Operation Twist: Is it an Antibiotic with Side Effects?

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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, like transfer from RBI, 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, private consumption expenditure is at a high, and global investors buy a significant portion of US Government debt. India's economic position is the opposite. Hardly a time to shorten the maturity profile.

  India's current non-banking finance company crisis in India may be attributed to short-term liabilities financing long-term assets. Liquidity crisis catalyzed a solvency crisis. 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 reduce the government's need to infuse capital in the weak banks. If this was the objective, did RBI implement Operation Twist too soon? Or are we looking at Rs10,000crore of Operation Twist every week until March 31?

Perhaps, Operation Twist is a good signal when the economy is doing well, but non-governments do not recognize the wellness. Unfortunately, the "signal" cannot make up for a poor economic scenario – and can be counter-productive, if the twisted interest rates do not sustain. Experience of the past tells us that once investors get used to short-term securities, it gets difficult to bring about term extension. All in all, short-term gains to be weighed against long-term, deeper side effects.

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