Source : www.indianexpress.com Date : 2019-12-23

OPERATION TWIST

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

On Thursday, the Reserve Bank of India announced its decision to conduct simultaneous purchase and sale of government securities for Rs 10,000 crore each under its Open Market Operations (OMO) after a review of the current liquidity, market situation and evolving financial conditions. Financial markets perceive this as an Indian variant of Operation Twist, as the asset purchase programme kicked off by the Kennedy administration in the US in 1961 and later in 2011 by the US Federal Reserve to help lower long-term interest rates, was called.

The OMO as an instrument of monetary policy is aimed at either withdrawing liquidity or boosting it, including during periods of robust capital flows. The essential aim of such a programme would be not just to influence long-term interest rates but also to provide a boost to the economy by making the cost of capital or funds cheaper for business and industry and other borrowers. These asset purchase or bond buying and selling programmes were launched in the US first during a recession and later during a prolonged slowdown — which India is now undergoing. The RBI has a far more compelling reason than just the slowdown to launch the latest programme. Even after aggressively cutting its policy rate by 135 basis points this year, monetary policy transmission has been weak with banks loath to lower rates significantly given the state of their balance sheets. That leaves the central bank with hardly any policy tools to influence rates. Moreover, for such a programme to have an impact, there should be a well functioning market for government securities with depth. The link between India’s bond market and the real economy has been relatively weak and making it worse is a half functional financial sector now. Coupled with this is the large fiscal slippage — the fiscal deficit at the end of April-October this year at well over 100 per cent of the budgeted target — the spike in inflation and toned down projections of GDP growth. A programme aimed at reducing long-term bond yields may only have limited impact as long as the government runs a large deficit, as the US experience also shows.

Globally, there is a growing recognition that central banks are running out of ammunition. The underlying message is clear. The government should get to work on a credible fiscal deficit reduction plan, fix the broken financial system along with unveiling a roadmap for state-owned banks, get its divestment programme going and ensure that packages for sectoral issues, specially real estate, are operationalised swiftly. Else, efforts at twisting interest rates will flounder.

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