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A STUDY ON THE EVOLUTION OF CENTRAL BANKS: A CASE STUDY 0F INDIA

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ABSTRACT:

The past two decades we have seen various changes in central banks and the way they function. Central banks are something which have evolved so much during the start till now that there has been end number of policy changes and laws in the central banks of most of the countries. These changes are not just seen in any one country but in most of the countries all over the globe. I personally believe that this evolution in the central bank although it faced many many ups and downs financially and politically but this was all for good in each of the country, as its said that modern problems are required to be solved with new methods and they cannot be solved with old policies.

If we talk about the evolution of the central banks on a global basis then there are some countries that have restructured their older institutions as central banks. Where as there are some countries like the countries of soviet union, they have established entirely new central banks.so, in this research report we will study about the progress and downfall of central banks as well as the independence and transparency of the central banks of various nations during the past 10 to 15 years. Although we will be discussing the global perspective of the central banks and comparing it with the central bank of India and analyse where does India stand globally, but this study will mainly be a case study of India wherein we

will be using the data of other countries for the comparison so that we get a detailed data analysis for our research.

1. INTRODUCTION:

1.1 overview:

The central bank in India is known the central bank of India or RBI, the central bank of India, was established in the year 1934 under the Reserve Bank of India Act 1934 (II of 1934). Although the bank was established in the year 1934 that is even before the time India got it's Independence, but the bank commenced it's operations on 1st of April in the year 1935. Initially when the Reserve Bank of India started operating in India as the central bank of the country it had very limited functions as compared to the current scenario. These functions were to ensure the regulation of the issue of the bank notes, in order to maintain monetary stability it was the job of the central bank to maintain reserves and operate the credit and currency system of India in such a way that it is advantageous to the country's economy.

1.2. Background:

Now, coming to history of the central bank of India i.e RBI . During my research I found out that the establishment of the Reserve Bank of India was a long process along with the process of legislation which began in January 1927 that is 7 years before the central bank was actually established as the presentation took place in March in the year 1934. The idea of central bank in India actually evolved from a process that can be traced through the efforts which were made to set up a banking institution in the year 1773 when the governor of Bengal who later became the governor general, proposed his plan for a General Bank in Bengal and in Bihar, the governor was known as Warren Hastings. This general bank was set up in April in the year 1773 itself. This bank which was the general bank had some characteristics of a central bank because it could act as a asset for the revenue collections in some districts. Not just this but other than facilitating government revenue collections the general banks could also take payments on behalf of the merchants, who could also be saved the risk and the expenses involved in making remittances to the depots for manufactured goods. This project was very short lived as the bank got closed in the year 1975. The closing of the bank did not mean that the objectives of the bank were not met, actually it had also made considerable profits.

Now, at the beginning of the year 1806, with the bank of Bengal, the government of India established three main functional banks and these banks were granted the permission to issue notes but up to a certain limit, this went on till the year 1862, till the time government was given the right to issue notes under the paper currency Act. These banks were basically three operational central banks of India, as these banks were trusted with public debt management ad also were liable to manage the cash balances of the government of India. Soon after the government realised that as the economy is growing and as we enter the modern era there felt a need to centralize these government balances which were currently being controlled by three banks. The government started realising that this way economy cannot function systematically so a single bank could increase the banking presence across India. However, as it is not easy to combine the work of three banks into one and function as one single central bank for the whole country, so on this opinion there were a lot of debates which could not reach to the conclusions or consensus. On the proposals of the merging of these three banks and establish a separate central bank.

Later, after many debates the government could reach a conclusion and these three presidency banks were merged in the year 1921, which led to the formation of the Imperial bank of India, which was a commercial bank. The Imperial bank of India performed some central banking functions like it was the banker of the government of a country and it was a banker's bank, alongside the core duty of a bank which was issuance of the currency notes and management of foreign exchange still continued to be the responsibilies of the central government of a country. The running of three presidency banks did give some experience to the government of that time. Experiences such as the managerial and regulatory aspects leading to financial difficulties in the Bombay Presidency bank, which made it difficult for the government to withdraw it's own cash balances. This was the time when government also realised that keeping large balances with presidency banks was not giving any advantages in terms of trade and market. The government could not even instantly withdraw all of its large cash balances as that could lead to crisis. After this experience the government of India was suggested that they should keep it's reserves in it's own custody. After this incidence the establishment of the government treasuries took place. However, later after the establishment of Imperial bank these treasuries were abolished and all asset balances were kept with the Bank as they were also made the only banker to the Government.

2. RESEARCH METHODOLOGY:

To conduct this research report, I devised a methodology that allowed me to understand the evolution of central banks and how it functions, and it's impact on the economy. I tracked down the information through the newspapers, various websites and research papers given in the bibliography after the concluding part of the report.

