government of India.<sup>4</sup>

A number of other financial institutions also came under the jurisdiction of the public sector during the period. Several other institutional mechanisms were also evolved. All this altered the nature of the relationship between the government and the Reserve Bank, which was left with little say in the structure of the financial system.<sup>5</sup>

## Origin of Reserve Bank of India:

India to set up a banking institution with the elements of a central bank, we find that up to as late as 1920, the functions envisaged for the proposed bank were of a mixed type, reflecting the practices abroad. Also, it was only towards the close of the nineteenth century and the beginning of the twentieth that the term 'central bank' came to be used in India in the official despatches. It was proposed at that time to amalgamate the three Presidency Banks into one strong institution; the central banking functions envisaged for the new institution were not only those of note issue and banker to Government, as in the earlier proposals, but also maintenance of the gold standard, promoting gold circulation as well as measuring and dealing with requirements of trade for foreign remittances. The new bank was to perform commercial banking functions as well, as the Presidency Banks had been doing till then. Even the 'State Bank' proposed by John Maynard

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<sup>4</sup> <https://blogmedia.testbook.com/blog/wp-content/uploads/2017/12/Roles-Functions-of-Reserve-Bank-of-India-GK-Notes-for-Bank-SSC-in-PDF.pdf>

<sup>5</sup> <https://rbidocs.rbi.org.in/rdocs/content/PDFs/90060.pdf>

Keynes in 1913 was to engage in both central banking and commercial banking functions.<sup>6</sup>

The Reserve Bank of India was established following the Reserve Bank of India Act of 1934. Though privately owned initially, it was nationalized in 1949 and since then fully owned by Government of India (GoI)

### **1935- 1949 -**

The Reserve Bank of India was founded on 1 April 1935 to respond to economic troubles after the [First World War](#). The Reserve Bank of India was conceptualized based on the guidelines presented by the Central Legislative Assembly which passed these guidelines as the RBI Act 1934. RBI was conceptualized as per the guidelines, working style and outlook presented by [Dr. B. R. Ambedkar](#) in his book titled “The Problem of the Rupee – Its origin and its solution” and presented to the Hilton Young Commission. The bank was set up based on the recommendations of the 1926 Royal Commission on Indian Currency and Finance, also known as the Hilton – Young Commission.

The original choice for the seal of RBI was the East India Company [Double Mohur](#), with the sketch of the Lion and Palm Tree. However, it was decided to replace the lion with the tiger, the national animal of India.<sup>7</sup> The Preamble of the RBI describes its basic functions to regulate the issue of bank notes, keep reserves to secure monetary stability in India, and generally to operate the currency and credit system in the best interests of the country. The Central Office of the RBI was established in Calcutta (now Kolkata) but was moved to Bombay (now Mumbai) in 1937. The RBI also acted as Burma's (now Myanmar) central bank until April 1947 (except during the years of Japanese occupation (1942 – 45)), even though Burma seceded from the Indian Union in 1937. After the [Partition of India](#) in August 1947, the bank served as the central bank for [Pakistan](#) until June 1948 when the [State Bank of Pakistan](#) commenced operations. Though set up as a shareholders' bank, the RBI has been fully owned by the [Government of India](#) since its nationalization in 1949. RBI has monopoly of note issue.

### **1961 – 1968 -**

As a result of bank crashes, the RBI was requested to establish and monitor a deposit insurance system. Meant to restore the trust in the national bank system, it was initialized on 7 December

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<sup>6</sup> <https://rbidocs.rbi.org.in/rdocs/content/PDFs/89634.pdf>

<sup>7</sup> <https://www.scribd.com/document/438775866/Role-Of-RBI-In-Economic-And-Social-Development-Copy-pdf>

1961. The Indian government founded funds to promote the economy ,and used the slogan "Developing Banking". The government of India restructured the national bank market and nationalized a lot of institutes. As a result, the RBI had to play the central part in controlling and supporting this public banking sector.

