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

Prelims and Mains focus: About the RBI’s Operation Twist; its need and impact

News: Recently, the Reserve Bank of India (RBI) decided to undertake its own version of Operation Twist to bring down 10-year yields of government securities (G-Secs) and drive monetary transmission.

Why is Operation Twist so important?

Operation Twist is a move in which a central bank decides to simultaneously buy long-dated securities while selling short-term securities. The objective behind such an operation is management of the yield curve. Other central banks, including the US Federal Reserve, have used similar measures. This is the first time RBI has undertaken such an unconventional policy measure with the aim of flattening the yield curve by lowering longer rates to boost lending and growth. On Monday, RBI undertook its second round of open market operations (OMOs), the first round of which was undertaken on 23 October.

Did RBI buy, sell bonds of the same amounts?

A conventional Operation Twist involves a central bank buying and selling securities of the same amounts. The purchase of securities pushes down the yields of long-dated securities, while the sale of short-term bonds drives up their yield. This transaction is undertaken as it effectively reduces the term premia. But in the case of RBI’s recent move, on 23 October, the central bank bought a net of Rs.10,000 crore of 10-year bonds and sold one-year bonds of Rs.6,825 crore. On 30 December, RBI again bought 10-year bonds worth Rs.10,000 crore while selling one-year bonds worth Rs.8,501 crore.

So did the move have an impact on bond yields?
The recent Operation Twist impacted bond yields that had shot up to 6.705% on 18 December. The move was announced on 19 December 2019 and yields moderated to 6.501% on 1 January 2020. Ending uncertainty on fiscal deficit numbers for 2019-20 and 2020-21 and a credible long-term fiscal consolidation path will help moderate bond yields.

Why did 10-year yields rise after 30 Dec?

In the past, RBI had ruled out its desire to get into yield curve management. But by undertaking Operation Twist, it has provided strong signals to markets that could be well on the cards. Despite this, the second Operation Twist on 30 December didn’t pare yields as investors are jittery due to concerns regarding the FY20 fiscal deficit. RBI also released the calendar for state borrowings of Rs.2 trillion for the Q4 FY20. Operation Twist is likely to have subdued the impact of these developments on the yield curve.

Can we expect more such operations?

Over the last few months there has been a call for OMOs to drive monetary transmission. More such operations are possible as RBI tries to improve transmission and the monetary policy panel continues with an accommodative stand. A countercyclical fiscal policy is warranted due to the growth slowdown and is factored in by investors. Thus, by revising deficit targets and creating a credible medium-term consolidation path, the Centre can send bond markets a positive signal, which would supplement RBI’s Operation Twist.