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Implication And Impact Of Operation Twist In India

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ABSTRACT

Purpose

Balanced economy toil for macroeconomic stability and speeding up the subsequent structural reforms in the financial system of country. The purpose is to create a competitive environment in the financial sector by taking care of price solidity and growth. In order to make that balance, economy requires sturdy and steady finance sectors where firms can easily avail credit. For the compliance, bank lending required to be sustainable and independent of bank loans.

High blend of various markets and increasing globalization, compelled for reforms in the operating financial framework with respect to available instruments, followed procedure and architecture of institutions. In this context, monetary policy strategy called **Operation Twist** is used by central banks with an objective to revive economic growth through reducing long-term interest rates. Operation Twist was first exercised in 23rd December 2019by Reserve Bank of India. Our paper attempts to understand the contribution of operation twist strategy to speed up growth and reduce interest rate for managing economy effectively.

Methodology

Review of available literature related to adoption of unconventional monetary tools with special reference to operation twist for reviving the economy was undertaken to understand the requirement for exercising such tools the their overall impact on economic growth.

Findings

With an objective to control the yield, in total operation twist has been applied in three phases. The first phase of operation twist was carried out by the Reserve Bank of India on 23rd December 2019, followed by successful second phase and third phase. The results were exceptional. The effect was witnessed instantly day as the Government bond fell by 0.2 percentage points on the same day.

Practical Implications

Thus, Operation twist could help banks free up their long-term capital for boosting long-term investments and increasing their lending opportunities. It has been an optimistic and prompt remedy in the endeavor to restore the health of Indian economy.

Originality value

Need, Framework and Implication of operation twist; one of the monetary policy tools was analyzed carefully in relation to India. Very few articles are available on operation twist. This paper attempts to remain original and describe real impact of operation twist tool.

KEYWORDS: Economy, Monetary Policy, Operation twist, Bond, Yield, Inflation.

INTRODUCTION:

Every now and then economies across the globe face the problems of slowdown, recession, crash, etc. all these phases are related to a lack of generation of demand at the core, as it is clearly evident that demand creation is the main driving force behind any economy.

Whenever such a situation arises the governments and the central banks are placed with the responsibility of paving a way for demand creation in order to refuel the economic growth and development.

Conventional and non-conventional approaches are the two different methods that are evidently available with the central bank to achieve the perceived targets. Conventional methods are the ones where the central bank depends on the other economic intermediaries like commercial banks for bringing in the required change. Like Quantitative measures of reducing the base rates, Selective credit easing policies, etc.

On the other hand, the unconventional methods which are more popular these days include the removal of all such intermediaries. Here the central bank modifies its own balance sheet in order to create a direct demand in the economy.

Operation Twist was one such measure introduced and adopted by the federal bank in the years 1967 and 2008 respectively where the federal bank twisted its balance sheet by buying long-term bonds and simultaneously selling the short-term G-Secs. The main aim of such a move was to bring down the yield of long-term bonds. Since interest rates for the large denominated demand generating long-term loans were based on the yield on long-term bonds.

The name was given by the media due to the visual impact it created on the shape of the yield curve. In a linear upward sloping yield curve, this action literally twisted the ends of the yield curve. To put it another way, the yield curve twisted as the short-term rates went up and the long-term rates came down simultaneously.

Originally employed by the US Federal Reserve in 1961 and then again in 2008-09. It was also implemented in India by the Reserve Bank of India in the year 2019-20, as the conventional Monetary policy tools were unable to achieve the desired objectives of RBI.

Operation Twist is an open market operation administered by a country's central bank where Short-term securities are sold and long-term securities are bought, at the same time. It was a homage to the famous "twist" move of Chubby Checker. Operation Twist was originally a Federal Reserve monetary policy initiative employed by the US economy to lower the long-term interest rates when all the other traditional monetary tools failed. Its mechanism was timed purchase and sale of US treasuries of different maturities.

Similar to the American Operation Twist, the RBI operation was first conducted in December 2019 carried out by selling of short-term securities and buying of long term securities through Open Market Operations to curtail down prevailing long term interest rates.

The term operation twist means the simultaneous buying of long-term bonds by the government and selling of short-term bonds, suggesting a "twisting "of the yield curve and bringing down the long-term interest rates. It is a nonconventional monetary policy tool used by the Central Banks in stimulating economic growth by promoting demand in the economy triggered by lowered long-term interest rates. The operation was a life savior and played a major role in creating demand for the almost dead US economy.