### **1969 – 1985 -**

In 1969, the Indira Gandhi-headed government nationalized 14 major commercial banks. Upon Indira Gandhi's return to power in 1980, a further six banks were nationalized. The regulation of the economy and especially the financial sector was reinforced by the Government of India in the 1970s and 1980s. The central bank became the central player and increased its policies a lot for various tasks like interests, reserve ratio and visible deposits. These measures aimed at better economic development and had a huge effect on the company policy of the institutes. The banks lent money in selected sectors, like agricultural business and small trade companies. The Banking Commission was established on Wednesday, 29 January 1969, to analyze banking costs, effects of legislations and banking procedures, including non-banking financial intermediaries and indigenous banking on Government of India economy; with Mr. R.G. Saraiya as the chairman. The branch was forced to establish two new offices in the country for every newly established office in a town. The oil crises in 1973 resulted in increasing inflation, and the RBI restricted monetary policy to reduce the effects.<sup>8</sup>

### **1985 – 1990 -**

A lot of committees analyzed the Indian economy between 1985 and 1991. Their results had an effect on the RBI. The Board for Industrial and Financial Reconstruction, the Indira Gandhi Institute of Development Research and the Security & Exchange Board of India investigated the national economy as a whole, and the security and exchange board proposed better methods for more effective markets and the protection of invest or interests. The Indian financial market was a leading example for so-called "financial repression" (McKinnon and Shaw). The Discount and Finance House of India began its operations in the monetary market in April 1988; the National Housing Bank, founded in July 1988, was forced to invest in the property market and a new financial law improved the versatility of direct deposit by more security measures and liberalization.

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<sup>8</sup> <https://www.seacen.org/file/file/2016/RP98/CBFR-Chapter3.pdf>

**1991 – 1999 -**

the national economy contracted in July 1991 as the Indian rupee was devalued. The currency lost 18% of its value relative to the US dollar, and the Narsimham Committee advised restructuring the financial sector by a temporal reduced reserve ratio as well as the statutory liquidity ratio. New guidelines were published in 1993 to establish a private banking sector. This turning point was meant to reinforce the market and was often called neo-liberal. The central bank deregulated bank interests and some sectors of the financial market like the trust and property markets. This first phase was a success and the central government forced a diversity liberalization to diversify owner structures in 1998.

The National Stock Exchange of India took the trade on in June 1994 and the RBI allowed nationalized banks in July to interact with the capital market to reinforce their capital base. The central bank founded a subsidiary company the Bharatiya Reserve Bank Note Mudran Private Limited-on 3 February 1995 to produce banknotes.

**Since 2000 -**

The Foreign Exchange Management Act, 1999 came into force in June 2000. It should improve the item in 2004-2005 (National Electronic Fund Transfer). The Security Printing & Minting Corporation of India Ltd., a merger of nine institutions, was founded in 2006 and produces banknotes and coins.

The national economy's growth rate came down to 5.8% in the last quarter of 2008- 2009 and the central bank promotes the economic development.

In 2016, the Government of India amended the RBI Act to establish the Monetary Policy Committee (MPC) to set. This limited the role of the RBI in setting interest rates, as the MPC membership is evenly divided between members of the RBI (including the RBI governor) and independent members appointed by the government. However, in the event of a tie, the vote of the RBI governor is decisive.

### **Development of RBI:**

The introduction of the Bill in 1927 was followed by a prolonged debate and discussion, after which the Bill was reintroduced in 1933 as The Reserve Bank of India Bill which was passed by

Assembly in the same year and by Council of States in 1934. The Reserve Bank was established in 1935 as a shareholders' institution in April 1935. The preamble to the RBI Act 1934, states the objective of RBI is 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 included (i) issue of currency; (ii) banker to the Government; and, (iii) banker to other banks. After its establishment, it served as the Central Bank of Burma (Myanmar) up to April 1947, even after it seceded from the Indian Union in 1937. After the partition of India, the Reserve Bank served as the Central Bank of Pakistan up to June 1948 when the State Bank of Pakistan commenced operations. The Bank was nationalized in 1949. The focus and priority attached to various functions by the Reserve Bank have changed over time in line with the economic and financial developments in the country. As in many other countries, matters relating to currency and exchange, such as the question of the monetary standard and the exchange rate, received far more attention than the subject of banking, especially central banking (RBI, 1970). The Bank began its operations by taking over from the Government, the functions that were thus far, performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The existing currency offices at Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore and Cawnpore (Kanpur) became branches of the Issue Department.<sup>9</sup>

Soon after independence, the country began pursuing its development aspirations and the Bank was seen playing a crucial in the process, particularly for the agriculture sector. The developmental role of the Bank became more pronounced in the 1960s, when finance began to be considered as a major catalyst for development. Apart from putting in place, a policy framework for sectoral lending such as priority sector lending norms, the Bank also played a crucial role in establishment of development institutions in the country which specialized in sector-specific finance needs as well as finance infrastructure in the country.

