



Mains Practice Question

Q. What are open market operations (OMOs) and how do they affect the money supply and interest rates in the economy? (250 words)

11 Oct, 2023 GS Paper 3 Economy

Approach

- Begin with a concise introduction that defines what open market operations are.
- Discuss how OMOs affect the money supply. Also, explain how OMOs influence interest rates.
- You can conclude the answer by mentioning their significance in the context of monetary policy.

Introduction

Open Market Operations (OMOs) are one of the primary tools used by central banks, such as the Reserve Bank of India, to adjust the liquidity in the economy. OMOs involve the buying and selling of government securities, such as Treasury bills, bonds, and notes, in the open market.

Body

How OMOs work and their impact on the money supply and interest rates:

- **Buying and Selling Securities:** When a central bank wants to increase the money supply, it conducts OMOs by purchasing government securities from banks and other financial institutions in the open market. Conversely, when it aims to reduce the money supply, it sells these securities to the market.
- **Impact on Money Supply:**
 - **Buying Securities (Expanding the Money Supply):** When the **central bank buys securities, it injects money into the banking system.** Banks receive cash in exchange for the securities they sell to the central bank. This, in turn, increases the reserves of commercial banks, allowing them to lend more money to businesses and consumers. As a result, the money supply in the economy expands.
 - **Selling Securities (Contracting the Money Supply):** Conversely, when the **central bank sells securities, it takes money out of the banking system.** Banks pay for these securities with their reserves, reducing their ability to lend. This leads to a decrease in the money supply and can make borrowing more expensive for businesses and individuals.
- **Impact on Interest Rates:**
 - **Buying Securities (Lowering Interest Rates):** An increase in the money supply resulting from **central bank purchases puts downward pressure on short-term interest rates. When banks have more money to lend** and compete for borrowers, they tend to lower interest rates to attract borrowers. This can make borrowing cheaper, stimulating economic activity.
 - **Selling Securities (Raising Interest Rates):** Conversely, when the central bank sells securities and contracts the money supply, it can lead to an increase in short-term interest rates. With less money available for lending, banks may charge higher interest rates, making borrowing more expensive. **This can help cool down an overheating economy**

or combat inflation.

Conclusion

Overall, OMOs are a versatile and effective tool for central banks to fine-tune the money supply and interest rates in an economy. They play a crucial role in achieving the central bank's monetary policy objectives, such as controlling inflation, promoting economic growth, and maintaining financial stability.

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