Operation Twist: Are we Seeding a New Problem?

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The Reserve Bank of India (RBI) appears to be replicating the *Operation Twist* strategy that is being pursued in the United States viz. simultaneous purchase of long-bonds, and sale of short-bonds through open market operations. The purchase of long-bonds by the monetary authority raises its price in the market, and reduces long-term yield (price and yield move in opposite directions); sale of short-bonds by the monetary authority reduces its price and raises short-term yield. Thus, the strategy reduces the *term spread* (difference between long-term and short-term sovereign yields), while keeping overall money supply constant.

Shallow market makes it easier to influence yields in India. Potential benefits of Operation Twist are:

- RBI will earn higher interest-spread by swapping into long-term bonds. Incremental income can be transferred to the Government as dividend;
- Government's interest cost on future borrowings (which are expected to be long-term) will go down. This again will help reduce the Government's fiscal deficit;
- Economics of setting up new projects, which are typically financed with long-term funds, improves (especially for the private sector);
- Mark-to-market valuation of long-term bond portfolios will increase. This will improve the balance sheet of banks, debt mutual fund schemes and other financial sector investors.

Thus, on paper, Operation Twist is a silver bullet to solve India's current problems of spiraling fiscal deficit, declining GDP growth and weak balance sheets in the financial sector. A deeper dive into the issue raises concerns:

- If we take a composite view of RBI and the Government, Operation Twist essentially shortens the maturity profile of Government debt. This may be fine for the US where unemployment is at a low and private consumption expenditure is at a high. India's economic position is the opposite. Hardly a time to shorten the maturity profile.

  Let us not forget that India's non-banking finance company crisis in India was precipitated by short-term liabilities financing long-term assets. The power to print currency notes is not an effective mitigant to such re-financing risks.
- Whether the problem with the Indian economy is structural or cyclical can be debated. What is undeniable is that the fiscal deficit will balloon in the months to come. What is the guarantee that the reduction in cost of future Government borrowings will materialize?
- Most companies in the private sector are concerned about servicing their current debt amid weakening consumption expenditure and low capacity utilization. Even mega-sized business groups have announced plans to go debt-free in a few years. Will they set up new projects based on such twists in interest rate? In any case, the private debt market in India is not liquid enough to influence economic decisions of industry.
- Bank balance sheets at the end of the financial year will definitely improve, if the reduction in long-term yield lasts that long. This will minimize the government's need for capital infusion in the weak banks. If this was the objective, did RBI implement Operation Twist too much before March 31? Or are we looking at Rs10,000crore of Operation Twist every week?

Perhaps, Operation Twist is a good signal when the economy is doing well, but non-governments do not recognize the wellness. However, the signal cannot make up for a poor economic scenario – and can be counter-productive, if the twisted interest rates do not sustain.

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