Some of these included the Deposit Insurance and Credit Guarantee Corporation of India, the Unit Trust of India, the Industrial Development Bank of India, the National Bank of Agriculture and Rural Development and the Discount and Finance House of India. Exchange rate related issues and price stability began receiving more attention in the 1970s and 1980s. The breakdown of Bretton Woods stable exchange rate and oil shock of 1973- 74 posed serious balance of payments problem for the country leading to the enactment of the Foreign Exchange Regulation

Act (FERA) 1973, which focused on foreign exchange conservation rather than regulation. Thus, implementation of the FERA and managing scarce foreign exchange reserves received greater attention of the Bank during 1970s

Beginning the 1980s, managing inflation in the economy emerged as a focus area and the monetary framework put in place was an outcome of global thinking in favor of the Monetarist approach. This period saw a significant expansion of the domestic monetary base due to a large budgetary deficit of the Government and the Reserve Bank's financing of these deficits. The Committee to Review the Working of the Monetary System (Sukhamoy Chakravarty 1985)<sup>10</sup> suggested that monetary targeting should be made in a formal and secure manner whereby the monetary targets are decided on the basis of desired growth in output and the tolerable level of inflation (RBI, 2006). The policy framework in the Indian economy saw a major shift beginning the 1990s with a move towards liberalization and globalization with commensurate implications for the role of the Reserve Bank in the economy, which warranted a change in its focus areas as well as operational framework. In the changed scenario, the role of financial markets became increasingly important for meeting the financing needs of the commercial sector as well as for policy transmission. Development of the debt market also received special attention from the Bank during the 1990s. Foreign exchange markets received a major thrust with the replacement of FERA 1973 with a new legislation, the Foreign Exchange Management Act (FEMA) 1999, which focused on facilitating external trade and payments and promoted the orderly development and maintenance of the foreign exchange market in India. The Reserve Bank also absorbed short-term liquidity through repo operations during the 1990s. Apart from developing the financial markets, steps were also taken to strengthen the banking system through addressing non-performing loan problems and taking prudential norms close to international standards.

The liquidity framework went through a major shift in the beginning of the 2000s with the implementation of full-fledged Liquidity Adjustment Facility (LAF) in June 2000 with the policy rate representing the interest rate corridor for monetary policy transmission. During the decade, the Reserve Bank discontinued buying government securities in the primary market under the Fiscal Responsibility and Budget Management (FRBM) Act 2003, imparting autonomy and effectiveness to its monetary and liquidity management operations. Beginning 2005, the Reserve Bank placed a major focus on financial inclusion with several initiatives taken to bring the hitherto excluded population in the ambit of the formal banking and financial sector. Financial

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<sup>10</sup> Chairman of the Committee to Review the Working of the Monetary System.

inclusion efforts during the 2000s differed from earlier efforts as the focus this time was on individuals, rather than an aggregative approach aimed at sectoral and regional levels. Efforts were also made for the promotion of financial literacy to enable the public to avail banking services on the one hand, and to create awareness about the increasing number of fraudulent activities on the other.

Inflation management saw a paradigm shift beginning 2014, with a change in the anchor from WPI-based inflation to CPI-based inflation and the adoption of a disinflation glide path to reduce the inflation rate to below 6% January 2016. The inflation targeting framework was formalized with the signing of an agreement between the Government and the Reserve Bank in February 2015, to reduce the inflation rate to 4+/-2% by 2017-18 and maintain it at that level thereafter.

