More cuts to come in Russia’s key rate

Russia's central bank is deciding between a 25 and 50 basis point cut on 25 October, but that's not its biggest dilemma. A more dovish signal, guiding the market towards the lower end of the 6.0-7.0% neutral key rate range, would be a much more important development for the market

Russian Central Bank Head, Elvira Nabiullina

Last Friday, Russian financial markets received strong support from the Bank of Russia (CBR) governor Elvira Nabiullina, who indicated in a CBNC interview that the CBR is ready to make more decisive moves in the face of declining inflationary risks. That was the second set of dovish statements by the governor in seven days, as earlier she gave guidance to expect a cut in the year-end CPI forecast at the upcoming October 25 meeting.

She also indicated that the CBR would consider a faster key rate-cutting pace (currently at 7.0%). While the initial dovish shift was taken as a sign of two consecutive 25 bp cuts in October and December (we weren't alone as we indicated here), now a number of market participants have shifted towards expecting a 50 bp cut on October 25. While we acknowledge that the likelihood of this scenario has indeed increased, and the CBR will decide between a 25 and 50 bp cut this Friday, we still consider a mix of a 25 bp cut and a dovish commentary to be the base case scenario.

The case for a more dovish stance by the Russian monetary authorities has indeed increased recently:

- **CPI growth decelerated sharply from 4.3% YoY at the time of the previous key rate decision to 3.8% YoY** as of now (and most likely to 3.7% YoY by October 25). This definitely calls for a downgrade of CBR's very conservative 4.0-4.5% year-end CPI target and even challenges our more aggressive 3.7% YoY forecast. https://think.ing.com/snaps/russia-broad-based-cpi-slowdown/. We note that CPI will drop below 3% YoY in 1Q20 on a high base effect, and it is not clear whether it will manage to accelerate to the targeted 4.0% by the end of 2020.
- The recent set of economic activity data suggests that **households are back in savings mode**, as retail deposit growth adjusted for FX revaluation accelerated to 9.3% YoY in September, a 27 month high, while retail lending and trade growth continued to gradually decelerate. https://think.ing.com/articles/russia-september-activity-interesting-but-uninspiring/. This could create a more comfortable context for the CBR to ease its otherwise conservative approach

The abovementioned considerations are the key reasons why we recently lowered our long-term key rate target from 6.50% to 6.00%, the lower bound of the neutral key rate range, to be reached by mid-2020. At the same time, we increasingly believe the scale of a single cut to 50 bp at the upcoming meeting would be unnecessary, especially at the non-core meeting.

- **There is no urgency to support economic growth with monetary tools**. In its communication, the CBR highlights the constrictive role of the budget policy in the current economic slowdown, a situation which is expected to reverse after 2019 with National Projects gaining traction. It also indicates that it is happy with the current loan growth rates, and acceleration driven by lower interest rates would result in an accumulation of financial risks.
- **Most of the disinflationary factors are volatile and external to monetary policy**. While the CBR governor expressed some concern with weak demand, most of the reasons for the below-expected CPI trend are beyond the CBR's direct control, including favourable global grain prices, calmer external financial markets, RUB strengthening and the underperformance of budget spending this year (budget spending would need to accelerate from 6% YoY in 9M19 to 17% YoY in 4Q19 if the annual plan is to be fulfilled). A gradual reduction in the key rate would lower the risk of a reversal in case there's a sudden deterioration of the CPI trend on the cost input side.
- **The CBR governor's statement is more likely to focus on longer-term guidance.** Other than the fact that the recent dovish statements were made ahead of the traditional media blackout period ahead of the October 25 meeting, there is little evidence to suggest that Ms Nabiullina intends to adjust near-term expectations. It makes more sense that she would use an interview targeted at foreign investors who care more about the longer end of the yield curve, as an opportunity to massage down the terminal rate expectations, which according to our estimates were previously anchored around 6.5%. She made a similar point at a local conference a week before, targeted at a different audience, in order to shift expectations towards the continuation of the gradual cutting cycle vs. a less confident signal given at September meeting.

https://think.ing.com/snaps/bank-of-russia-capitulates-to-weaker-inflation/

We consider a 25 bp cut at the October 25 meeting as our base case. However, a 50 bp is also not out of the question. In any case, the mid-term signal will be the key focus, and we expect to see hints of the terminal rate expected by the CBR to slide from the middle to the lower bound of the indicated neutral rate range of 6.0-7.0%. A change in the range itself or the long-term CPI target of 4.0% is not very likely, given that both the key rate and CPI have only recently reached their targets.

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