Russia: Key rate raised to 7.75%; Central Bank less certain about future

The decision to raise the key rate by 25 basis points to 7.75%, and to resume FX purchases on the open market starting in mid-January, was not very surprising. However, we are concerned about the way these decisions have been communicated to the market. It appears the central bank is signalling lower confidence in CPI and the rouble in the short-term

Source: Shutterstock

7.75%

Russia key rate

FX purchases to resume January 15, 2019

Higher than expected

The Bank of Russia announced a return to FX purchases on the open market starting 15 January, 2019, and to raise the key rate from 7.5% to 7.75%, effective immediately. While the first decision was pre-announced and widely expected, the increase in the key rate was a more controversial move. Our base case scenario was for the key rate to remain unchanged, in line with the consensus, however we noted that the ultimate decision was likely to be a close call, and the most recent newsflow, including an acceleration in the weekly CPI in December and faster net private capital outflow in November, could tip the scales in favour of a hike. This risk seems to have materialised.

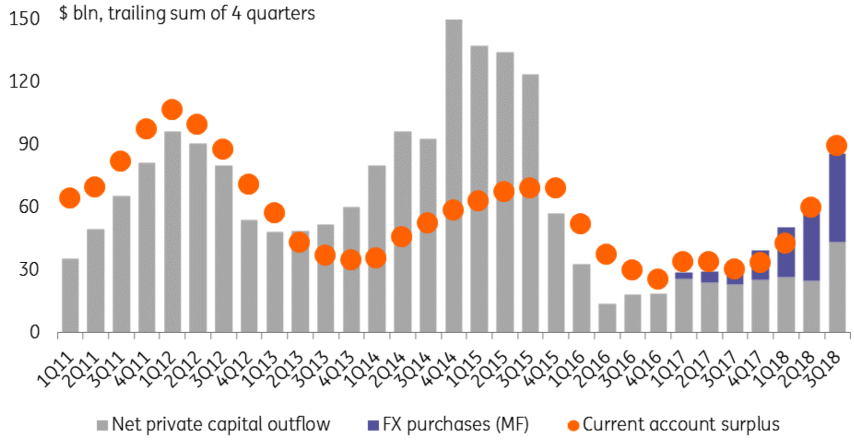
The commentary along with the decision, however, took us by surprise, as it doesn't clarify the CBR's motives. The tone and content of today's communique resembles that of the October statement, when the rate was kept unchanged. One might suggest that a December hike was needed to reflect a deterioration in the CBR's outlook on local CPI or external markets, however there are no such indications from the text: the CBR still expects to see CPI within 4.2% year-on-year as of year-end 2018 and 5.0-5.5% as of YE19, and no change in wording about external markets followed. The press conference of CBR Governor Elvira Nabiullina was also hawkish in tone, however it was generally in line with previous statements.

An increase in the key rate amid an unchanged outlook could be interpreted as if the Central Bank is now channelling less confidence in its own outlook, which is not a positive signal to the market. The sources of uncertainty for the CBR view, based on the CBR communication and our understanding, could include 1) the scale of the price shock and deterioration of households' inflationary expectations following the VAT hike from 18% to 20% in two weeks and other factors; 2) lack of clarity regarding emerging market risk appetite, that might be negatively affected in case of a slowdown in China and reignition of trade tensions; 3) risk of further sanctions pressure on Russia.

Our primary concern however is that with the lack of an obvious explanation for the hike, market participants could directly link the decision with the CBR operations on the FX market, which would be negative for two reasons.

- First, it would further complicate the inflation targeting efforts to remove the exchange rate as an anchor of expectations for the local economic agents and replace it with CPI and the key rate.
- Second, it would reinforce the market misconception that the rouble exchange rate requires extra protection as a result of renewed FX purchases. According to our estimates, the current account surplus in 2019 will total around $80 billion and will be large enough to accommodate $40-45 billion of purchases, implied by the budget rule under our $66/bbl Urals house view, and net private capital outflow of up to $40 billion. We also note, that in the environment of low investment demand, the Ministry of Finance's FX purchases lower the amount of FX that otherwise would have been available to finance private capital outflow (increase in international assets). In that sense, we agree with Governor Nabiullina's statement that FX purchases do not add to risks to the rouble.

Finance Ministry's FX interventions help sterilize large current account, not needed by the economy anyway - thus reducing the net private capital outflow



Source: Bank of Russia, Finance Ministry, ING

On balance, we take the CBR decisions as neutral to our RUB and CPI outlook. Under the assumption of no new shocks related to geopolitics and global trade we continue to see RUB in RUB63-66/USD range for 2019, and CPI peaking at 5.5-6.0% mid-year. Under that scenario there is no need for further tightening in the CBR policy in 2019.

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