Open Market Operations: Merits and Demerits

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Abstract

Open market operations refer to the sale or purchase of government securities in the open market by the central bank to the commercial banks in order to control the amount of credit flow in the economy. This method of controlling the credit flow in the economy is particularly followed during a state of inflation. In India the Reserve Bank has engaged itself in open market operations almost on a regular basis and successfully controlled the flow of credit. This article aims to explore the merits and demerits of open market operations. One of the greatest merits of open market operations is that it enables the central bank to maintain its control on the commercial banks and the economy of the country. On the other hand to make the policy of open market operations successful the capital market has to be organized.

Key words: open market operations, government securities, central bank, commercial banks.

Introduction:

Open market operations refer to the sale and purchase of government securities in/ from the open market by the central bank. However, in modern economics this term also refers to the sale and purchase of not only government securities but also of other papers in/ from open markets. The main objective of open market operations is to influence the amount of funds left with commercial banks, thereby putting an impact on the amount of funds in the hands of the citizens of the country.

During times of inflation, the central bank prefers to sell government securities and other papers in the open markets. After purchasing these from the central bank commercial banks are left with a low level of funds. Hence, they have to maintain a low amount of reserve with the central bank. Thus, their loan allowance capacity goes down and there is a shortage of funds in the hands of the citizens of the country. As amount of funds in the hands of the people are less, so their demand for commodities also go down, thereby lowering levels of inflation. Thus open market operation can help in the lowering of levels of inflation.

Just the reverse happens during recession. During recession the central bank purchases government securities and other papers from the hands of the commercial banks. Thus commercial banks are left with huge amount of funds with them. Hence, their capacity to give loans to citizens also increases. In such a phase, people can get more funds from the commercial banks and that also quite easily. Thus, demand for commodities start to get impacted. Due to availability of more funds in their hands demand for commodities rise steadily. This puts a thrust to investment, which impacts the supply of commodities in the markets. In order to supply more of the commodities in the market more labor has to be employed. Thus, employability comes down and the recession gets controlled. This is how open market operations have been a very effective way to control and get rid of recession.

Through open market operations the central bank can put a significant influence on the amount of credit that banks may allow or disallow. It is a very effective financial tool for controlling the credit market. In developing economies usually open market operations have not been very successful because in such economies the credit market is not very organized.

Literature Review:

1. Evidence from USA:

Campbell R. Harvey of Duke University, Durham, USA and Roger D. Huang of University of Notre Dame, Notre Dame, USA prepared a research article named "The impact of the Federal Reserve Bank's open market operations" which was published in Journal of Financial Markets in 2002. In this research the researchers first of all found out the previously unavailable data about open market operations from 1982 to 1988 and used this data to throw light on the impact of open market operations on foreign currencies and fixed income instruments. The results detailed a dramatic increase in volatility during Fed Time, consistent with market expectations of Fed intervention during this time interval. It was found that there was little systematic difference in market impact between reserve draining and reserve adding operations. The results suggested that the markets are potentially confused about the purpose of the open market operations.

2. Evidence from Kenya:

Godfrey Kampan Putunoi prepared a research paper titled "The Effectiveness of Open Market Operations in Monetary Policy Implementation: The Case of Kenya" in 2015. The researcher in this research made an effort to judge the effectiveness of open market operations in monetary policy implementation in Kenya. The issue was tested empirically by assessing the impact of a monetary policy shock on output, prices and the nominal effective exchange rate for Kenya using quarterly time series data spanning from 1997Q4–2014Q1. By usage of techniques of Vector Auto Regression, the researcher found that an exogenous rise in repo rate tends to be followed by a decline in prices and an appreciation in the nominal exchange rate but is insignificant on output. The researcher recommended that growth of financial sector in Kenya is urgently required for economic policies to be successful in Kenya.

3. Evidence from Nigeria:

A paper titled "Does Open Market Operations as a Monetary Operation tool have Impact on Price Stability in Nigeria?" was prepared by J.U.J. Onwumere, G. Ibe Imo and Uche Boniface Ugwuanyi in 2012. In this paper the researchers commented that open market operation was introduced in Nigeria in 1993. Since then it has been extensively used by the central bank along with many other financial tools. However, there seems no significant reduction in the level of inflation in this country. The level of inflation in Nigeria has never been reduced to single digits on a consistent basis. Under such circumstances, the researchers attempted to study the success of open market operations as a tool of monetary operation for bringing price stability in Nigeria from 1993 to 2007. Using OLS regression model the researchers found that open market operations have positive non-significant impact on price stability in Nigeria. The results also revealed that there was a positive correlation between open market operation and consumer price stability of the Central Bank of Nigeria for the period. Therefore open market operation remains a useful tool. Hence it was recommended by the researchers that it should be used in conjunction with other relevant ones in the maintenance of price stability in Nigeria.

