Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: About Operation Twist and its significance; RBI: structure and functions

News: The yield on the 10-year government bond fell 15 basis points on Friday, its steepest fall in two months, after the Reserve Bank of India (RBI) conducted a special open market operation—simultaneously buying long tenor bonds and selling short-tenor government bonds—dubbed ‘Operation Twist’ by the market.

Background

The concept was drawn from US Federal Reserve’s Operation Twist that was announced in September 2011 and ran through end-2012 to make long-term borrowing cheaper and spur bank lending. The Fed had swapped short-term bonds for longer-term debt. The policy was effective as the term premium dropped to a low of 33 bps in mid-2012, from around 70 bps.

Objective of Operation Twist

The simultaneous sale and purchase operation has a two-pronged objective:

- Lowering the steep term premium at the longer end of the yield curve despite the RBI’s accommodative monetary policy, and
- Surplus systemic liquidity and correcting yields at the shorter end, which had dropped below the benchmark rate of 5.15%.

The yield on the 2029 benchmark bond fell as much as 15 bps to 6.604%, the steepest fall since 9 October. While the yield on the 14-year government paper slid 20 bps, the yield on the 2020 bond jumped 5 bps. One basis point is a hundredth of a percentage point.

The RBI on Thursday said it will purchase Rs.10,000 crore of the 10-year benchmark bonds, and sell an equal amount of debt maturing in 2020 through an auction on 23 December, making Operation Twist liquidity-neutral.
Significance of the move

- Operation Twist was aimed at bringing longer term yields lower. Despite the 135 bps repo rate cut in the current cycle (between February and December 2019), the spread between 10-year bond yield and the repo has widened to 170 bps, much higher than the average spread of 55 bps during the 2015-2017 easing.
- The so-called twist announced will supply more securities to the market in the tenor segment where liquidity was influencing buying interest (up to 1 year), and purchase segments where market liquidity wasn’t converting to risk capital.
- RBI announced the special open market operation to boost transmission, akin to a ‘twist’ to change the maturity profile of its holding of government bonds.
- The policy stance is accommodative to support growth. Bonds have been under pressure over the past few sessions after S&P warned that it may downgrade India’s debt, and indications of a pause by the RBI after an aggressive rate cut cycle. Between 4 December, the day before the policy statement, and 19 December, the 10-year bond yield had jumped over 30 bps.

Way ahead

Analysts will now await the Union budget to see if the government is able to meet its fiscal deficit targets.

While the current operations of the RBI may temporarily start reining in term spreads, the government also needs to actively court foreign capital to part-finance its deficit, at least in the near term. This can be rule-based to avoid risk of excesses, but must be done for now given the stark paucity of domestic savings.

About RBI

- Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India. RBI started its operations from April 1, 1935. It was established via the RBI act 1934, so it is also known as a statutory body. Similarly, SBI is also a statutory body deriving its legality from SBI Act 1935.
RBI did not start as a Government owned bank but as a privately held bank without major government ownership. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government.

After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned bank.

Hilton Young Commission

Hilton-Young Commission was the Royal Commission on Indian Currency and Finance set up by British Government of India in 1920s. In 1926, this commission had recommended to the government to create a central bank in the country. On the basis of mainly this commission, the RBI act was passed.

Headquarters of RBI

Original headquarters of RBI were in Kolkata, but in 1937, it was shifted to Shahid Bhagat Singh Marg, Mumbai.

Main functions of RBI

- To work as monetary authority and implement its Monetary Policy
- To serve as issuer of bank notes
- Serve as banker to central and state governments
- Serve as debt manager to central and state governments
- Provide ways and means advances to the state governments
- Serve as banker to the banks and lender of last resort (LORL) for them
- Work as supervisor and regulator of the banking & financial system
- Management of Foreign Exchange Reserves of the country
- Support the government in development of the country