I followed the following methods to complete my report:

1. With the help of newspapers, articles and websites I studied about the basic information on the central banks.

2. This also helped me understand about what role does a central bank plays in the economy.

3. I tracked down the data of various months and previous years to understand the difference between various changes in policies in the various years.

4. I collected the data on the downfall and rise of the central banks, in which I studied about how the central bank of India went through various ups and downs.

5. After studying the data I have also worked upon the reasons for such changes.

6. The research report also talks about the central banks of various countries

7. While I studied the data daily but covering each and every data was not possible so I took help of some of the research papers by some renowned researchers and economists.

8. On the basis of this research analysis I drew the conclusion of my research.

9. In the abstract I have summarized the main purpose of the study for those who may not have the time to go through the whole report.
10. All the reference sites are attached in the bibliography provided in the end.

3. Theoretical framework:

3.1. ESTABLISHMENT OF THE RESERVE BANK OF INDIA:

The legal process of establishing the Reserve Bank of India began in the year 1927 with the introduction of Gold Standard and Reserve Bank of India Bill in the Legislative Assembly. This bill was passed with provisions for the reserve Bank to take over the management of the currency notes from the Governor-General in the Council. The introduction of this Bill in the year 1927 gave rise to a lot of debates and discussions, after these debates and discussions, this Bill was re-introduced in the year 1933 as "The Reserve Bank of India Bill" which was passed by Assembly in the same year and by Council of States in 1934. In the year 1935, the Reserve Bank of India was established as a shareholder's institute in the month of April. This 1934 act of reserve bank of India states the objectives of RBI which are - 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". There were three main functions of the Reserve Bank of India during the time it was established, these functions were- (1)- issue of currency (rupees), (2)- banker to the Government; and, (3)- banker to other banks.

In the year 1947, after the partition of India, the Reserve Bank served as the Central Bank of Pakistan up till June till the year 1948 when the Bank of Pakistan commenced operations. The Reserve Bank was nationalized in the year 1949. However, in terms of various economic and the financial developments the focus and priorities related to the functions by the reserve bank of India have been changed. As in India like many other countries the focus of the central bank was not just on the subject of banking but they also started prioritizing matters relating to currency and exchange like the question of the monetary standard and the foreign exchange rate became a function of the central bank of India. The reserve 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, also the management of Government accounts and public debt. Soon after independence of the country in the year 1947, India began pursuing its development aspirations and the reserve Bank was seen playing a crucial in the process, particularly for the agriculture sector. The role of central ban became even for prominent and important during the 1960s as tis was the time when finance was starting to be considered as a major catalyst for the development process of the country. The reserve bank of India was not just doing a good job in framing policies for the country but they were also 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. During the years 1970s and 1980s, exchange rate related issues and price stability began receiving even more attention.

Beginning the 1980s, managing the inflation in the economy became a focus area and the monetary framework put in place was an outcome of global thinking in favor of the Monetary 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 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. Beginning the 1990s the policy framework in the Indian economy saw a major shift with a move towards liberalization and globalization with appropriate implications for the role of the Reserve Bank in the Indian economy, which warranted a change in its focused areas as well as operational framework.

Beginning of the 2000s the liquidity framework went through a major shift with the implementation of full-fledged Liquidity Adjustment Facility (LAF) in June in the year 2000 with the policy rate representing the interest rate corridor for monetary policy transmission. During this 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 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.

4. Analysis:

4.1 Independence and transparency of central banks: case of India-A number of economists and researchers have investigated/researched and constructed an index of independence of central banks, the have basically constructed a framework within which central bank of some nations operate and constructed index to which the central banks of their countries are independent. These indexes are based on some traits like length of bankers' terms, or the role government officials on the bank board and even on the contract among the government and the central bank.

Some of the major findings of these researchers or economists are that countries with a more independent central bank have less comparatively lower inflation and these countries did not have higher unemployment, they also had lower real GDP growth or comparatively larger business cycles.

In India, the RBI is the central bank of India, it is a government organisation like other public sector unit. At present the reserve bank of India (RBI) is not as independent as other nations, thus it does not enjoy the power to conduct an independent monetary policy.

Although the issuing of ad hoc T- bills has been abolished from India recently but the central government of India has to borrow from the reserved bank of India the reason behind this need is when the fiscal deficit cannot be covered by additional taxes or borrowing from markets then the government of India has to borrow. Undoubtedly, the RBI has been putting strict controls on the member bank of RBI so that they cannot lend to anyone beyond a limit, but still it has to lend to the central government whenever there is need for monetisation of fiscal deficit. As things stand today, the achievement of India's financial arrangement relies upon the accomplishment of financial approach because of the present money related monetary connection. Furthermore, this empowers the government of India to enjoy inflationary financing of its fiscal deficit. So, the only way to control inflation in India at the current period is the link between various monetary and fiscal policies. This can only become true if and when the reserve bank of India becomes an independent unit, that is free from all government control.