Analysis and Interpretations:

On studying the fundamental concepts and the literatures mentioned in the "Literature Review" portion of this article, the following merits and demerits of open market operations have been reached.

- **Merits:**
  - The main agent in open market operations is the central bank. The central bank is very powerful within the economy as it is to a huge extent that the central bank is one of the controllers and determinant factors of the economy. Hence, it is easy for the central bank to conduct open market operations. The commercial banks and other banking institutions are below the central bank in the hierarchy and so they are bound to listen to what the central bank says for the betterment of the economy. Hence, conduction of open market operations is a very simple economic tool.
  - Another merit of open market operation is that the moment the central bank asks the commercial banks to sale or purchase government securities or other securities, they have to do so. This is because as it has been put earlier that the commercial banks are below the central bank in the banking hierarchy. Thus, open market operations can be implemented very quickly. It saves a lot of time compared to other such economic tools.
  - The open market operation can be used to curb inflation and recession. These are two of the most important problems that the economy of any country may face.

Thus, open market operation is very commonly used. It has gone through evolution and is able to adapt itself with the changing economic scenarios.

- Open market operations indirectly help to put a thrust towards generation of employment within the country.

- **<u>Demerits:</u>**
  - In a globalized world the economies of the various countries are inter connected with each other. It is not necessary that the economic problems in a country are due to internal factors. These days it is very common that economic problems arise as a result of the repercussion of economic problems in some other country. The recession of 2008 that started in USA impacted many other nations like UK, Japan, Australia and even India to some extent. This is a great example of economic problems of one nation creating problems in another.

    Open market operations involve two parties mainly. One is the central bank and the other is the commercial banks. These commercial banks include those operating in the nation from where the central bank is. The central bank has no control on commercial banks operating outside the country. Thus, open market operation may be conducted within the nation only. In today's globalized world when a lot of problems arise due to economic problems in other countries, in such a scenario open market operation is not an answer. That's why many modern economists believe that open market operations have lost their edge in the post globalization period.
  - Open market operations can be conducted in economies where the banking structure and the capital market are organized. In developing economies generally it is seen that the banking structure is not well organized. So when the central bank wants to conduct open market operations the commercial banks may not necessarily listen to it, thereby making open market operations a failed economic tool in such economies. Similarly, when the capital market is not organized loans may be taken by citizens of the country from local money lenders. In such a case open market operation cannot be a success. Hence, one of the biggest and most important limitations of open market operations is that it can be successfully implemented in developed economies but not in developing economies.
  - Thirdly, open market operations can be successfully implemented in economies where there are no restrictions on holding of government securities and other securities. But in today's world there are such restrictions commonly prevalent, the objective being reduction of concentration of wealth, proper distribution of

wealth, spreading financial security among citizens etc. Hence, in today's world it is difficult to implement open market operations.

Recommendations and Suggestions:

Open market operations is very simple to understand and easy to implement. Classical economists believed that open market operations may not be implemented successfully in developing economies. It is true that in order to make open market operations successful the capital market should be organized. More importantly, the commercial banks should be ready to listen to the instructions of the central bank during open market operations. But in reality it has been observed in places where the banking hierarchy is not properly established and commercial banks may not listen to the instructions of the central bank, there also open market operations can be of immense help to the central bank. Open market operations slowly and gradually establish the banking hierarchy and the supremacy of the central bank in the banking system of the country. When periodical instructions are given to the commercial banks by the central bank, at the initial phase the commercial banks may not be eager to listen to such instructions. However, with time they fall into the loop and start to listen to these instructions. Thus, open market operations may not successfully be conducted in developing economies at the first phase but they have an impact. When the central bank of the country repeatedly conducts open market operations in a developing economy, with repeated attempts it starts to gain importance. Hence, effort can be given to conduct open market operations in developing economies, too.

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