Open Market Operations (OMO)

An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stability in government securities market. This involves meeting the demand of base money at the target interest rate by buying and selling government securities, or other financial instruments. Monetary targets, such as inflation, interest rates, or exchange rates, are used to guide this implementation.

Since most money now exists in the form of electronic records rather than in the form of paper, open market operations are conducted simply by electronically increasing or decreasing (crediting or debiting) the amount of base money that a bank has in its reserve account at the central bank. Thus, the process does not literally require new currency. However, this will increase the central bank's requirement to print currency when the member bank demands banknotes, in exchange for a decrease in its electronic balance.

When there is an increased demand for base money, the central bank must act if it wishes to maintain the short-term interest rate. It does this by increasing the supply of base money. The central bank goes to the open market to buy a financial asset, such as government bonds. To pay for these assets, bank reserves in the form of new base money (for example newly printed cash) are transferred to the seller's bank and the seller's account is credited. Thus, the total amount of base money in the economy is increased. Conversely, if the central bank sells these assets in the open market, the amount of base money held by the buyer's bank is decreased, effectively destroying base money.