Bank of Russia admits local real rates are too high

Bank of Russia delivered a key rate cut and surprised the market by making a dovish shift in guidance without any improvement in the official CPI outlook. We take it as a sign the central bank has started to consider local real rates too high and is using the current disinflation as a window of opportunity. We now see scope for 50 bp in cuts in the key rate in 1-2Q20

Russian Central Bank Head, Elvira Nabiullina

6.00% Russian key rate

down from 6.25%

Not just a cut, but a change in approach

Bank of Russia (CBR) delivered a 25 bp key rate cut to 6.00%, which was in line with expectations of most of market participants and analysts. Even to us (we had a contrarian call) the cut itself was not a huge surprise, given the slowdown in CPI and CBR's December guidance, that some limited scope for further cuts persisted. Meanwhile, the part that was a surprise to everyone, is that instead of guiding for a pause to assess growing local and external uncertainties, the CBR has strengthened its guidance for further cuts: if the previous guidance points at a possibility of one cut in 1H20 (the one that has happened today), the current one indicates a high likelihood of several cuts in the near-term. Such communication is not typical of the Russian central bank, as it took place:

- amid higher market volatility, which was triggered by the coronavirus outbreak and that has resulted in an oil price drop to the levels of the CBR's base case scenario (US$55/bbl). Last year's oil price performance was consistently stronger than the CBR forecasts, contributing to the revision in rate outlook
- amid uncertainties regarding fiscal policy. The updated budget draft, which will reveal the size of upcoming fiscal easing, has yet to be submitted, and earlier government officials indicated that the stimulus will be large enough to assure a 1.0-1.7 percentage point improvement in the Russian GDP growth rate in 2020-21, hinting at a potentially high scale of easing
- (most importantly) without any improvement in the official CPI forecast. To remind, the softening in the CBR stance in 2019 took place amid a gradual improvement in the CPI outlook for year-end 2019 from 5.0-5.5% in the beginning of the year to 2.9-3.2% at the end. This time the official CPI outlook for year-end 2020 remained unchanged at 3.5-4.0%. Bank of Russia governor Nabiullina highlighted all the reasons why inflation in Russia should return back to the targeted 4.0%, which are fully in line with our view.

Therefore, we see the February move as a change in the CBR's approach.

CBR sees real rate lower; further cuts to come in 1-2Q

Our interpretation of the fact that the dovish shift in nominal rate guidance is taking place without any improvement in medium-term inflationary expectations is that Bank of Russia now sees the real rate level as too high. Earlier we mentioned that the debate on whether the CBR's 2-3% real key rate approach is sustainable is likely to come to the forefront, and the monetary authorities will eventually have to address the concerns of some market participants, that the Russian real rates are higher than levels justified by the level or risks the country is running. The recent actions and statements by the CBR suggest that the answer came faster than expected. With officially expected CPI of 3.5-4.0% in 12 months and the likely reduction in the key rate level from the current 6.00%, real rates are likely to approach 2%, the lower bound, soon, which is indirectly confirmed by Governor Nabiullina saying the nominal key rate can go below the 6-7% neutral range.

With the approach to monetary policy softened, we now see scope for further key rate cuts, which are likely to take place sooner rather than later. Given the expected trajectory of CPI in 2020, which suggests a material slowdown in 1Q20 to 2.0-2.5% on high base effects and recovery in 2H20, the most likely window of opportunity is 1H20, during which a couple of 25 bp cuts are possible, being a positive sign for the local debt market. Meanwhile the two key factors of uncertainty, including the scale of fiscal easing (Governor Nabiullina highlighted that CBR's macro forecasts do not yet reflect the upcoming updates to the budget draft) and the coronavirus outbreak, remain.

Central Bank independence to come in focus

In our view, the sudden shift in the monetary policy approach is not negative. As shown by our recent research, Russia's real rates, based on expected CPI, are second only to Mexico, which is running bigger foreign and domestic policy risks and has a much weaker current account and therefore requires a highly positive real rate to support FX. Russia's other peers (Saudi Arabia, South Africa, Malaysia, Indinesia, Turkey) have real key rates that are 1-2 pp lower. Finally, Russia's GDP growth trend is the weakest among its peers. By those metrics Russia indeed can afford somewhat lower real rates without sacrificing the macro stability.

At the same time, this sudden shift also triggers a number of observations related to the central bank independence:

1. The change in approach happened 3 weeks after the pro-growth shift in the executive branch of the government.
2. Two days ahead of the key rate decision Andrei Belousov, new first deputy PM, called for a new mechanism of coordination between Bank of Russia and the Cabinet to assure economic growth without damaging macroeconomic stability. That statement forced the CBR to emerge from its self-imposed 1-week media blackout in order to reassure the markets that the initiative was mutual.
3. Governor Nabiullina during her press-conference stressed the importance of preserving the achievements of the conservative monetary and fiscal policy. Normally her statements following the key rate decisions were reserved to current trends.

As a result, while we do not take any of the above as a conclusive evidence of some pressure on the central bank independence, we do not exlude that markets will be following this subject more closely from now on. To remind, Russian central bank's independence and credibility as an inflation targeter is one of the key components of Russia's attractiveness for international investors.

> A strong dovish shift in the monetary policy approach suggests Bank of Russia may now tolerate some decline in the real rate, and the temporary slump in the Russian CPI expected in the near-term is providing a window of opportunity for an aditional 50 bp decrease in the key rate in 1-2Q20, being a positive driver for the bond market and more or less neutral for RUB. A moderate decline in the rates is justified by the cross-country comparison and should not result in a deterioration in the macro stability. Meanwhile, central bank independence in the face of a more growth-focused cabinet will remain a watch factor from now on. Future CBR reaction to a possible change in the CPI outlook (as a result of possible fiscal updates and/or global market developments) will be an important indicator of monetary policy priorities.

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