9 February 2018

Flash Comment

Bank of Russia: a cautious and consistent 25bp cut

- **Russia's central bank (CBR) cut its key rate by 25bp to 7.50% on 9 February, as inflation has hit its post -Soviet low at 2.2% y/y.**
- **At the same time, the CBR sounded dovish in its statement announcing completion of 'the transition from moderately tight to neutral monetary policy in 2018'. This creates pressure for the key rate to go below our previous conservative scenario (6.75% by the end-2018).**
- **From now, we expect the CBR to cut to 6.50% (previously 6.75%) by the end of 2018 and to 6.00% by the end-2019, given no geopolitical 'black swans' or crude price crush.**
- **The recent slowdown in Russia's economic growth is likely to vanish, delivering stronger growth figures in H2 18.**

Assessment and outlook

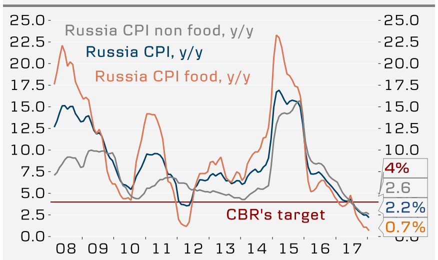
The CBR cut its key rate by 25bp to 7.50% on 9 February. While we expected the current cut, as did Bloomberg consensus, traders' pricing was more dovish. The cautious and sustained cut is well justified, in our view, given that inflation has hit its post-Soviet low at 2.2% y/y, staying far below the CBR's target of 4.0% y/y. In contrast, inflation expectations remain sticky, declining marginally.

Reading the CBR's latest statement on the decision, we find the tone to be dovish, despite the 'hawkish' cut, which pushed the RUB into rally.

Main assumptions behind today's decision

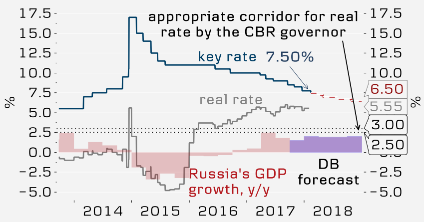
- **'Inflation remained sustainably low'.** Food prices continued to decline. We see that the CBR is succeeding in anchoring inflation around the 4.0% target despite the RUB's recent effect on inflation slowdown being set to 'be exhausted by the end of Q1 18'.
- **'A balanced recovery of lending' with no pro-inflationary risks.** At the same time, positive real rates are supporting savings. The CBR also believes 'the shape of the yield curve will continue to return back to normal' from the currently inverted shape.
- **'Short-term pro-inflationary risks have abated'.** The CBR has become more positive on the slowdown in inflation, seeing a lower probability of CPI exceeding the target in 2018. The CBR is also positive on the fiscal rule by the Ministry of Finance, which is neutralising the impact of oil fluctuations on inflation. Yet, the CBR sees pro-inflationary risks in 2019-20 as a labour force shortage could weigh more on real wage growth, while an increase in productivity could still lag.
- **However, the CBR remained cautious, avoiding a 50bp cut as** 'the uncertainty over the situation in global financial markets has increased' and inflation expectations remain sticky.

Falling inflation keeps door wide open for generous rate cuts



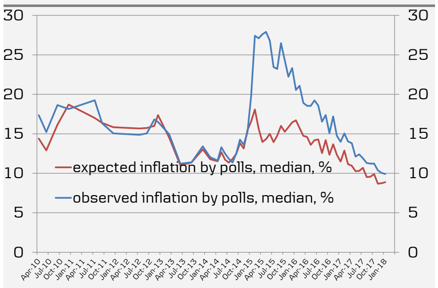
Source: Bloomberg, Macrobond Financial, Danske Bank

CBR has plenty of room to ease through 2018-19 switching to neutral monetary policy



Source: CBR, Bloomberg, Macrobond Financial, Danske Bank

Inflation expectations remain sticky supporting more cautious stance by CBR, not impeding rate cuts though



Source: CBR, Danske Bank

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We expect the CBR to cut the key rate by 25bp at its monetary policy meeting on 23 March, while sudden geopolitical deterioration and an oil price fall are major risks for our dovish call.

Economic growth is set to get support

As the CBR has become more dovish in its medium-term views, faster easing than we previously expected would add to a slowdown in economic growth. Russia's GDP growth decelerated from 2.5% y/y in Q2 17 to 1.8% y/y in Q3 17, pushing the preliminary print for 2017 GDP expansion to a modest 1.5% y/y. We keep our GDP forecasts unchanged, expecting Russia's economy to expand by 2.0% y/y in 2018 and 2.1% y/y in 2019.

Cautious key rate cuts remain RUB positive

Traditionally and as we expected, the RUB reacted positively to the CBR's decision immediately following the announcement. Yet, on Friday afternoon, the USD/RUB bounced back to its opening levels. The Russia-friendly assessment by the US Treasury this week and an unwillingness to sanction Russia's government debt or other financial instruments has cheered up RUB sentiment. Given the improved sentiment, **Russia's local debt – OFZs** – reacted positively to the decision, having more space to rally on further monetary easing.

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

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Expected updates

None.

Date of first publication

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