Need to apply Operation Twist

Whenever inflation goes up repo rate increases which untimely increases interest rates and discouraged loans but for last few years there was very less consumption prevailing. In order to encourage consumption by retailers in form of loans RBI reduced repo rate but market did not register it because commercial banks did not reduce the interest rates that's why people were not consuming anything which ultimately enhanced nonperforming assets.

Despite of all steps to offer better and reduced interest rate to retail borrowers, no positive impact was visible in market. This made the RBI to intervene to speed growth and reduce interest rate. So, RBI purchased long term bonds which increased price of 10 year tenure long term bond resulted in reduced yield and sold short term bonds 5 year denominated bonds due to which the inflow of such bonds got increased in market which means that the prices of such bonds reduced due to which it reached near to standard rate or repo rates. So the yield curve got flattened and banks reduced their interest rate and started investing in the long term bonds and long term loans which created advantage for retail borrowers. Ultimate objective was to stabilize interest rates for retail borrowers.

How Operation twist operates

- The Central Bank under this operation does simultaneous buying of long-term bonds and selling of short-term bonds. Thus without the requirement of any additional funds, the proceeds from the sale of short-term securities are utilized for purchasing long-term bonds.

- The interest rate for long-term borrowings in India is determined by the long-term yields. These long-term borrowings create aggregate demand.

- Bond yield is the amount of interest that the investors get. The formula for calculating bond yield is = Annual Coupon Payment / Face value of the Bond

- There is an inverse relationship between the bond prices and the yield. i.e. if the bond prices go up the yield comes down and vice versa.

- As the Central Banks purchase the long-term bonds, their demand increases, and resultantly the prices for the bonds also increase. An increase in Bond prices results in a decrease in bond Yield.

- Lower yield promotes lower interest rates and cheaper borrowings stimulating aggregate demand in the economy.

- This also results in a dip in the expected returns from long-term savings which shifts the focus of a common man from saving to spending creating a spiral-up increase in Aggregate demand.

So under operation twist RBI sold short term securities in market by which public money reached to RBI. RBI use this received money in purchasing long term government securities, this way supply of long term government securities reduced. So due to limited supply and high demand of securities, price increase and yield decrease. Whenever bond prices increase yield decrease. So objective was to increase the price of long term securities (high bond price) by decreasing supply of long term securities. Earlier as well RBI was reducing repo rate but yield was simultaneously going up which widened the gap. Low yield reduced the gap which ultimately called commercial bank to reduce interest rate, and this way the consumption increase. As bank also gives loan for long term so increase in long term security price became the best option to reduce interest rate of commercial banks.

LITERATURE REVIEW:

This paper attempts to find the answer of question "Has operation twist succeeded in twisting the term structure of interest rates? By reviewing the generally accepted theory of relationship between interest rates and selected economic time series: a report on the estimation of parameters of two equations of interest rate, the variable to study are taken from this theory only; and an analysis on how these two equations will be used to interpret concerning "Operation Twist". (Thomas Holland, 1969).

Paper describes that RBI used Operation Twist by reviewing current and evolving liquidity and market conditions induced by covid-19 pandemic. RBI's simultaneous sales and purchases of government securities, termed 'Operation Twist' was a weapon to regulate yields in the market. It states that Operation Twist is a program of quantitative easing used by the RBI. It also justifies the need for applying this instrument and its overall impact on economy (Aamandeep & Nilam, 2020).

Article describes that how on December 19, the Reserve Bank of India decided to conduct its version of ‘Operation Twist’ through simultaneous purchase and sale of government securities under Open Market Operations (OMOs) for Rs 10,000 crore each on December 23. Discuss the functioning of monetary policy Operation Twist, which by purchase and sale of government securities attempts to boost the economy and bring down long-term interest rates. (Goerge Mathew, 2019)

Article brings attention that how from last December onwards; RBI has been conducting a special tranche of OMOs, whereby the central bank is simultaneously selling short-term securities and buying long-term securities. Here, the objective of OMO was not to regulate liquidity, but to manage the yield curve, and it came to be known as the Indian version of ‘Operation Twist’ (Deepthi Methew, 2020).