Economists have proved that the countries which have an independent central bank for example Germany, Switzerland, and the USA, they have always tended to have a comparatively lower inflation rate as compared to the countries with a dependent central bank like India, Spain, etc. Although an independent or dependent central bank does affect the inflation rate of a country but still is not directly correlated with the level of employment or the real GDP growth rate, nor does it involve any trade-off intead it has a benefit of lower inflation without any visible cost.

“Now, talking about some practical figures of the ongoing activities in the central bank (RBI), recently The Reserve Bank of India has approved a $ 24.4 billion payout to the federal government, because of which many questions where raised pointing out that has Prime Minister Narendra Modi had pushed the bank into a more political role rather than taking it towars making an independent bank?

Now, when the central bank approved $24.4 billion (1.76 trillion rupees) payout then the central banks role was turned upside down, now it was not the main player of the monetary system. Some critics have also said that the transfer came three days after the finance minister Nirmala Sitharaman announced the plans to give a boost to India’s shuttering economy, which according to some critics was not a coincidence.

Prime Minister Narendra Modi has been under pressure to boost growth of the economy since after his Hindu nationalist party which is the Bhartiya Janata Party(BJP) was re elected in May. The problem arises that the his government has still been unsuccessful in order to increase tax revenues to pay for all programmes. During his previous term Modi has tried demonetization which did wash out some corruption and but its main aim was to increase the tax base which was not a huge success, he then introduced one tax system which is the GST (goods and services tax) but those high tax rates put break in the demand and it has also failed a little bit to keep up with its potential.

The government says that the RBI's capital has risen and it can be used more efficiently so now the government has now decided to take RBI's excess fund that is known as Contingency Risk Buffer (CRB).

Some of the members of the party also says that the RBI's total capital of 10.5 trillion rupees , between 5.3 trillion and 7.3 trillion rupees was excess and that some of that amount could be transferred to the government's accounts. Some of them also asked RBI to stand with them in order to fight with the issues of economic growth and development of the country as India is a developing country it requires more financial support which can be expected to be received from the Reserve Bank of India.

Now ofcourse this idea of borrowing the reserved bank's fund faced some criticism, critics said that nowhere around the globe does a central bank give away its contingency risk buffer(CRB), because as the name it self suggests it is the amount which should be kept with the central bank for the time of maximum monetary problems faced by the economy. They also say that since the government is not respecting central bank's independence now may have to face financial problems in the country in future.

The critics also have disclosed that the contingency fund is reserved from the profits received by the RBI but during last few years 100% of the profits are being transferred to the government whereas around 46.5% of the profits should be transferred to the RBI's contingency funds account. Even the Jahan committee set up by the reserve bank of India in 2018 suggested that the contingency reserves are only between 5.5%-6.5% whereas they should be maintained at around 9%-10%. The ratio has now declined from 10% in 2013 to 5.34% in 2019

5. CONCLUSION:

To conclude these above research papers and the government issues and poloicices we can understand that there were two main aped narratives about the increased transfer of the Reserve Bank Of India surplus; which were The first one is: the government, facing a resource crisis, has arm-twisted the "Reserve Bank of India to transfer some of its reserves, which is almost in the nature of family silver. This is not good for the country. As when and if the country faces a crisis, the Resreve Bnak of India may not have the desired amount of money to protect it. Also it denotes an erosion of the RBI's independence."

"The second, on the contrary, is: the central bank is a unique institution; it is backed by the faith reposed on it by the central government, and therefore, a huge amount of reserves with the central bank is in the nature of idle cash which could have been utilized more productively in the economy. This year, the central government has done precisely this."

Economists have proved that the countries which have an independent central bank for example Germany, Switzerland, and the USA, they have always tended to have a comparatively lower inflation rate as compared to the countries with a dependent central bank like India, Spain, etc. Although an independent or dependent central bank does affect the inflation rate of a country but still is not directly correlated with the level of employment or the real GDP growth rate, nor does it involve any trade-off instead it has a benefit of lower inflation without any visible cost.

Some of the economists are also of the view that there is no way that a democratic and a developing country like India can have a completely independent central bank but they are on the other hand also of the opinion that the central bank even though it is not completely independent it should still be given a right to take part in the decisions of the central government of the country, if not all the major decisions then at list the decisions related to the financial activities taking place in the economy or which can be harmful for the economy and people.

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