Theory of Liquidity:

→ **Liquidity**
- → how quickly you can get your hands on your cash
- → means to get your money back whenever you want it.
- → = emergency savings account (or) cash that you have which you can use in case of any unforeseen happening/ financial set-back.
- → Egs of liquid assets: (Cash, savings account, checkable account) → can be withdrawn as & when required.

→ Keynes theory: (Theory of liquidity preference)
[Theory of money supply & money demand]

Interest rates balance money supply & money demand

- **Nominal** → rate of interest before considering inflation (without considering inflation)
- **Real** → rate of interest an investor, a saver or a lender expects to receive (receives) after allowing for inflation.

Inflation rate = Nominal interest rate − real interest rate.

Open market operations: (OMO)

→ OMO are the activities organised by the RBI by sale and purchase of govt. securities (g-secs) to control money supply conditions.

→ RBI sells g-secs in open market ⇒ suck out liquidity from the system. → we pay money → liquidity ↓.

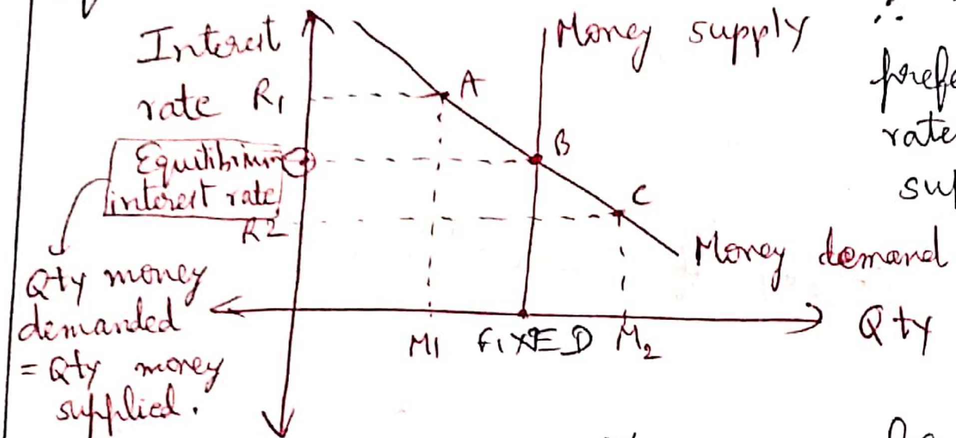
→ RBI buys g-secs ⇒ infuse liquidity into the system. they pay ⇒ we get money → liquidity ✓

→ RBI carries out OMO through commercial banks and not directly with the public.

→ ↑ money supply in the economy ⇒ RBI purchases g-secs.

[interest rate is opportunity cost.]

↳ Equilibrium in the money market :



∴ Theory of liquidity preference ⇒ interest rates balance money supply & demand.

→ as discount rate ↑ses ⇒ money borrowed by commercial bank ↓ses

→ Money supply is fixed by RBI and is independent of interest rates.

→ interest rate = R1 > eq. interest rate ⇒ M_1 = qty of money ppl want to have < Money supplied by RBI ⇒ Surplus of money puts downward pressure of interest rate. (A to B)

→ interest rate = R2 < eq. interest rate ⇒ M_2 = qty of money ppl want to have > Money supplied by RBI ⇒ shortage of money put upward pressure of interest rate from C to B.

→ So, the forces of money supply & demand push the interest rate towards eq. where the ppl are satisfied with money supplied by RBI.