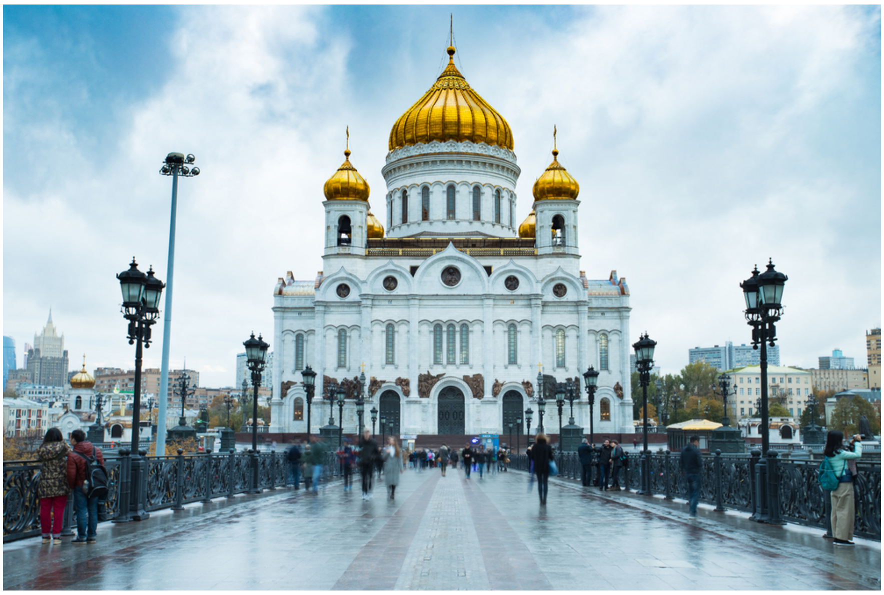
Russia's central bank cuts rates and signals more could be on the way

The central bank of Russia cut the policy rate by 50 bp to 5.5% and hinted at further cuts, which seem plausible by international standards. However, this shouldn't be interpreted as a hard commitment given the uncertainties of the inflation trend and the budget policy



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5.50%

Russian key rate

50 bp cut

As expected

50 bp rate cut and more could be on the way

- Bank of Russia delivered the much expected 50 basis point rate cut to 5.50% today. The decision and announced reasoning are in line with our view that the sharp deterioration of global and local GDP growth prospects, as well as some stabilisation of financial markets, allow the central bank to proceed with the monetary easing despite the acceleration of CPI to 3.1% YoY and 3.8-4.8% YoY by the end of the year, according to CBR's updated forecasts. According to governor Nabiullina, the Bank did not abandon its estimate of neutral key rate range of 6.0-7.0% (real rate of 2-3% under 4.0% CPI), however, the deterioration of growth outlook justifies loosening in the monetary policy.

- The forward guidance is dovish, as the central bank seems to be open to the prospect of a further key rate reduction at its next meeting due to take place on 19 June. The governor Nabiullina indicated the potential for a rate cut under any scenario and stressed the need for a more decisive response, which we interpret as a readiness to proceed with 50 bp moves instead of more standard 25 bp. Furthermore, she didn't rule out the possibility of a 100 bp rate cut either.
- This guidance is more dovish than our initial estimate of 50-100 bp downside from then-level of 6.0%.

