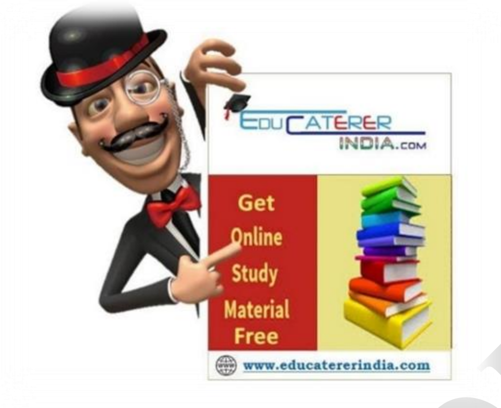
Minimum Reserve System of RBI- Explained



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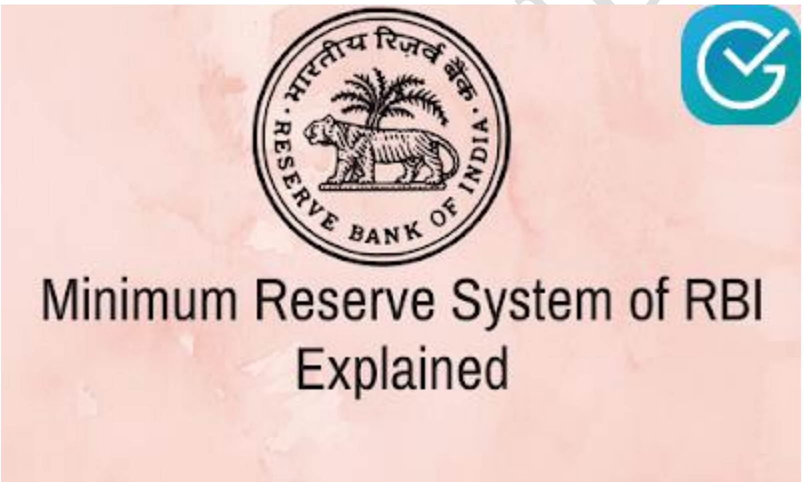

Introduction

The Reserve bank of India has the authority to issue currency. The current system of Indian government to issue notes is “Minimum Reserve System”. Under this policy, the minimum reserves to be maintained in the form of gold and foreign exchange should consists of rupees 200 crore. Out this reserve, the value of gold to be maintained is rupees 115 crore. This system was introduced in 1956 replacing the proportional reserve system, and continues till date.

Currency Issue Department

The RBI has Issue Department under it for issue of currency. Minimum reserves refer to the reserves maintained by the RBI against the notes issued. The currency issued is the liability to RBI, as it has to pay the currency holder the amount promised on the currency note. Therefore RBI maintains certain reserve against this liability. The department can issue any number of notes maintaining the aforementioned reserve. But RBI has certain rules for issue of currency which is based on the economy of the country. This system is inflationary in nature. This system has flexibility to increase the money supply to meet the transactional needs of the people in the country.

RBI Act of 1935

The issue of currency note is under the RBI Act of 1935. There are a number of amendments made under this act. The present currency note cannot be issued by the RBI in unlimited amount as it is an inconvertible paper note. Under the current provisions, additional currency can be issued by the EBI without maintaining the additional reserves.

Advantages:

- This method is elastic in nature.
- Increase in issue of notes does not require increase in the minimum reserves.
- This method is reliable during financial crisis and emergencies like war, earth quake and floods.
- This method is suitable for poor and developing countries.

Disadvantages:

- There is a danger of over issue thereby increasing the money supply which brings inflation.
- The effective use of monetary policy measures can show good result to control the inflation.

How new currencies are issued by RBI-

- Based on the economic growth of the country, RBI decides to expand the money supply. With increase in the economic growth, the amount of newly issued money increases. This maintains the economy without falling into inflation.
- Each unit of new currency issued is a liability to the RBI, as it has to pay to the bearer the amount promised on the currency. To be able to pay this amount, there should be equal amount of assets with the RBI. Therefore, RBI procures certain assets which are equal to the newly issued currency. These assets are in the form of government bonds or foreign assets. The foreign assets are kept at the Banking Department and the reserves to be maintained are kept at Issue Department.
- The assets to be maintained by the RBI as a backup of the currency to be issued consists of gold in the form of gold coins and gold bullion, foreign securities, government of India securities , commercial paper, internal bills of exchange and rupee coin.