Russia key rate: back to easing cycle

By cutting the key rate by 25bp to 7.50% the Bank of Russia has returned to an easing cycle. Current guidance suggests there is a room for 50-100bp cut in the next 12 months. We now see high likelihood of a couple of cuts in July and September. The longer term path appears less certain, given recent indications of an easing in budget policy from 2020.

Source: Flickr

7.5%

Russia key rate

a 25 bp cut

As expected

June cut clearly justified

We are not surprised by the decision to cut. The arguments in favor of such a move have been piling up since May, and have intensified over the last week, on:

- global expectations of a Fed rate cut as early as July (according to Bloomberg calculations);
- RUB staying unexpectedly strong thanks to continued capital inflows into the state local debt market (OFZ) at around $3-4bn per month;
- local CPI dropping to 5.0% YoY as of mid-June, from 5.3% YoY in March, amid weak consumer demand.

Overall, the CBR rationale part presented in the commentary is fully in line with our preview of a week ago.

https://think.ing.com/snaps/russia-key-rate-to-be-cut-dovish-guidance-may-be-reinforced/

Return to easing cycle confirmed, more cuts to come in the near term

Also, unsurprisingly, the CBR has reinforced its dovish guidance by:

- lowering the year-end 2019 CPI forecast range by 0.5 ppt to 4.2-4.7% (our current forecast is 4.6% and, based on the most recent weekly CPI data, now has scope for further reduction);
- pointing out the weaker than expected GDP growth of 0.5% YoY in 1Q19 and downgrading the 2019 GDP growth forecast range by 0.2ppt to 1.0-1.5% (closer to our conservative 1.0% GDP forecast);
- confirming a reduction in the near-term inflationary risks, as "the effects of the VAT hike have fully materialised" and global expectations for the US Fed rate have become more dovish

Based on those signals we now believe there is a high likelihood of further cuts at the meetings on 26 July and 6 September (earlier we were expecting only one additional 25bp cut, in September), provided there are no significant external shocks.

Mid-term room for manoeuvre still significant

The mid-term signal, however, has remained quite cautious in our view:

- CBR has guided for "a transition to neutral neutral monetary policy until mid-2020" which translates into 6.5-7.0% nominal key rate (4.0% CPI plus equilibrium 2.5-3.0% real rate) in line with our 6.75% forecast;
- CBR acknowledged persisting risks, including unanchored local CPI expectatons which remain elevated, together with a multitude of valid external risks, including global trade tensions, other geopolitical factors, and volatility in oil prices;
- CBR has specifically mentioned the risks of easing in the local budget policy approach as the new mid-term risk, saying that 'mid-term inflation dynamics may be affected by fiscal policy parameters, including decisions on the use of the liquid part of the National Wealth Fund in excess of the threshold level set at 7% of GDP'.

We fully share those concerns, and would like to elaborate on the final point. Indeed, while previously the Russian Finance Ministry was against investing the National Welfare Fund (state savings, mostly in liquid FX assets) locally, recently it has changed its stance. According to first deputy PM and Finance Minister Anton Siluanov, the government will consider investing a portion of NWF locally after it exceeds 7% of GDP in 2020.Given the current fiscal projections, we estimate that the change in the approach to investing NWF opens up the potential for additional RUB injections of up to RUB3.5tr (3% og GDP) in 2020. This is the sum that will likely by then have been accumulated in NWF in exceess of 7% of GDP and will not exceed 40% of the total NWF, with the latter the maximum RUB portion.

> *Given current fiscal projections, we estimate that the relaxation of the approach to investing NWF opens up the potential for additional RUB injections of up to RUB3.5 tr (3% of GDP) in 2020.*

The decision confirms our long-held expectations of direct or indirect budget policy easing in response to weak growth and a lack of private financing for National Projects (RUB7.5bn out of a total RUB26tr were supposed to be private). In order to invest NWF in roubles the Minfin will most likely convert part of its FX currently held with CBR, which will then buy Minfin's FX with newly emitted roubles - this will increase the RUB supply, being potentially negative for RUB exchange rate and boosting longer-term CPI risks.

> We now see potential for reducing our YE2019 CPI outlook from the current 4.6% and expect two 25bp cuts in July and September. The longer-term key rate trajectory appears clouded by a number of risks, and we reiterate our long-standing 6.75% key rate forecast for mid-2020.

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