To incorporate the evolution of monetary and financial developments in the country, the Reserve Bank felt the need to rearticulate, in contemporary terms, its core purpose as given in the preamble to the RBI Act 1934. The purpose was to delineate the Reserve Bank's strategic objectives and provide a framework and backdrop for the formulation of Reserve Bank policies and the charting of its direction. Accordingly, the Reserve Bank issued its 'Core Purpose, Values and Vision' Statement in April 2015. The Core Purpose is defined as fostering monetary and financial stability conducive to sustainable economic growth and ensuring the development of an efficient and inclusive financial system. The Statement also delineated the shared values that guide organizational decisions and employee actions in pursuit of the Reserve Bank's Core Purpose. Setting a vision for itself, the Bank is committed to pursue public interest and common good as a leading central bank that is recognized for its credible, transparent and proactive policies (RBI, 2015).

### **Functions of RBI (India's Central Bank):**

As a central bank, the Reserve Bank has significant powers and duties to perform. For smooth and speedy progress of the Indian Financial System, it has to perform some important tasks. Among others it includes maintaining monetary and financial stability, to develop and maintain stable payment system, to promote and develop financial infrastructure and to regulate or control the financial institutions.

## 1. Traditional Functions of RBI

Traditional functions are those functions which every central bank of each nation performs all over the world. Basically these functions are in line with the objectives with which the bank is set up. It includes fundamental functions of the Central Bank. They comprise the following tasks.

### a. Issue of Currency Notes

The RBI has the sole right or authority or monopoly of issuing currency notes except one rupee note and coins of smaller denomination. These currency notes are legal tender issued by the RBI. Currently it is in denominations of Rs. 2, 5, 10, 20, 50, 100, 500, and 1,000. The RBI has powers not only to issue and withdraw but even to exchange these currency notes for other denominations. It issues these notes against the security of gold bullion, foreign securities, rupee coins, exchange bills and promissory notes and government of India bonds.

### b. Banker to other Banks

The RBI being an apex monetary institution has obligatory powers to guide, help and direct other commercial banks in the country. The RBI can control the volumes of banks reserves and allow other banks to create credit in that proportion. Every commercial bank has to maintain a part of their reserves with its parent's viz. the RBI. Similarly in need or in urgency these banks approach the RBI for fund. Thus it is called as the lender of the last resort.

### c. Banker to the Government:

The RBI being the apex monetary body has to work as an agent of the central and state governments. It performs various banking function such as to accept deposits, taxes and make payments on behalf of the government. It works as a representative of the government even at the international level. It maintains government accounts, provides financial advice to the government. It manages government public debts and maintains foreign exchange reserves on behalf of the government. It provides overdraft facility to the government when it faces financial crunch.

### d. Exchange Rate Management:

It is an essential function of the RBI. In order to maintain stability in the external value of rupee, it has to prepare domestic policies in that direction. Also it needs to prepare and implement the foreign exchange rate policy which will help in attaining the exchange rate stability. In order to maintain the exchange rate stability it has to bring demand and supply of the foreign currency (US Dollar) close to each other.

**e. Credit Control Function:**

Commercial bank in the country creates credit according to the demand in the economy. But if this credit creation is unchecked or unregulated then it leads the economy into inflationary cycles. On the other credit creation is below the required limit then it harms the growth of the economy. As a central bank of the nation the RBI has to look for growth with price stability. Thus it regulates the credit creation capacity of commercial banks by using various credit control tools.

**f. Supervisory Function:**

The RBI has been endowed with vast powers for supervising the banking system in the country. It has powers to issue license for setting up new banks, to open new branches, to decide minimum reserves, to inspect functioning of commercial banks in India and abroad, and to guide and direct the commercial banks in India. It can have periodical inspections an audit of the commercial banks in India.

## **2. Developmental / Promotional Functions of RBI**

Along with the routine traditional functions, central banks especially in the developing country like India have to perform numerous functions. These functions are country specific functions and can change according to the requirements of that country. The RBI has been performing as a promoter of the financial system since its inception. Some of the major development functions of the RBI are maintained below.

**a. Development of the Financial System**

The financial system comprises the financial institutions, financial markets and financial instruments. The sound and efficient financial system is a precondition of the rapid economic development of the nation. The RBI has encouraged establishment of main banking and non-banking institutions to cater to the credit requirements of diverse sectors of the economy.

