

UPSC 2020

General Studies Mains – III

Indian Economy Notes

Topic – Cash Reserve Ratio (CRR)

Cash Reserve Ratio or CRR is the minimum amount as specified by the Central Bank, to be maintained by the Commercial banks of the public deposits with the Central Bank.

This article will upkeep you with CRR, its background, advantages and importance of Cash Reserve Ratio, Effects of CRR on Banks, depositors and interest rates and the need to maintain Cash Reserve Ratio.

Aspirants of competitive exams like UPSC exam, Bank exam, RRB, SSC and other [Government exams](#) must be well versed with CRR. Cash Reserve Ratio is an important topic for the general awareness section of all the competitive exams.

Table of Contents:

What is the Cash Reserve Ratio?
Definition of CRR
Need For Banks To Maintain CRR
Advantages Of CRR
Importance Of Cash Reserve Ratio
Effects Of CRR
Cash Reserve Ratio In Gist

What is the Cash Reserve Ratio?

CRR is an essential monetary policy tool used for controlling the money supply in the economy, a regulation implemented in almost every nation by the Central Bank of that country.

CRR rate is the minimum percentage of cash deposits (as specified by RBI) that must be maintained by every commercial bank as per the requirement of the Central Bank i.e. RBI.

Cash Reserve Ratio Rate is computed as a percentage of the net demand and time liabilities of each bank. Net Demand and Time Liability is reached with the total of the savings account, current account, and fixed deposit balances.

Though the permissible range of CRR rate is between 3 to 15%, the current CRR of India is 4%. That means banks have to keep 4 rupees with the RBI whenever their deposit increases by 100 rupees. Higher CRR means lower amount of money available with banks to lend out or invest i.e. lower would be the liquidity and vice versa.

Definition of CRR

Cash reserve Ratio is a particular minimum amount of the total deposits of customer that needs to be maintained by the commercial bank as a reserve either is cash or as deposits with RBI. The CRR rate will be fixed as per the guidelines of the Central Bank.

Explanation - The amount specified as the Cash Reserve Ratio is held or reserved in cash or cash equivalents with RBI. The aim of CRR is to ensure that banks do not run out of cash to meet their depositors' payment demands.

Need For Banks To Maintain CRR

The cash flow of the entire economy is constantly worked and monitored by RBI. The Reserve Bank of India has several monetary instruments to control the economy in terms of different aspects. One such monetary tool is the cash reserve ratio or CRR rate. Every commercial bank is mandated by RBI to abide by the specified CRR rules provided to each bank.

However, when CRR rate for the amount maintained with RBI is high, the liquidity in the economy will be low. Cash Reserve ratio works vice versa, the lower the CRR reserved with the RBI, the higher will be the economy's overall liquidity.

- The overall liquidity is managed and administered thoroughly when all the commercial banks maintain the necessary CRR rate, thus benefiting each bank.
- Maintaining the specified Cash Reserve ratio helps banks hold the right amount of funds with them and never fall short of it when needed by their depositors for personal needs.

Advantages Of CRR

CRR helps in spreading money circulation in the economy to manage the overall liquidity. CRR rate is fixed as per the money supply in the financial market. When there is an increase in monetary supply, the RBI instantly increases the CRR to remove the excess funds. Similarly, during the case of liquidity shortage or decrease in the monetary supply in the economy, RBI will decrease the CRR rate to let out more money into the market. Let's take a look at other advantages of Cash reserve ratio.

- CRR helps commercial banks to build and sustain the solvency position.
- It ensures the liquidity system is consistent and maintained well in all commercial banks.
- RBI gets to control and coordinate the credit maintained by banks through CRR rate which helps to have a smooth supply of cash and credit in the economy.
- When CRR rate is reduced by RBI, commercial banks are able to offer more advances to borrowers which in turn increases the flow of cash to the public.

- CRR helps in improving the declining rate by absorbing the liquidity when market interest rates go down intensely.
- Cash reserve ratio implementation is more effective than the other monetary instruments Like Market Stabilization Scheme bonds. Mainly because MSS bonds take a lot of time in controlling the liquidity system in the country.
- During the surplus rupee situation, CRR plays a constructive role in easing the financial environment.

Importance of Cash Reserve Ratio

Cash Reserve Ratio maintained by banks holds importance for both Banks as well as the depositors.

In case of depositors, when the banks sincerely maintain the required CRR rate, depositors don't have to worry for their deposits as a portion of their money is absolutely safe in the form of reserve maintained with RBI.

The importance of CRR for banks is as mentioned below:

Banks allow customers to open deposits mainly for lending. Banks like to lend a maximum amount of funds to borrowers and retain very little money with themselves for other purposes. Therefore, banks like it when the CRR rate is low.

Maximum lending by the banks helps them achieve high profits. However, banks do have enough funds to meet a sudden demand for withdrawals when they use a major portion of their money for lending purposes.

This is where CRR comes into the picture. The Cash Reserve ratio rate is fixed by RBI in order to avoid such situations where the bank cannot meet repayments due to shortage of funds.

Effects Of CRR

First of all, the chief goal of CRR is to ensure that a small portion of funds is always available against the deposits. Second, is to enable the RBI control rates and overall liquidity in the nation.

Now, banks prefer CRR when it is low because they need to maintain the specified ratio of funds with RBI without earning any interest on the reserved fund that means the money is kept for free.

The increased CRR rate means that banks have low lending capacity in terms of funds. Consequently, banks would like to open more deposit accounts. Also, Banks will increase the interest rate which will discourage borrowers from applying for loans because high-interest rates indicate higher loan expenses.

If any depositor has invested in bank stocks, then increased CRR rate indicates that their bank will have lower margins.

Similarly, when CRR rate is low, banks have more money to invest in other businesses this reduces the interest rates charged on loans.

Also, low cash reserve ratio means money supply of the banking system will increase. Increased money supply means high inflation.

Cash Reserve Ratio In Gist

The Cash Reserve Ratio or the CRR is a regulation used by the Central Banks in most countries by which it sets the minimum fraction of customer deposits and currency that every commercial bank is required to hold as reserves with themselves. The required reserves are generally held in the form of deposits made with the central bank, or as cash physically stored in the vaults of the banks. The CRR is also called the Reserve Requirement.

The CRR is often used as a monetary policy tool by the central bank to influence the country's interest and borrowing rates by altering the funds available for banks to make loans with. In the West, central banks seldom change the CRR since it would cause instant liquidity problems for banks having low excess reserves. There, they normally prefer using open market operations like selling and buying government bonds to control the monetary policy. In China, the central bank (The People's Bank of China) utilises the CRR as a tool to fight inflation. It had increased the reserve requirement 10 times in 2007 and 11 times since 2010 beginning.