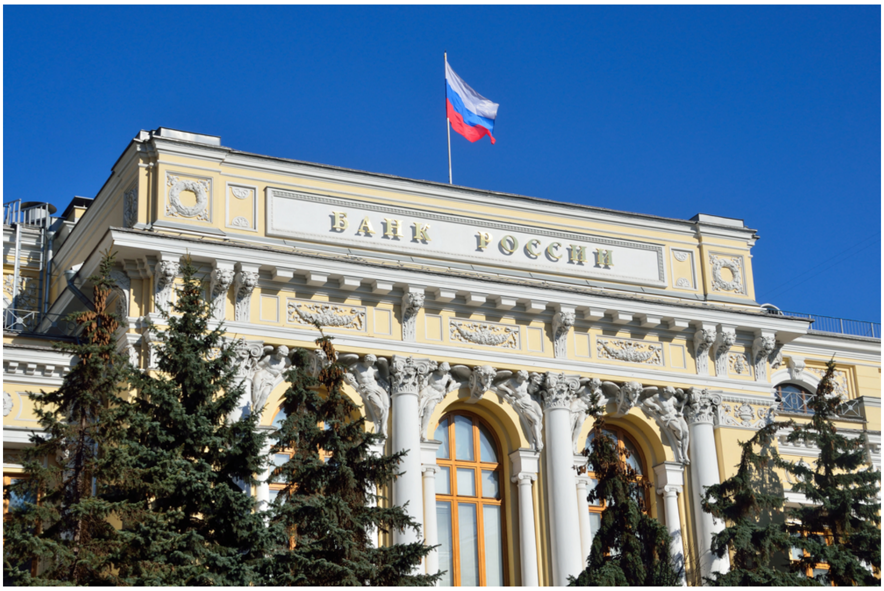
Russia central bank preview: Still no strong case for a hike

Developments in the Russian economy, and on the financial markets, since the previous decision to keep rates unchanged (on 26 October) suggest there are no strong grounds to hike this time. At this Friday's meeting, we expect the key rate to stay at 7.5%, with cautious rhetoric and a confirmation that the bank will resume FX purchases in January



Central Bank of Russia, Moscow

7.5% CBR key rate forecast

for December 14 meeting

This rate decision less straightforward than the last

At the last meeting in October, the forecast for key rates to stay on hold at 7.5% was a no-brainer. But this time, the central bank will be deciding between a 'hold' and a 'hike', as suggested by the Central Bank of Russia Governor Elvira Nabiullina several weeks ago.

Expectations for a hike have intensified following negative geopolitical newsflow related to US-Ukraine tensions, an acceleration of inflation, and the CBR's indication that it will likely restart FX purchases on the open market on behalf of the Finance Ministry in January (to be confirmed on Friday). As of now, 9 out 26 economists polled by Bloomberg and 12 out of 27 polled by Reuters expect a hike. Anectodatal evidence from the bond and money market also suggest that investors are divided on the matter.

We acknowledge the non-zero likelihood of a hike, however, a broad set of arguments has to be considered before taking a hike as a base-case scenario. The CBR communique from 26 October stipulated that a hike would be considered based on two key considerations: 1) CPI performance relative to the CBR's forecast and 2) the financial markets' reaction to external risks. We also believe the FX purchases and overall monetary conditions in Russia should be taken into account.

Inflation is within the CBR guidelines

We think the available data on inflationary trends shows no immediate sign of overshooting the CBR guidelines.

- CPI accelerated from 3.5% year-on-year in October to 3.8% in November, as food prices picked up from a low base. Unless weekly CPI, released this Wednesday, shows signs of a further pick up in the average daily rate, the full-year CPI will still be within the 3.8-4.2% range identified by the CBR.
- Households' 12-month inflationary expectations picked up from 9.3% in October to 9.8% in November (still lower than September's 10.1%), which may reflect a delayed reaction to the rouble depreciation and gasoline price growth, both of which have now stabilised.
- Demand-side pressures on CPI seem to be in check, with the consumer confidence index-measured by the CBR- stagnating in November after three consecutive months of improvement. Actual retail trade decelerated to a 14-month low of 1.9% year-on-year in October, below expectations. Unemployment picked up from the September low of 4.5% to 4.7%.

External risks remain elevated, but financial markets have not deteriorated much

Over the last six weeks, the newsflow for global financial markets has been mixed, with a more dovish tone from the Federal Reserve, two-way signals on the US-China tensions, EU challenges including budget issues in Italy and now France, as well as a very messy Brexit story. At the same time, Russia's FX peer group, including but not limited to the South African rand, Turkish lira, Mexican peso and Brazilian real, have shown only a very minor depreciation against the US dollar, by 1.4%, which is much less dramatic than the 6.2% depreciation against the USD over the six weeks that preceded the CBR's previous rate hike on 14 September.

The Russian FX market has fared even better - with only a 1.1% depreciation in the rouble relative to the USD over the last six weeks. This is despite a major $18/bbl (-23%) drop in the price of Brent and mixed geopolitical newsflow, including rising tensions between Russia and Ukraine, uncertainty about new US sanctions and the ongoing US probe into Russian interference in the

2016 presidential election.

The abovementioned considerations suggest that while uncertainty regarding the financial market remains high, there are no signs of immediate deterioration that would require changes to the interest rate policy.

FX purchases in 2019 are not a threat to the rouble

We also do not see FX purchases as a direct threat to the rouble that would require the CBR to provide additional insulation via higher rates. True, the rouble fares better without intervention, but the return of FX purchases does not necessarily mean a strong depreciation vs. the current level, at least in the short turn. Under the current oil prices, interventions will total $8-10 billion in 1Q19, which is one-third of the expected $25-30 billion current account surplus. Even accounting for the net corporate foreign debt redemption, which will likely total $5-8 billion, the current account surplus will be large enough to cushion against additional non-foreign debt-related capital outflows.

We also note that we find it unlikely that the CBR will decide to recommence FX interventions in case market conditions deteriorate (in case of strong portfolio outflows). In reality, those interventions will likely just smooth the rouble appreciation.

Another point is that we question the efficiency of using the key interest rate, which in real terms is already the highest among Russia's peers, as a tool to offset sterilization measures related to the current account.

Monetary conditions are tightening without key rate hike

Finally, we note that the monetary conditions in Russia seem to be tightening already even in an environment of unchanged rates. Since mid-year the spread of 3-month interest rates to the key rate have increased from zero to 100 basis points, reflecting a shrinking liquidity surplus from ¬RUB4 trillion to ¬RUB3 trillion and the banks' preparation for the tightening in the short term liquidity coverage ratio (LCR) under Basel III from the current 90% to 100% starting in 2019. This reduces the need to adjust interest rate policy in the short term.

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