**b. Development of Agriculture**

In an agrarian economy like ours, the RBI has to provide special attention for the credit need of agriculture and allied activities. It has successfully rendered service in this direction by increasing the flow of credit to this sector. It has earlier the Agriculture Refinance and Development Corporation (ARDC) to look after the credit, National Bank for Agriculture and Rural Development (NABARD) and Regional Rural Banks (RRBs).

**c. Provision of Industrial Finance**

Rapid industrial growth is the key to faster economic development. In this regard, the

adequate and timely availability of credit to small, medium and large industry is very significant. In this regard the RBI has always been instrumental in setting up special financial institutions such as ICICI Ltd. IDBI, SIDBI and EXIM BANK etc.

**d. Provisions of Training**

The RBI has always tried to provide essential training to the staff of the banking industry. The RBI has set up the bankers' training colleges at several places. National Institute of Bank Management ie NIBM. Bankers Staff College i.e BSC and College of Agriculture Banking i.e CAB are few to mention.

**e. Collection of Data:**

Being the apex monetary authority of the country, the RBI collects process and disseminates statistical data on several topics. It includes interest rate, inflation, savings and investments etc. This data proves to be quite useful for researchers and policy makers.

**f. Publication of the Reports:**

The Reserve Bank has its separate publication division. This division collects and publishes data on several sectors of the economy. The reports and bulletins are regularly published by the RBI. It includes RBI weekly reports, RBI Annual Report, Report on Trend and Progress of Commercial Banks India., etc. This information is made available to the public also at cheaper rates.

**g. Promotion of Banking Habits**

As an apex organization, the RBI always tries to promote the banking habits in the country. It institutionalizes savings and takes measures for an expansion of the banking network. It has set up many institutions such as the Deposit Insurance Corporation-1962, UTI-1964, IDBI- 1964, NABARD-1982, NHB-1988, etc. These organizations develop and promote banking habits among the people. During economic reforms it has taken many initiatives for encouraging and promoting banking in India.

**h. Promotion of Export through Refinance:**

The RBI always tries to encourage the facilities for providing finance for foreign trade especially exports from India. The Export-Import Bank of India (EXIM Bank India) and the Export Credit Guarantee Corporation of India (ECGC) are supported by refinancing their lending for export purpose.

**3. Supervisory Functions of RBI**

The reserve bank also performs many supervisory functions. It has authority to regulate and administer the entire banking and financial system. Some of its supervisory functions

are given below.

**a. Granting license to banks**

The RBI grants license to banks for carrying its business. License is also given for opening extension counters, new branches, even to close down existing branches.

**b. Bank Inspection**

The RBI grants license to banks working as per the directives and in a prudent manner without undue risk. In addition to this it can ask for periodical information from banks on various components of assets and liabilities.

**c. Control over NBFIs**

The Non-Bank Financial Institutions are not influenced by the working of a monetary policy. However RBI has a right to issue directives to the NBFIs from time to time regarding their functioning. Through periodic inspection, it can control the NBFIs.

**d. Implementation of the Deposit Insurance Scheme :**

The RBI has set up the Deposit Insurance Guarantee Corporation in order to protect the deposits of small depositors. All bank deposits below Rs. One lakh are insured with this corporation. The RBI work to implement the Deposit Insurance Scheme in case of a bank failure.

### **Conclusion:**

The Reserve Bank was founded on the pattern of European central banks; but the evolution of its functions has undergone radical transformations from traditional central banking in the formative years to that of building institutional infrastructure during the development phase and ensuring financial sector soundness in the reform phase. With the onset of economic planning and along with the structural transformation of the Indian economy, the functions of the Reserve Bank expanded manifold.

Reserve Bank had to take a proactive role in the nation building process in filling the resource gaps of the Governments in Plan financing and in creating necessary financial infrastructure. As a 'mother-of institutions', the Reserve Bank played a crucial role in the development of the financial sector in India. In the initial years, the emphasis was on putting in place the institutional machinery to support developmental planning, whereas in the reform era, the focus has been on developing and nurturing the financial markets.

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