19 September 2016

Flash Comment

Russia's central bank: a hawkish cut

- **Russia's central bank cut its key rate by 50bp to 10.0% on 16 September.**
- **The CBR's tone turns hawkish, signalling clearly that rate cuts are excluded in 2016.**
- **We believe that a surprise rate cut in 2016 could be used, if RUB strengthens too much given the crude price.**
- **The CBR ready to return to central bank bonds in early 2017 in order to absorb interbank liquidity.**

Assessment and outlook

Russia's central bank (the CBR) cut its key rate on Friday 16 September by 50bp to 10.0%, in line with the consensus and our expectations. Yet, contrary to the market pricing and economists' expectations, the CBR in its statement and the governor Elvira Nabiullina during her press conference noticeably emphasised that 'the current key rate needs to be maintained till end-2016 with a possibility to cut it in Q1-Q2 17', which we see as the cornerstone of Friday's message on Russia's short- and mid-term monetary policy.

The main reasons to cut the key rate while becoming hawkish in the short- and mid-term given by the central bank were:

1) *'Inflation has demonstrated a noticeable decline'*. According to the CBR, inflation dropped to 6.6% y/y as of 12 September, while during the last rate decision (unchanged) in July the CPI was 7.2% y/y. For the resumed disinflation, the central bank praised a stronger RUB and a better-than-expected external economic environment. The CBR sees inflation at around 4.5% y/y in September 2017, reaching the 4% target by late 2017. We believe that if the next rate cut is delayed to Q2 17, it would create downside risks for our 2017 GDP growth forecast of 1.2% y/y.

2) *'The Bank of Russia expects that the decision made and maintenance of the key rate at the level it reached will bring down inflation expectations'*. The CBR and its governor Nabiullina expressed concerns about the rigidity of declining inflation expectations, which justifies the hawkishness of the current monetary stance. By the prolonged tight monetary policy, the CBR shows it is not willing to boost demand for credit, which we also see being macro negative as the real rate is set to exceed 3%.

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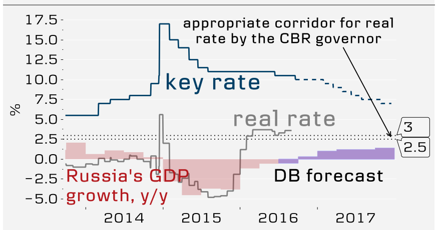
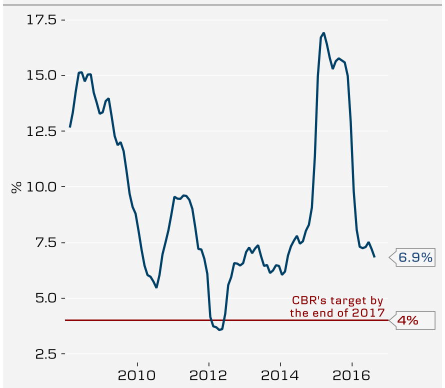
CBR cuts as data supports easing



Source: Macrobond Financial, Danske Bank Markets

...while disinflation allows more cuts...



Source: Macrobond Financial, Danske Bank Markets

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3) *'Persistent revival in production activity is still unstable and patchy across industries and regions'.* The CBR is cutting in order to avoid depressing further slumping investments and several growing industries, while being conservative about upcoming economic growth. It states that 'positive quarterly GDP growth is possible in H2 16; however in 2017, GDP growth will not be high, staying below 1%'.

4) *'The risks of failure to deliver inflation at the 4% target in 2017 persist mainly due to the inertia of inflation expectations and potential weaker household saving motives'.* Reiterating the second bullet of its statement, the CBR expresses concerns about possible global volatility risks and uncertain fiscal consolidation in 2017, which could keep inflation elevated.

The RUB received some support immediately after the decision as the statement's hawkishness erased hopes for another rate cut in 2016. Yet, as the CPI data for the US was released turning out to be stronger-than-expected, the RUB's own story evaporated and it joined global fears of the Fed's stance becoming more hawkish followed by the better data. By the end of Friday the USD/RUB was trading higher than 65.10. However, we remain slightly bullish on the RUB as carry-traders buy the currency in order to benefit from large interest rate differential. We have kept our USD/RUB forecast at 64.30 (1M), 63.00 (3M), 60.00 (6M) and 57.10 (12M), expecting the Fed to keep rates unchanged in 2016.

Russia's local bonds – OFZs – got a chilly reception from diminished hopes of another rate cut by the CBR. We recommend to stay on hold from the previous 'buy' until the CBR's path is again clear for further easing.

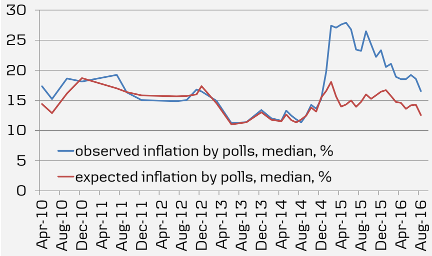
There are certainly external risks present which could keep the RUB weaker and inflation elevated: The Fed's monetary stance could become more hawkish earlier than expected sending the crude and EM sentiment down, while new western sanctions could also weigh on Russia's assets. While we expect these risks to be moderate in the mid term, the CBR prefers to stay conservative and overcautious. We expect the CBR to keep rates unchanged at its monetary policy meeting on 28 October 2016.

CBR ready to return to the central bank bonds

As the CBR has been concerned about prevailing excess liquidity since early 2016, for the second time this year the central bank mentioned that it is returning to previously used short-term bonds – OBRs – expanding its liquidity absorption tools for better money market rate control in addition to deposit auctions and deposit operations. According to the central bank, OBRs, zero-coupon discount bonds, may have tenors from several months (3M and 6M) up to one year and be traded on the secondary market, which is accessible by resident credit organisations only. The coupon period is set to be 3M, and the coupon will be equal to the CBR's key rate on each day of the coupon period.

In practice, since November 2010, OBRs' tenors were reduced to three months from six months previously. Yet, auctions ceased in September 2011. Liquidity could be a challenge for the upcoming issues if the CBR is not taking a market maker's role on the secondary market. However, more attractive yields than earned through short-term OFZs would add to liquidity on the OBR market.

...but the CBR sees inflation expectations decline being sticky



Source: CBR, Danske Bank Markets

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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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