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RBI IS NOT TWISTING ENOUGH TO BEND A STUBBORN YIELD CURVE

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

MUMBAI : On 6 January, when the Reserve Bank of India (RBI) announced its first Operation Twist of this year, the government had to pay a premium of 0.80 percentage points to borrow through a 10-year bond instead of the 1-year treasury bill if it chose to do so.

Fast forward to today, that term premium has widened to 2.43 percentage points. During this period, the RBI has done three operation twist auctions.

Operation Twist is nothing but selling short-term and buying long-term bonds in order to flatten the yield curve. Just like the infection curve of the coronavirus pandemic refuses to be tamed, the yield curve too is acting stubborn.

Bond traders believe that the central bank is not putting its heart into its Operation Twist. Hence, the results are far from satisfying. “They need to be slightly more consistent and do these periodically," said Lakshmi Iyer, chief investment officer, debt and head-products at Kotak Mahindra Asset Management Company.

The latest auction, announced on Monday, is the fourth so far this year and comes after a gap of nearly two months.

To be sure, the widening of the term premium is largely because of a collapse of short-term yields. The yield on 91-day and even the 364-day treasury bills is near all-time lows now. Even so, long-term bond yields have not eased commensurate with the liquidity and low interest rate conditions in the banking system. That is because of the expected heavy supply of government bonds especially at the longer end. Note that the government’s gross borrowing from the market is formidable at 12 trillion rupees for FY21.

Bond traders believe that with more open market operations from the central bank, yields will drop.

The need for a flatter yield curve with long-term yields falling is critical for transmission to corporate bonds too. Private sector issuers have not been able to raise money in tenures longer than five years simply because investors seek higher returns. This stubbornly high cost of borrowing has been felt even by AAA-rated companies.

In fact, the spread between the 10-year AAA-rated corporate bond and the corresponding government bond has only gone up. A small blessing is that there is no need presently to borrow long term as companies need working capital and are not making investment plans. The RBI needs to make use of this time to bend the curve.

It is clear that the RBI’s Operation Twist is not making much difference and an increase in the frequency of intervention is needed.

As companies begin to slowly make plans to raise long-term money, transmission needs to pick up. For now, since the need is only for working capital, low short-term yields are helping issuers in the corporate bond market.

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