Macro forecasts cut and plans to intervene in the FX market

- The central bank's macro expectations have worsened significantly, with the GDP drop seen in 4-6% range, including -8% YoY in 2Q20 with subsequent QoQ recovery amid the gradual easing of quarantine, which has been in place since the end of March. However, this is more pessimistic than our 2.5% drop in expectations as we see the Bank's forecast as realistic if the lockdowns are extended until the end of May.
- CBR's expectations are based on current (very modest) fiscal stimulus, which according to the Bank's estimates assures support of 2% of GDP (i.e. without it GDP drop would have been 2 pp YoY deeper this year). In our view, the announced fiscal stimulus could be improved by at least another 1% GDP, which may affect macro forecasts and the monetary policy.
- CBR's expectations of current account have also worsened, as under assumed drop in average Urals to $27/bbl in 2020 (meaning average $20/bbl in 2-4Q20), and a 10-15% drop in physical volumes of exports, the current account will be in a $35 billion deficit this year. This forecast also made under assumption of a drop in imports by 6-12% YoY in real terms and by 19% YoY in USD terms, which in our view is justified by the 17% YTD USD/RUB depreciation. One way to interpret this forecast is that the central bank believes that the recent ruble depreciation isn't enough to ensure a balanced current account. As the under-collection of fuel exports are replaced with FX sales from the National Wealth Fund as per the fiscal rule, the negative current account does not necessarily give a strong signal for further RUB depreciation but is still worth taking note of as a risk factor.
- CBR's capital account expectations remain benign, with net private capital outflow seen at only $15 bln for 2020, suggesting $2 bln net inflow in 2-4Q20 after $17 bln outflows in 1Q20. Also, CBR assumes $4bln net capital inflow into the government sector (mostly state debt) in 2020, or $1.5 bln inflow in 2-4Q20 after $2.5 bln in 1Q20. We generally agree with CBR's assessment of the private sector flows, as we indicated earlier that the foreign asset position accumulated earlier by the private sector, combined with the reduction in the foreign debt since 2014 suggest little room for capital outflow in the current conditions. In addition, in case of stabilization of financial markets, CBR's assessment of just $1.5 bln inflows into public sector (read portfolio investments into local currency government bonds, OFZ), may prove too pessimistic.

- The central bank expects its international reserves to decline by $47 bln in 2020. According to the governor, starting 10 March, CBR sold $5.5 bln on the FX market, including $2.9 bln as per fiscal rule (reflecting Urals being below $42.4/bbl cut-off price) and another $2.6 bln of additional sales amid Urals below $25/bbl reflecting sales related to NWF's purchase of 50% equity stake in Sberbank from CBR.
- Based on this, we 'translate' the CBR's reserves forecast as follows: under average $20/bbl Urals (which it expects for 2-4Q20) CBR will sell $20 bln of FX in April-December based on the standard fiscal rule, and another $27 bln of FX reflecting the entire sum of estimated SBER deal. Putting it another way, under Urals of $20/bbl daily FX sales may total $225-250 mn per day, including $100 mn as per standard fiscal rule and $125-150 mn of additional sales as per SBER deal.
- In the near-term, each $5/bbl drop in the oil price from that level increases the total daily FX sales by $50-100 mn, limiting the negative effect of oil price on the ruble exchange rate.

Another 50-100 bp rate cut plausible but there are strings attached

Based on today's announcement, we expect to see another rate cut at the next meeting and it is more likely to be a 50 bp rather than the standard 25bp, as CBR's negative assessment of Russia's economic performance is more likely to be confirmed rather than improve. The potential pressure on rouble from the low oil prices and accelerating CPI, which is due to come, will have little bearing on the rate decision in the near-term.

Meanwhile, for now, we would not take the governor's statement on possible 100 bp cut from the current level as a hard commitment. We fully agree with the regulator that the level of uncertainty is currently very high and see it in at least two dimensions:

- The very wide range of CBR's 2020 CPI forecast of 3.8-4.8% highlights the high level of uncertainty regarding the CPI trend in Russia, and the CBR governor reiterated the commitment to inflation targeting in the long run. We stand by our cautious take on CPI, which allows for acceleration to 4.5-5.0% at some point this year (4.0-4.5% as of year-end) due to agro price growth and rouble depreciation (which may worsen in 2Q20) amid the traditionally muted desinflationary effect of demand. If our pessimistic take proves correct, it might limit CBR's safe space for a rate cut.
- Very little has been said about the fiscal policy in Russia, and not just by the CBR, but also by the ministry of finace, which has so far refrained from making detailed public statements on the budget parameters. Meanwhile, governor Nabiullina highlighted that CBR's base case scenario incorporates only the fiscal measures officially announced. In our view, the announced fiscal stimulus of 2-3% GDP is too modest to be sustainable, and the recent indication by the government officials that Russia may need to boost its net debt placement program from the current RUB1.7 trillion by another RUB1.5-2.0 trillion (i.e. by c.1.5% of GDP) speaks in favour of our view. We believe that potential widening in the Russian fiscal stimulus may lower the urgency for the central bank to ease monetray policy aggressively.

As a result, for now, we stick to our initial view that the scope for a rate cut from the current level is limited at 50 bp.

Also, while we generally keep a constructive view on Russian bonds and the money market (benefitting from ample local liquidity and justified non-resident's interest to OFZ), we note that the positive spreads to the key policy rate may remain elevated going forward, reflecting drainage of RUB liquidity due to FX interventions and the prospects of material increase of OFZ borrowing programme.

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