From forex swaps instead of its traditional bond purchases to embracing an ‘Operation Twist’, the RBI is pushing the boundaries of conventional central bank policy to improve rate transmission, spur credit to the economy and keeping rupee stable. Effectiveness of bond operations is discussed in article. Attempt was made to find the reason behind shifting from conventional to non conventional monetary instrument (Amit Pabari, 2019).

Article attempts to justify the conduct of RBI that since prices and yields move in opposite directions, by purchasing longer-term bonds, the RBI can help drive the bond prices up and yields down. Simultaneously, selling shorter-term bonds caused their yields to go up (since their prices would fall). In combination, these two actions twist the shape of the yield curve. (Amit Chaturvedi, 2021)

RESEARCH METHODOLOGY:

Secondary data has been used for conducting the research. Basis of data collection are articles on operation twist, other country research papers and information available on internet provided by RBI.

PRE IMPLEMENTATION PHASE:

The economy was not portraying a cheerful time. The unemployment rate was at a 45-year peak, the GDP at a 13-year low, and much more was happening during 2019-2020. The growth rate was deteriorating and along with that, the hopes of people were fading away. The economy faced two major blows in the name of demonetization and GST. Where on one hand demonetization badly affected the consumer demand and liquidity in the market, and GST aggravated the supply-side woes.

With an aim of boosting the economic activity, RBI lowered the Repo Rate. (Repo rate is the rate at which commercial banks borrow money from RBI) RBI assumed that with a reduced repo rate the banks will borrow more and will pass on the benefit of lower interest rates to the general public which in turn will enable consumers to get a cheaper loan and will raise the demand.
However, rising bad loans and high credit-to-deposit ratio failed the idea. Also, savings had fallen because of the low economic activity because of which deposits were falling thus, banks were in the lurch. This RBI realized that conventional monetary policy tools like policy rates are becoming ineffective in achieving the desired goals.

Despite reducing the repo rates by 1.55 bps, banks did not reduce the interest rates. Even the idea of linking interest rates mandatorily to an external benchmark rate like government security was in vain. RBI desperately wanted to have reduced long-term yields as it will make loans for homes, cars, finance projects, etc. relatively less expensive and the savings will become less desirable due to lower yields.

IMPACT OF OPERATION TWIST:

Consumer demands: Money remains for the long term is made available to the banks, which in turn lend for economic activities like buying houses, cars or financing projects at lower rates.

Bond Prices: As the central bank brings long-term securities (bonds), their demand goes up which in turn pushes their prices up. The bond yield decreases with a price increase (inverse relationship). Low yield, results in decreased interest rates.

Bank operations: Due to CRR and SLR norms, banks are bound to keep some amount as Government securities. Operation twist enabled the selling of their long-term bonds to the government since they have the fear to lose on yield if they held it for more time.

Disappearance of stagflation: Greater borrowing to consumers by the bank increased the overall demand in the economy. This momentum to the market might rescue the Indian economy from slipping into stagflation due to the lagging economy in Covid-19 crisis.

Impact on Investor: Those investors who had invested in fixed income based securities in relation to long term debts will be benefitted due to relaxation in the yield of long term bonds. If the same scenario prevails borrower and consumers would be benefitted with reduced interest rates on retail loans. This will ultimately gear up spending and consumption in the economy and contribute in revival and growth of economy.

Yield curve and Interest Rate: There is inverse relation between price and yield. RBI purchase of long term bonds raises the bond price and lowers the yield. At the same time when RBI sells short term bonds, bond prices decrease and yields increase. In purview of this scenario RBI buys long term government securities and shells short term government securities which make demand for government securities high. This way high bond prices counter balance lower yield on long term securities for investors.

CONCLUSION:

In order to control the yield, the first phase of operation twist was carried out by the Reserve Bank of India on 23rd December 2019. RBI had sold Rs.6825 crores worth one-year short-term bonds to buy 10 years of long-term bonds worth Rs. 10000 crores that will mature in 2029.

In the second phase, it sold Rs. 8501 crores worth short-term bonds with one-year maturity to purchase 10 years of long-term bonds worth Rs.10000 crores. In the third round, RBI bought long-term securities maturing in 2024 and 2026.

The results were miraculous. The effect was visible on the same day. In fact, as soon as RBI started the third round, the yield on 10 year Government bond fell by 0.2 percentage points on the same day.

Thus, Operation twist could help banks free up their long-term capital for boosting long-term investments and increasing their lending opportunities. It has been an optimistic and prompt remedy in the endeavor to restore the health of Indian economy.

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