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

News: The Reserve Bank of India (RBI) has put out a press release saying it wants to buy 10-year government securities worth Rs.10,000 crore and wants to sell 1-year government securities worth Rs.10,000 crore. This move has been labelled Operation Twist.

How does Operation Twist get its name?
The US Federal Reserve was the first central bank that attempted such an exercise of buying and selling government securities at the same time. This happened in 1961. At that time, the “twist” was a new dance craze sparked by singer Chubby Checker. Since then the name for such an exercise carried out by a central bank has stuck. Much later, Operation Twist was tried in the US in the aftermath of the financial crisis. In this case, the Federal Reserve purchased government securities with maturities varying from six years to 30 years and sold government securities with maturities of three years or less.

Why is this called Operation Twist?
The idea is to twist the yield curve. The yield curve is a graph that plots the yields of government securities (or other financial securities) of different maturities. The yield is the per-year return an investor can earn on a financial security by staying invested in it till maturity. When a central bank buys government securities, the prices go up. At a higher price, the yields or the returns come down as the interest paid on the securities stays the same. Vice versa, when the bank sells government securities, the prices fall and the return or the yield on the security goes up. This creates a visual effect of a twist in the yield curve.

Will money supply increase because of RBI’s move?
If the central bank buys government securities a few times, it will increase the money supply in the economy, which is likely to lead to higher inflation, with a greater amount of money chasing the same amount of goods and services. By selling securities worth a similar amount, RBI will not end up increasing the money supply because of this operation.

**How has the bond market reacted?**

Financial markets discount for possibilities. Though the buying and selling of government securities is slated for Monday, the yield on 10-year government securities fell up to 15 basis points to 6.6% on Friday. **One basis point is one hundredth of a percentage point.** This means **long-term borrowing for the government has become slightly cheaper.** Lending to the government is the most secure form of lending and as such the yields available on government securities tend to be a benchmark for all other forms of lending.

**What’s the idea behind Operation Twist?**

The idea is to drive down the yields on 10-year government securities. This can happen if the government continues with Operation Twist. A one-off operation will not help and yields will climb back soon. The hope is that with yields coming down, banks will cut lending rates given that lending to the government is deemed to be the safest, and if that comes down, so should the remaining rates as well.