Danske Bank Markets

Investment Research — General Market Conditions

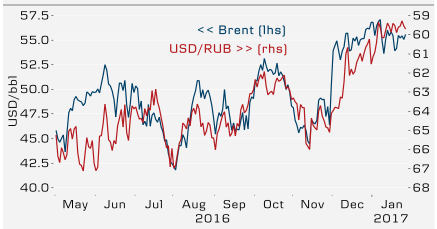
27 January 2017

Flash Comment

Russia unveils FX purchases plan putting a 'speed limit' on the RUB

- **Russia's Ministry of Finance (Minfin) announced it will start FX purchases through the central bank (CBR) in February 2017 if the Urals price stays over USD40/bl.**
- **We expect the new framework to brake the RUB's excessive strengthening, pushing volatility down on rising oil, improving fiscal stability and the outlook on public finances. Yet, following the announcement, the markets interpreted the CBR's intention as a partial abandoning of the free float regime, which adds nervousness and can be seen as a move towards 'the oil peg of the RUB'.**
- **We expect Russia to continue with its borrowing plan in 2017. We see the possibility of improvements in country ratings in 2017. We see upside risks for our USD/RUB 1M and 3M FX forecasts (58.70 and 56.30, respectively).**

RUB remains oil driven

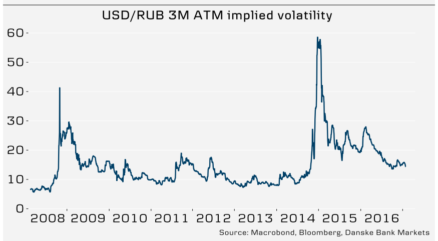


Source: Macrobond Financial, Danske Bank Markets

Assessment and outlook

The CBR and Minfin have announced that the impact of excessive oil revenues on public finances will be reduced by the mechanism of buying extra FX flows if the Urals oil price exceeds USD40/bl, which is the assumed price for Russia's budget in the upcoming years. The mechanism is considered to be a temporal solution before budget law introduces the budget rule in 2020. By introducing the 'austerity' mechanism, the monetary authorities seek to improve financial stability and the predictability of internal economic conditions.

RUB volatility set to fall further on rising oil price but would rise on falling crude



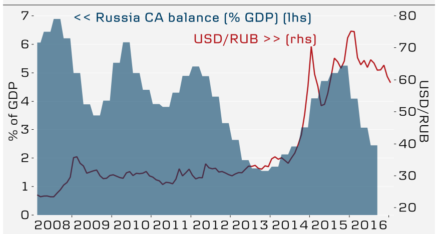
Source: Macrobond Financial, Danske Bank Markets

How will the mechanism work?

The officials have confirmed that at current oil prices monthly purchases could reach USD1bn, which we see being easily absorbed by the markets. Moscow Exchange monthly trading volumes in FX markets are around RUB31.0trn (circa USD517bn), including spot trades totalling RUB7.5trn (circa USD125bn) accounting for around USD5-7bn daily in spot. The Minfin will announce the intended amount of purchases on the third working day every month before 12:00 Moscow time (the next announcement is due on 3 February 2017). In order to get the daily amount, the total sum will be divided by the number of trading days starting from the fifth trading day of each month until the fourth day (inclusive) of the following month. The purchases will be equally spread over the trading session.

According to the Minfin, while the 'excessive' hard currency flows from oil revenues will be purchased, the ministry will sell the FX on a Urals price below USD40/bl. The amount intended for sale would not exceed the total sum of FX purchased earlier on a higher-than-USD40/bl crude price. In the current form, it is intended the mechanism will be in place until the end 2017.

Strong CA surplus set to support RUB in the long run



Source: Macrobond Financial, Danske Bank Markets

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Market implications and major risks

Within 24 hours of the Minfin's announcement, the USD/RUB jumped 2.5% while the EUR/RUB climbed 2.2%. The latter pair ended the session on 26 January some 1.6% higher following the announcement. While the CBR reconfirmed its commitment to the free floating RUB and the Minfin stated that the planned FX operations will have on the 'whole a neutral impact on [the] money market', the markets became pretty nervous as they digested the statement. We believe many players consider the new mechanism a return to a semi-pegged RUB, putting a cap on the rising oil price.

In our view, if implemented, **the mechanism will push RUB volatility lower on an increasing crude price, while fuelling extra swings on falling oil.** There is a risk that both citizens and corporations will run back to FX, losing their faith in the RUB strengthening on higher oil, keeping their positions in FX.

We expect **the new mechanism to be RUB negative, especially in the short run, and RUB liquidity positive, pushing money markets rates down**, if it is fully implemented. Yet, believe the CBR would be able to absorb easily any extra liquidity that appears during the operations.

While the CBR says that the new mechanism would not pose any risks to its 4% y/y inflation target for the end of 2017, a slightly weaker RUB would stop the decrease in inflation expectations. Thus, **the CBR could be more cautious in cutting the key rate in 2017**. Before the announcement on the FX operations mechanism, we expected the key rate to go down to 7.0% by the end of 2017. If the mechanism is implemented, we expect the key rate to reach 8.0% by the end of 2017.

We see significant upside risks for our short-term USD/RUB forecast (58.70 in 1M and 56.10 in 3M) before we see the results of the Minfin's steps in February. However, the RUB remains oil price driven. For now, we have not changed our medium- and long-term forecasts for the USD/RUB (55.10 in 6M and 51.15 in 12M), remaining in wait-and-see mode.

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This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The author of the research report is Vladimir Miklashevsky, Senior Analyst.

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None.

Date of first publication

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