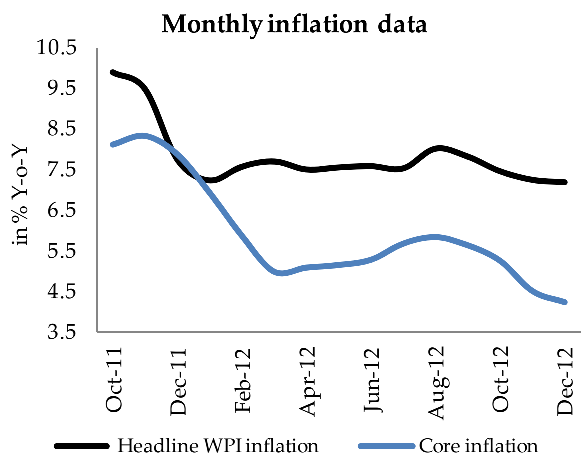
Policy cuts-One down, not many more to go

After keeping the markets on tenterhooks over whether or not he will follow through with his guidance of policy easing at today's third quarter review, Governor Subbarao finally obliged market players, not only cutting the repo rate by 25 bps but complementing that with a 25 bps CRR cut. Market reaction though subdued (possibly because the rate cut expectation was largely priced in) has been positive. After a somewhat hawkish macro and monetary review released yesterday and comments by the governor earlier this month on inflation still remaining "high" a small section of the market had got a tad concerned about whether a policy cut was indeed in the offing at today's review.

Given the tight liquidity conditions that have prevailed in recent months and the pickup in the credit deposit ratio from 75.0% in September to over 77.0% at present, a repo rate cut by itself would have worked as a mere easing signal at this stage and transmission to lending rates would have been low if not absent. **It is likely however that after today's CRR cut (that is expected to infuse Rs 18,000 cr into the system) that the monetary transmission process would get a leg up and some reduction in effective lending rates could follow the 25 bps repo rate cut today.**

Fig.1.: Subdued core inflation is likely to pave the way for further policy easing

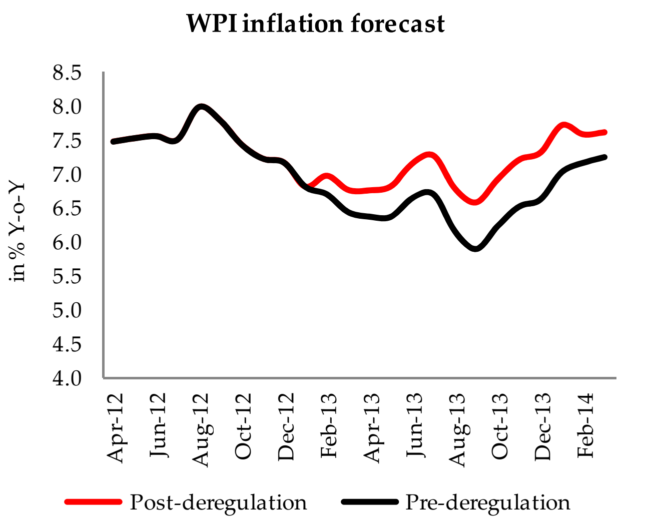


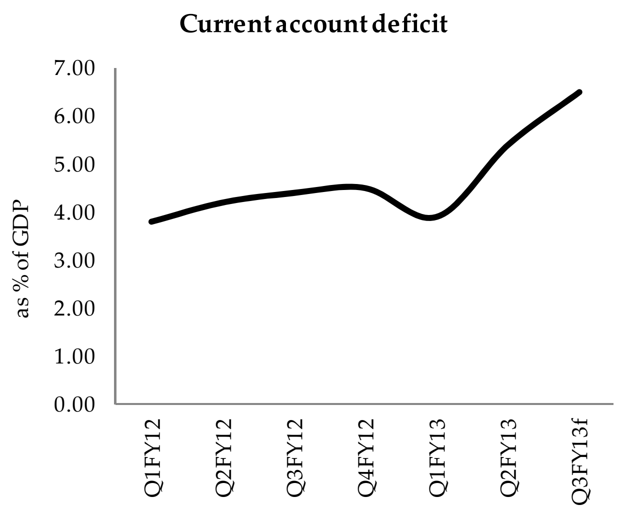
Source: Office of Economic Advisor & HDFC Bank

With today's policy rate cut out of the way, the focus is now likely to shift to the extent of policy easing going ahead. The central bank has lowered its FY13 growth forecast from 5.8% to 5.5% and has pulled down its March, 2013 WPI inflation forecast lower from 7.5% to 6.8%. Further, given the fall in non-food manufactured goods inflation (this has fallen from 5.7% in July to 4.2% in December) and receding demand-side pressures the RBI expects inflation to remain subdued and in the range of 6.8-7.0%. It is likely therefore that the macro backdrop will remain soft and further policy easing is likely. While the RBI's guidance reflects this, it does so with a certain degree of caution, indicating that while the macro conditions provide space for "***monetary policy to give greater emphasis to growth risks***" this space is ***"limited".***

The RBI has fallen back on well known risks to inflation to qualify this statement. Specifically, the RBI expects that factors such as elevated food inflation and the prospect of suppressed inflation (administered prices of fuel for example) coming out in the open could constrain the downward movement in inflation and that this is likely to be "slow and gradual". More importantly, the RBI has emphasized the risks from a large fiscal and current account gap and admits that further policy easing will not only be conditioned by the evolving "growth-inflation dynamic" as it always does **but will also** be directed by the "management of risks from the twin deficits". **We believe therefore that monetary policy reactions ,will going ahead, no longer be guided by inflation alone and that macro-stability risks from an elevated current account and fiscal deficit will be given as much importance in the policy decision process.**

Fig 2&3: The space for policy easing is limited





Source: Office of Economic Advisor & HDFC Bank
Note: Post-deregulation inflation estimates factor in only the direct impact of a 50 paise hike in diesel prices till September or a cumulative Rs 4.50 hike in diesel prices between now and H2FY14 end

Source: RBI & HDFC Bank
Note: Current account deficit fig. for Q3FY13 forecasted

The upshot is that while policy easing is still likely going ahead, there is reason to believe that its magnitude could be smaller than initially anticipated and a measured, more calibrated policy easing cycle is likely instead. **This could mean further repo rate cuts of 50-75 bps at the most** that could constrain the recent rally on the long-end of the curve. **We believe that the long-end had overpriced the extent of policy easing going ahead and it is unlikely that the 10-yr bond yield will soften much below 7.75-7.80% levels over the next two months.** The short-end could however ease from current levels in response to today's CRR cut as well as the prospect of further policy easing in the near-term **paving the way for the yield curve to steepen in the near-term.**

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